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Decision No. 87838 OCT 4 1977

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Air California to increase its intrastate passenger fares.	Application No. 56790 (Filed October 1, 1976)
Application of Air California under the Shortened Procedure Tariff Docket to make increases described below as soon as possible on not less than five (5) days' notice.	Application No. 56961 (Filed December 27, 1976)

Graham & James, by Boris H. Lakusta, Attorney at Law, for applicant.
Sylvia Siegel and Ann Murphy, Attorney at Law, for Toward Utility Rate Normalization (TURN); and Albert Lewis Gieleghem, for himself, protestants.
C. L. Banks, for Pacific Southwest Airlines, interested party.
Thomas F. Grant, Attorney at Law, Milton J. DeBarr, and Edward C. Cole, for the Commission staff.

O P I N I O N

Air California (Air Cal) operates as a passenger air carrier between airports located at Santa Ana, San Francisco, San Jose, Oakland, Sacramento, Santa Ana (Orange County Airport), Ontario, Palm Springs, and San Diego. Temporary authority has been granted to Air Cal to serve South Lake Tahoe airport. Air Cal utilizes Boeing 737 jet aircraft and Lockheed L-188 Electra propjet aircraft in the performance of its scheduled service.

In Application No. 56790, Air Cal seeks a general fare increase of 6.4 percent designed to yield $3,118,000 additional revenue annually based on revenue and expense estimates for a 1977 test year. In (SPT) Application No. 56961, Air Cal seeks ex parte authority to increase its Tahoe air fares by 10 percent.[1] The annual revenue increase from the proposed Tahoe fares is estimated to be $427,000. Air Cal also seeks an additional annual increase in revenue of $354,685 to cover added fuel costs incurred since the filing of Applications Nos. 56790 and 56961. Present and proposed fares are shown in Appendix A. Present fares do not include the fuel offset increase granted by Decision No. 87119 dated March 22, 1977 in Application No. 56963. Proposed and alternate fares include such increase.

A duly notice public hearing in the consolidated proceedings was held before Examiner Mallory at San Francisco on January 27, 28, and 31, and February 1, 7, and 11, 1977. The matters were submitted upon the filing of concurrent briefs on March 14, 1977. Briefs were filed by Air Cal, the Commission staff, and TURN. A. L. Gieleghem, appearing on his own behalf, advised the Commission that no brief would be filed by him as his position on material issues was stated in his oral testimony.

Background

Air Cal's last system fare increase was granted by Decision No. 85629 dated March 30, 1976 in Application No. 55784. The fare increases authorized therein were based on estimated results of operations for a test year ended March 31, 1977. The following table summarizes the test year operating results adopted as reasonable in that proceeding.

1/ Application No. 56961 was filed in the Commission's Shortened Procedure Tariff Docket. Such filings are processed without hearing in the absence of objection. Inasmuch as the relief requested in Application No. 56790 embraces the request in Application No. 56961 the matters were consolidated.

TABLE 1

Operating Results for Test Year Ended March 31, 1977
Adopted for the Purposes of Decision No. 85629

Statistics	
Passengers	1,728,000
Flight Hours	23,400
Revenue	$43,669,200
Expenses	38,907,700
Operating Income	4,761,500
Provision for Income Taxes	2,254,300
Net Income	2,507,200
Operating Ratio	
Before Taxes	89.10%
After Taxes	94.25%

Decision No. 87119 dated March 22, 1977 in Application No. 56963 authorized Air Cal to increase its revenues by 1.7 percent or $817,000 annually to offset fuel cost increases incurred through February 1977. Application No. 56790 seeks to recover the fuel cost increases for which relief was not granted in Decision No. 87119.

At the close of the hearing, Air Cal requested that the Tahoe fare proceeding (Application No. 56961) be dealt with separately so that relief could be accorded as soon as possible. In view of the partial relief granted to cover fuel cost increases, the request to consider Application No. 56961 separately from the general fare increase proceeding in Application No. 56790 will not be granted.

Evidence of Applicant

Evidence with respect to passenger and revenue forecasts and proposed fares was presented by Frederick R. Davis, Air Cal's vice president of Marketing. Evidence of expenses, rate base, and other financial matters was presented by Machiel P. Van Dordrecht, Air Cal's executive vice president, treasurer, and secretary.

Applicant relies upon the data shown in its Exhibits 1, 8, 9, 17, and 18 to support the relief sought.

Exhibit 1 shows the actual number of passengers transported by airport pairs for the year ended August 31, 1976, compared with the passenger forecast for the test year ending December 31, 1977 used by applicant in its estimated results of operations. Exhibit 1 shows 1,838,160 actual passengers for the historical period and estimates 2,052,600 passengers for 1977, or an increase of 11.7 percent. The actual number of passengers transported in the year ended August 31, 1976 of 1,838,160 exceeds the 1,728,000 passengers estimated to be carried in the test year ended March 31, 1977 set forth in Table 1, which formed the basis for revenue estimates in the last general fare increase granted in Decision No. 85629. That difference is 6.4 percent.

Exhibit 8 develops fuel cost increases subsequent to December 23, 1976. That exhibit shows that fuel cost and into-plane fueling charge increases incurred in addition to the amounts shown in the data appended to the application amount to $394,368 annually, based on 27,088 flight hours estimated to be operated in the test year ending December 31, 1977.

Exhibit 9 shows Air Cal's estimate of increased unit costs in the 1977 test year resulting from higher wages, payroll costs, fuel, aircraft parts, and indirect expenses. That exhibit indicates that when the data are adjusted to include present fuel costs, a 16.3 percent revenue increase is required to offset the increased operating costs measured therein.

Exhibit 17 is a comparison of present and proposed fares (see Appendix A); a forecast of revenues under such fares; income statements for an historical year ended August 31, 1976, and for a 1977 test year under present and proposed fares; and comparisons of historical unit costs with unit costs estimated for the 1977 test year.

The following table sets forth Air Cal's actual and estimated results of operations as set forth in Exhibit 17:

TABLE 2

AIR CALIFORNIA

Statement of Income
(Dollars in Thousands)

	12-Month Period Ended 8-31-76	1977 Forecast Present Fares	1977 Forecast Proposed Fares
Revenues			
Passengers	$41,952	$49,008	$52,947
Charter/Contract	839	265	265
Total	42,791	49,273	53,212
Freight @ $30.25 Per Flight Hour	685	819	819
Liquor @ $.14 Per Passenger	250	287	287
Other	550	205	205
Total Revenues	44,276	50,584	54,523
Operating Expenses			
Flying Operations	12,820	16,211	16,211
Aircraft Lease Cost	4,238	4,238	4,238
Direct Maintenance	3,556	4,395	4,395
Maintenance Burden	1,621	1,871	1,871
Passenger Services	2,829	3,632	3,632
Aircraft Services	2,308	2,843	2,843
Traffic Services	5,841	6,796	6,796
Sales and Promotion	3,021	3,598	3,803
Reservations	1,987	2,301	2,301
General Administration	2,043	2,149	2,152
Depreciation and Amortization	556	666	666
Total Operating Expenses	40,820	48,700	48,908
Operating Income	3,456	1,884	5,615
Nonoperating Income (Expenses) - Net	(27)	42	167
Earnings Before Income Taxes and Extraordinary Item	3,429	1,926	5,782
Income Taxes	1,182	857	2,586
Earnings Before Extraordinary Item	2,247	1,069	3,196
Extraordinary Item	203	-	-
Net Earnings	2,044	1,069	3,196
Operating Ratio - Before Income Taxes	92.2%	96.3%	89.7%
- After Income Taxes	94.9%	97.9%	94.1%
Statistical			
Passengers	1,795,341	2,052,600	2,052,600
Flight Hours	23,555	27,088	27,088
Load Factor	70.9%	69.2%	69.2%
Break-Even Load Factor	65.9%	66.6%	62.1%

Exhibit 18 was presented in rebuttal to staff test year estimates, and will be discussed below.

Air Cal's estimates are based on the following salient facts.

Passenger estimates reflect historical growth trends. Air Cal operates ten aircraft: eight Boeing 737's and two Electra (L-188's). Nine are leased and one is owned.[2/] No additional aircraft will be operated in the test year. Air Cal intends to achieve the projected increase in number of passengers through better utilization of aircraft; by diversion of short-haul traffic from Orange County to nearby airports; and through higher load factors, even though any material increase in load factor at principal points (such as Orange County Airport) will cause diversion or loss of traffic during peak periods. The increase in passengers produces an increase in flight hours.

The principal increased operating expenses are wage and payroll costs and fuel costs. Wages reflect the contracted wage increases for union personnel, which averages 10 percent for the test year. Wages of nonunion operating and administrative personnel are estimated to increase in the same percentage amount as related union personnel. Management and administrative employees' wages are increased 10 percent. Payroll costs based on union contracts reflect the contract terms; payroll costs for other employees are increased by similar amounts. Fuel costs are developed based on test year estimated flight hours, fuel burn per flight hours, and fuel costs as of the date of hearing. Fuel costs were further increased in February 1977, and such further increases were not known at the time the application was filed.

Other revenue and expense estimates (other than fares) assertedly are based on known changes in operations or in costs.

2/ Three aircraft are leased from West Coast Properties, a Westgate-California Corporation affiliate.

The provision for federal income taxes were determined in the following manner. Westgate-California Corporation (Westgate) owns 82 percent of Air Cal's equity. Westgate is in bankruptcy, and is being reorganized pursuant to a proceeding under Chapter 11 of the Federal Bankruptcy Act in federal court. Westgate files consolidated federal and state income tax returns which include the tax liabilities of Air Cal and other affiliates. Westgate paid no federal or state income tax in 1976. Westgate will pay no federal income tax in 1977, the test year, due to considerable loss carry forwards accumulated by Westgate. Air Cal and Westgate have entered into an agreement entitled Federal Tax Payment Allocation Agreement (Exhibit 11), which will be in effect during 1977. Pursuant to that agreement Air Cal will pay to Westgate in 1977 a sum equal to 82 percent of what would have been the applicant's federal income tax liability had it filed a separate federal income tax return. Inasmuch as Westgate will pay no income tax to the federal government in 1977, none of the money paid by Air Cal to Westgate pursuant to the agreement will, in turn, be paid to the federal government as Air Cal's income tax.

With respect to state income taxes, however, loss carry forwards are not recognized by the California Franchise Tax Board. Since Westgate may show a profit for 1977, the conglomerated affiliates, and therefore Air Cal, may pay California income tax in the test year. If the combined Westgate-Air Cal state tax return shows a loss for 1977, Air Cal will pay no state income tax for the test year. Air Cal includes provision for state income tax as if Air Cal was an independent company.

Evidence Adduced by Commission Staff

Evidence was presented by witnesses appearing in behalf of the Commission's Finance and Transportation Divisions. The joint staff report is set forth in Exhibit 10. Section B of that exhibit contains the report of the staff's financial examiner. The report states that Air Cal maintains its books of account generally in conformance with the system of accounts prescribed by the Civil Aeronautics Board (CAB).[3]

Operating Ratio vs Rate of Return

The staff financial examiner recommended that the Commission rely upon operating ratio, rather than rate of return or other methods, as a test of Air Cal's earnings under present and proposed fares. The rationale for this recommendation is based upon the following considerations.

1. Because most of Air Cal's aircraft are leased, there is no meaningful rate base on which to compute a return. Average net plant investment for the twelve months ended September 30, 1976 was $4,918,000. Recorded net operating income for that period was $3,531,000, yielding a return of 72 percent.

2. It may be possible to develop as a substitute for depreciated rate base the computed costs of ownership of aircraft and leaseholds in lieu of lease payments. Such an analysis by the staff in a prior proceeding assertedly did not warrant any ratemaking adjustment, so such an analysis was not made by the witness in this proceeding. A further reason for not making such analysis is that it would be difficult to obtain the depreciated cost of aircraft leased from a nonaffiliated lessor (GATX - Boothe Corporation).

3. An alternate to the above is to capitalize the leasehold values of aircraft at present worth after discounting remaining lease payments. The witness believes that a rate of return on that segment

3/ This Commission has not prescribed a Uniform System of Accounts for passenger air carriers. It has accepted Air Cal's accounting methods in prior proceedings based on the CAB system of accounts, and has directed Pacific Southwest Airlines, the other major intrastate air carrier, to establish its accounting records on the bases described in the CAB system.

of rate base would result in a second profit on leased equipment, which the lessor has already included in its lease charges. The witness, therefore, did not make such analyses.

The staff financial examiner further testified as follows concerning a reasonable operating ratio for Air Cal's 1977 test year operations: The operating ratios found reasonable in the two preceding rate cases are shown below:

	Operating Ratio	
	Before Taxes	After Taxes
Decision No. 82687, April 2, 1974	86.1%	92.7%
Decision No. 85629, March 30, 1976	89.1	94.2

Operating ratios for the year 1977 as projected by the staff are 86.9 percent before income taxes and 93.4 percent after income taxes, at requested fares. The financial condition of Air Cal has improved significantly in the past few years. As of September 30, 1976, Air Cal was almost debt free and its stockholder equity totaled over $8 million. Therefore, the staff of the Finance Division recommends that Air Cal be authorized an increase in fares that produces an operating ratio after taxes no more favorable than 94.2 percent as found reasonable in Air Cal's last fare application, (A.55784, D.85629).

Federal and State Income Taxes

The following is a summarization of the testimony of the staff financial examiner with respect to computation of income fares:

> Westgate's taxable income or loss for 1977 is unknown. It is possible that no income taxes will be paid by the consolidated entity in 1977. For this reason, the issue of phantom taxes can be raised and it can be argued that no taxes should be allowed for ratemaking consideration in the test year. In the historical year 1976 no income taxes were paid by Air Cal to either the State or Federal government, and in 1977 the payment of income taxes is indeed problematical. Therefore, it can be argued that income taxes should be

ignored and the benefit of zero income taxes should be passed on to the passengers of Air Cal. This approach would, in effect, make Air Cal's passengers the beneficiaries of the losses sustained by the stockholders of its affiliated companies.

Linking the allowable taxes of regulated enterprises to the effective tax rates of their parent companies and their consolidated affiliates could lead to some novel decisions, if applied consistently. If Westgate's consolidated effective tax rate was higher than Air Cal's would be if computed separately, should we allow Air Cal the higher income tax rate? If not, how can we justify limiting Air Cal to a rate lower than that computed on its own taxable income? Ratemaking principles must be applied consistently to avoid appearing capricious and arbitrary.

Another alternative that has been suggested is to allow Air Cal 82 percent of the projected taxes, on the grounds that it will pay this amount to Westgate per the tax allocation agreement. The problem with this alternative is that the payment to Westgate is not in any way a payment for taxes; it is merely a transfer of cash to Westgate, as trustee, which then distributes the money to its "deficit members". It is difficult to construe this transfer of funds as an expense properly chargeable to operations.

Air Cal should not suffer because its affiliated companies are incurring losses; nor should it benefit when its affiliates are successful, and as a result of their success are incurring tax liabilities which the applicant would in turn be permitted to pass on to its customers through increased fares. The success or failure of affiliated companies should in no way have a bearing on Air Cal's fares. For purposes of this report the staff has computed income taxes based on Air Cal's historical and projected taxable income without regard to affiliated gains, losses, or tax agreements.

Adequacy of Service

Section C of Exhibit 10 contains the report of a staff transportation engineer with respect to service. The witness recommended that Air Cal purchase an additional Electra (L-188) aircraft to be used in regular scheduled service at Orange County Airport. The recommendation was based on the following considerations:

Air Cal's operations at Orange County are limited by the public body operating the airport to an average of 24.6 jet aircraft departures per day as a means of noise reduction.[4/] The operating restrictions imposed at Orange County Airport do not permit Air Cal to add any additional jet aircraft flights.

The following shows the load factors on routes serving Orange County for the 10 months ended October 31, 1976:

SFO	77.5	OAK	72.1
SJC	78.3	SAN	35.6
SMF	76.8	PSP	32.7

The witness contends that load factor reduction is necessary to attract new passengers and to maintain sound economic service. The staff believes the system average 71.6 percent load factor should be reduced to 66.0 percent. The 66.0 percent load factor adopted by the staff in its 1977 test year estimates requires the number of departures at Orange County to approach the limit of 24.6. Load factor reduction at Orange County may be accomplished by adding flights or by using larger jet aircraft. Larger jet aircraft suitable to the short-hop operations of Air Cal are not available. Therefore, in order to increase service within the limitations in service imposed at Orange County Airport, other than jet aircraft must be used. The staff believes that increased flights at Orange County Airport and resulting decreased load factors in Air Cal's principal market can only be achieved by the operation of one additional propjet Electra aircraft.

Estimated Results of Operations

Section D of Exhibit 10 contains the staff's estimated results of operations. The staff engineer sponsoring the section testified that the staff included an additional Electra aircraft in its projections for the reasons stated above.

4/ Assertedly departures of L-188 aircraft are not counted in the above average. To reduce noise pollution jet aircraft may not be used between the hours of 10 p.m. and 6 a.m.

Revenues

The staff tested and concurs in Air Cal's estimates of passenger traffic and passenger revenues. Estimates of charter revenues are reduced from the prior historical period because of the exclusion of former interstate contract services required to be discontinued by an order of the CAB.[5/] The staff concurs in Air Cal's estimates of freight and baggage revenue and net beverage revenue. The staff's forecast of miscellaneous and nontransport revenues is based on historical experience.

Expenses

The staff developed estimated test year expenses by adjusting recorded data for the year ended September 30, 1976, as furnished by the Finance Division, for known increases in expenses, and for increases in flight hours and numbers of passengers in the test year.

Flying operations expenses include a seven percent increase in flight crew wages pursuant to labor contracts. Fuel cost increases cover the period through December 31, 1976, but do not include the increases incurred subsequent to that date.

Maintenance expense includes a wage increase for maintenance mechanics and related technicians. No provision was made for any increases in wages which may occur as the result of renegotiation of the wage contract for such labor which expired February 28, 1977.

Passenger service expenses include an average 10 percent increase for flight attendant salaries.

Salaries included in the Aircraft Services expense category reflect a three percent increase. Landing fees and jet into-plane fueling costs also were increased.

5/ Charter revenues estimated by the staff exceed Air Cal's estimates.

Salaries included in Traffic Services, Reservations, Sales and Promotion, and General and Administrative expense categories reflect increases ranging from two to five percent. Employees within those functions are subject to wage contracts.

In Depreciation expense, an allowance is made for an additional Electra L-188 in the test year.

Income taxes are computed on the full amount that Air Cal would incur as an independent company in the manner advocated by the staff financial examiner.

<u>Test Year Estimates</u>

The following table sets forth the Transportation Division staff's estimated operating results for a 1977 test year under present and proposed fares:

TABLE 3

AIR CALIFORNIA

Commission Staff
Estimated Results of Operations
Year Ending December 31, 1977

Item	Historical Year 10-1-75 to 9-30-76	Rate Year - 1-1-77 to 12-31-77 Present Fares	Proposed Fares	Alternate Fares
Statistics				
Passengers	1,867,899	2,052,600	2,052,600	2,052,600
Flight Hours	23,811.5	27,989	27,989	27,989
Load Factor	71.1%	66%	66%	66%
Revenue				
Scheduled Passengers	$42,711,759	$49,008,000	$52,126,000	$51,023,600
Charter/Contract	820,185	444,100	444,100	444,100
Freight and Baggage	731,517	819,000	819,000	819,000
Beverages Net	254,322	287,000	287,000	287,000
Misc. & Non-Trans. Rev.	477,231	477,000	477,000	477,000
Total Revenue	$44,995,014	$51,035,100	$54,153,100	$53,050,700
Expenses				
Flying Operations	$13,010,966	$15,714,100	$15,714,100	$15,714,100
Aircraft Lease Cost	4,238,400	4,238,400	4,238,400	4,238,400
Direct Maintenance	3,653,065	4,315,600	4,315,600	4,315,600
Maintenance Burden	1,617,786	1,662,200	1,662,200	1,662,200
Passenger Services	2,867,925	3,513,900	3,513,900	3,513,900
Aircraft Services	2,355,256	2,872,200	2,872,200	2,872,200
Traffic Services	5,953,127	6,384,200	6,384,200	6,384,200
Sales and Promotion	3,055,024	3,353,800	3,465,500	3,426,100
Reservations	2,025,616	2,156,500	2,156,500	2,156,500
General Administration	2,053,885	2,095,100	2,095,100	2,095,100
Depreciation	561,888	634,800	634,800	634,800
Total Expenses	$41,392,938	$46,940,800	$47,052,500	$47,013,100
Operating Income	$ 3,602,076	$ 4,094,300	$ 7,100,600	$ 6,037,600
Operating Ratio W/O Taxes	92.0%	92.0%	86.9%	88.6%
Income Taxes	$ 1,395,611	$ 1,962,700	$ 3,546,400	$ 2,986,500
Oper. Ratio With Taxes	95.1%	95.8%	93.4%	94.25%

Staff Recommendations

The staff recommends that the operating ratio method of evaluating reasonableness of earnings be adopted as reasonable for the purpose of this proceeding, and that the authorized operating ratio not be more favorable than 94.25 percent (after taxes) recommended by the staff in the last general fare proceeding. (Decision No. 85629 dated March 30, 1976 in Application No. 55784.) The column headed "Alternate Fares" in Table 3 shows estimated operating results under the staff's alternate proposed fares which are designed to produce an operating ratio of 94.25 percent after taxes. The proposed alternate fares will generate an additional $2,015,000 in passenger revenues over present fares, or an increase of 4.1 percent. Specific alternate fares are set forth in Exhibit 10.

Testimony of A. L. Gieleghem

Protestant A. L. Gieleghem, a former employee in the Commission's Finance Division, testified on his own behalf as a member of the public and a user of Air Cal's service.

Mr. Gieleghem strongly criticized the depth of the audit made by the staff in this proceeding.[6/] Mr. Gieleghem believes that certain issues raised at the staff level in connection with prior audits in which he participated were not adequately resolved to his satisfaction in the instant presentation, and such issues should have been explored in depth in connection with this proceeding.

6/ The extent of the audit made for this proceeding is described as follows in Exhibit 10:

> "The Finance and Accounts Division performed an extensive audit of Air California's records in late 1975 for the previous rate application. Our audit for this application was more limited because of time constraints; however, in view of the recent prior audit and the lack of exceptions noted at that time, plus the absence of any substantial changes in accounting procedures since then, we feel reasonably assured of the quality of the Applicant's records."

Mr. Gieleghem stated that further data should be produced concerning the level of the provision for aircraft lease termination liability, whether depreciation should be charged on rotable parts and subassemblies (rotable spares),[7/] the propriety of amortizing route development costs, data supporting the normalization of heavy engine maintenance expense, the future financing needs of applicant, the method of recording the purchase price of an Electra acquired from Holiday Airlines, and other matters. The witness was not prepared to advise the Commission of the manner or the extent that historical or test year revenues and expenses should be revised.

Protestant Gieleghem recommends that the application be denied. The reasons advanced for this recommendation are as follows:

> "The company's showing and using its own data indicate earnings of a magnitude in terms of both operating ratio and earnings on net investment and residual earnings on equity far beyond that necessary for the company, with respect to any potential financing or financial problems.
>
> "The financing mentioned in this record was limited, as I recall, to about one million dollars for a facility at Orange County Airport, plus another possible 800,000 for another L-188 Electra aircraft.
>
> "The real estate transaction, Mr. Examiner, will probably be self-financing, in that you can obtain money for such a transaction on a note secured by a deed of trust.
>
> "We determined in this record that there is $2.3 million available for the sum total of the projected capital additions of Air California, which add up to 1.8 million.

7/ Rotable spares, as used herein, include rotable parts and subassemblies related to primary components of flight equipment (principally engines) which are generally serviced or repaired and are used repeatedly, and which possess a service life equivalent to the major component to which they are related. Expendable flight equipment parts are not included. Rotable spares, after removal from aircraft and serviced or repaired, are placed into stock until needed.

> "I can see no problems at the moment with respect to Air California's ability to continue operations, give good service, and be in a position to finance any future capital additions when they occur, including, I believe, the purchase of wide-bodied aircraft, when that day materializes." (Transcript page 636, line 11, through page 637, line 2.)

Protestant Gieleghem agreed with the manner in which income taxes were calculated for the purpose of this proceeding as set forth in staff Exhibit 10.

Rebuttal Testimony of Applicant

Exhibit 18 contains Air Cal's evidence in rebuttal to the staff's presentation in Exhibit 10 (Table 3 above). That exhibit contains adjustments to Exhibit 10 in the following categories:

Additional Electra

Exhibit 18 eliminates the additional Electra that the staff proposes that Air Cal acquire for use in the test year. The only category affected is depreciation expense. Air Cal has no plans to acquire the additional Electra. Air Cal presented evidence to show that by shifting short-haul flights from Orange County, the hub of its operations, to satellite airports and reserving service at Orange County to long-haul flights it will be able to provide better service between Orange County airport and airports in the Bay Area and Sacramento, where the bulk of its passengers desire to fly. Air Cal also presented evidence to show that with such adjustment to its operating procedures it could increase the flight hours of its B-737 equipment sufficiently to handle the estimated increase in passengers and still maintain a load factor of 66 percent in the test year.

Inasmuch as Air Cal has no plan to acquire the added Electra and as it intends to employ other means to achieve better service at its hub airport at Orange County, we will eliminate the proposed additional Electra from test year estimates, and adjust depreciation expense accordingly.

Increased Fuel Costs

Air Cal pointed out that the staff Exhibit 10 fails to include provision for fuel increases incurred since the application was filed. Air Cal adjusted staff operating revenues and flying operation expenses to offset those increases. The staff disputes the amount of the adjustment on the basis that it had developed its projected expenses based on estimated fuel burn per hour which produces a lesser total fuel cost than Air Cal. The staff's estimated fuel burn is based on use of the added Electra, which we indicated above should not be used for development of test year estimates. The fuel cost adjustment increase to the staff exhibit which we determine to be reasonable is $430,700.

Passenger Revenues

Air Cal proposed a higher level of fares (Exhibit 17) than originally sought to compensate for increased fuel costs incurred since the application was filed. The staff's estimate of passenger revenues should be adjusted to reflect such higher sought fares. Corresponding adjustments are required in Aircraft Services and Sales and Promotion expenses related to proposed fares.

Charter Revenues

Air Cal was required to discontinue interstate charter operations by order of the CAB. The staff estimates of charter revenues eliminates interstate charters in the test year. Air Cal contends that it also will lose certain related intrastate charters performed for college athletic teams and similar organizations as a result of loss of the interstate charters. Such organizations desire to use a single charter carrier for both interstate and intrastate flights. Air Cal's contention is reasonable and its adjustment will be adopted.

Miscellaneous Revenues

The Miscellaneous Revenue estimate of the staff included revenue from a terminated aircraft lease to Aloha Airlines. The staff concurred in the adjustment to reduce its estimate by the amount of the payment under the discontinued lease arrangement.

Wages and Salaries

Air Cal disputes the method used by the staff in estimating wages and salaries in the test year. The staff used as a base the average salaries and wages from historical year data. Wage increases expected to occur in the test year were added to that base. Air Cal believes that wages in effect at the close of the historical year should be used, in lieu of the average for the historical year, as a basis for projecting test year wages. Exhibit 18 contains a comparison of actual monthly salaries averaged over the five-month period of September through December 1976 and January 1977 compared with the monthly average wages included in Air Cal's Exhibit 17. The comparison shows Air Cal's test year monthly average wages and salaries exceed the actual five-month average by the following percentages:

Wages and Salaries Included in	Amount
Maintenance Burden	9.1%
Aircraft Services	4.8
Traffic Services	1.5
Sales and Promotion	19.0
Reservations	(1.2)
General Administration	10.0

(Red Figure)

Air Cal's witness testified that the resultant increases in test year salaries over actual salaries for the five-month actual period reasonably represent the increases which Air Cal will experience in the test year and, therefore, wages and salaries developed in the staff's Exhibit 10 should be adjusted by substituting Air Cal's estimates from its Exhibit 17.[8/]

The data supplied by Air Cal indicates that the staff underestimated wages in the above categories of expenses except that it overestimated wages in Reservations expenses. The adjustments to the staff wage and salary estimates appear reasonable and will be adopted.

Advertising and Promotional

The staff used the Advertising and Promotional expense incurred in the historical period as its test year figure. Air Cal based its estimate on 1.7 percent of passenger revenues. Air Cal contends that its expenditures for advertising and promotion historically have been maintained at that percentage, and that when passenger revenues increase advertising and promotion expenses should be increased proportionately.

Actual expenditures for advertising are neither tied to the amount of revenues earned nor to the levels of other operating expenses. Advertising expense outlays should be justified on other bases than estimated revenues. We adopt as reasonable the staff estimate. We will expect additional justification in future proceedings as to the reasonable level of advertising expenses to be included in test year operating results.

Depreciation Expense

The staff used an historical monthly average rather than the monthly expense at the end of the historical period to project test year depreciation expense. Air Cal showed that actual depreciation for November 1976 was $52,400 or $628,800 annualized. Air Cal's adjustment is reasonable and will be adopted.

8/ The substitution results in a decrease in wages and salaries for Reservations because Air Cal's wage expense in this category assertedly was reduced through efficiencies initiated in the five-month historical period.

Direct Maintenance

The staff estimate for this expense is $162.25 per flight hour in the test year. Air Cal showed that the actual expense incurred in the historical year in this category was $197.00 per flight hour. Air Cal contends that the staff estimate, being less than the amount actually incurred, is far too low and believe that its method more correctly indicates expenses to be incurred. Air Cal's method will be adopted.

Provision for Federal Income Taxes

The question whether provision should be made for federal income taxes in the test was argued by the parties. Air Cal, the Commission's Transportation Division and Finance Division, and protestant Gieleghem argue that income taxes should be imputed as if Air Cal was a separate entity and not included in the joint tax returns of its parent Westgate. TURN and the Commission's Legal Division argue to the contrary. They would make no provision for income taxes in the test year.

The facts are not in dispute. The question presented is whether, based on these facts, (1) federal income taxes should be imputed as if Air Cal is an independent company not affiliated with Westgate, (2) whether taxes should be imputed based on the agreement (Exhibit 11) between Air Cal and Westgate, or (3) whether no income taxes should be imputed for test year operations.

We recognize that in recent utility rate matters involving electric, gas, and water companies we have usually determined income taxes for the utility affiliate based upon the parent company's capital structure and actual income tax liability, when both parent and affiliate are engaged in similar utility operations.[9] On the other hand, it usually has been our practice in utility rate increase proceedings to impute income taxes to a utility affiliate as if the utility were a separate and independent company when the parent engages in a business enterprise not in the same utility field. In the instances where we have determined income taxes for the utility affiliate as if it were an independent company, we have done so in order to make certain that the profitability of the unrelated nonutility activities of the parent will not influence the

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9/ See Federal Power Commission v United Gas Pipeline Co. (1967) 386 US 237.

tax liability of the utility. We have not found any utility rate proceeding where the facts are similar to those in this proceeding. Therefore, no precedent exists.

We have carefully considered the arguments of the parties, which need not be recited in detail herein. We conclude, based on the facts peculiar to this proceeding, that no federal income taxes should be imputed to Air Cal's test year operations. Westgate and the companies included on its consolidated federal income tax return will pay no federal income taxes in the test year. In recognition thereof, Air Cal and Westgate entered into an agreement that Air Cal will pay to Westgate 82 percent of the amount of the federal income tax liability it would have incurred as an independent company. That management decision was not made in consideration of the financial needs of Air Cal nor with the welfare or interests of its ratepayers in mind; it was made to supply cash to its bankrupt parent. Westgate will use such payments to discharge its responsibilities to its creditors. We do not have to recognize the agreement in Exhibit 11 in establishing reasonable test year operating results. It would be in the best interest of Air Cal and its ratepayers for Air Cal to use the funds paid to Westgate under the agreement in Exhibit 11 to increase its equity position, looking to the day in the near future when its aircraft leases terminate and it must renegotiate those leases or, more likely, acquire new aircraft. If the federal income tax saving would be retained by Air Cal against its future capital needs, rather than to reduce the obligations of its bankrupt parent, we would consider proper the inclusion of a provision for federal income taxes in Air Cal's test year expenses. The contrary being the fact, we cannot equitably make such provision.

We believe that in any future fare proceeding the factual situation presented to us herein will not be the same. We expect that Westgate will be discharged from bankruptcy, that it will have spun off unprofitable operations not related to the activities of Air Cal, and that the tax loss carry-overs available to offset current taxable income may be used up or substantially reduced. Therefore, we consider our action herein with respect to federal income taxes to apply only in this proceeding and not in any future fare proceeding of Air Cal.

Provision for State Income Taxes

While the evidence is conflicting on this point it appears that state income taxes will be paid by Westgate for the 1977 test year used herein. The evidence indicates that no loss carry forwards exist which would reduce taxable income for state franchise tax purposes. The agreement relating to payment to Westgate in lieu of federal income taxes (Exhibit 11) does not apply to state income taxes. Therefore, we find that it will be reasonable to make provision for state income taxes in our adopted results of operation for a 1977 test year.

Operating Ratio as a Test of Earnings Requirements

Applicant and the staff recommend that the operating ratio method be used herein as a test of Air Cal's earnings requirements in the test year. Protestant Gieleghem urged that we explore the use of a hypothetical rate base constructed by substituting ownership costs of aircraft for lease costs or by capitalizing lease costs. The record does not contain sufficient information to construct a hypothetical rate base on either basis. Moreover, the substitution of aircraft ownership costs presents problems to the staff and applicant because some of the aircraft are owned by GATX-Boothe, which is not an affiliate of Air Cal or Westgate. GATX is under no legal obligation to furnish data concerning original cost, accrued depreciation, or fast tax write-offs to our staff or to Air Cal.

Protestant Gieleghem acknowledged that the existing aircraft leases provide very favorable terms to Air Cal, and that without such favorable leases Air Cal could not have turned a loss operation into a profitable operation. In the circumstances, we conclude that the operating ratio method of measuring earnings is fair and equitable for the purpose of this proceeding.

We note that Air Cal's aircraft leases will terminate in about two years. Before that time Air Cal must make a determination as to how it will replace present aircraft necessary to provide service over its certificated routes. The options open to it are many, including renegotiation of existing leases, purchase of the leased aircraft, purchase of different aircraft, or any combination thereof. We cannot forecast in this proceeding Air Cal's future capital requirements because we are not informed of Air Cal's plans. We cannot anticipate whether Air Cal will require additional debt or equity capital in the future nor the amount thereof. Thus, no provision can or should be made herein for revenue requirements needed for servicing additional debt or for provision for return on additional equity which may be required for acquisition of aircraft upon termination of existing leases. Therefore, we must look at Air Cal's revenue requirements solely as they exist at this time.

It is clear that Air Cal has "turned the corner". A once marginal airline with a large negative stockholder equity and on the borderline of bankruptcy (Air California Interim Fare Increase (1969) 69 CPUC 381, 384), Air Cal is now operating at a profit, is almost debt free, and its stockholder equity exceeds $8,000,000 (staff Exhibit 10, page 7).

Air Cal's operating ratio need not be as favorable as that authorized in prior proceedings in order for it to continue to maintain the financial standing achieved in recent years.10/ The change in operating ratio (before taxes) between that authorized in 1974 and that authorized in 1976 was from 86.1 percent to 89.1 percent, or 3 percentage points. A lesser revision is appropriate here.

The operating ratio found reasonable herein considers the following factors: Air Cal is now operating at a profit. Air Cal has wiped out the large negative stockholder equity resulting from initial unprofitable operations, and has discharged almost all of its long-term debt. In the test year used herein Air Cal will have a healthy equity position and will make limited capital commitments. We find that an operating ratio of 93.3 percent before provision for state income taxes and a resulting operating ratio of 93.9 percent after provision for state income taxes will be reasonable for Air Cal for a 1977 test year. It should be clearly understood that an operating ratio at such level will be insufficient in the event large capital commitements should be made by Air Cal.

10/ We authorized increased fares designed to produce the following operating ratios in recent proceedings:

	Operating Ratio	
	Before Taxes	After Taxes
Decision No. 82687, April 2, 1974	86.1%	92.7%
Decision No. 85629, March 30, 1976	89.1%	94.2%

Tahoe Fares

No evidence was offered at the hearing, except that adduced in connection with Application No. 56790, with respect to the increase sought in Air Cal's Tahoe air fares. Application No. 56961 shows that Air Cal operated its Tahoe service at a loss of $71,000 on a fully allocated basis in the twelve-month period ended June 30, 1976. The last systemwide fare proceeding excluded Tahoe air fares from the increases which became effective in April 1976. No increase has been made in Air Cal's Tahoe fares since the inception of the service. The fare increase sought in Application No. 56961 would raise its revenues by $427,000.

Air Cal seeks to raise its Tahoe air fares by 10 percent. In Decision No. 87378 dated May 24, 1977 in Application No. 56858, Pacific Southwest Airlines (PSA) was granted a 20 percent increase in its Tahoe air fares. In that decision the Commission found that the Electra (L-188) aircraft used by PSA to perform Tahoe air service was less efficient than pure jet equipment and that higher air fares on a per-mile basis should be authorized over routes served with Electra (L-188) aircraft because such aircraft are more costly to operate on a seat-mile basis than aircraft utilized on other routes.

The alternate fare structure authorized in the order herein provides fares for markets served with pure jet equipment which are less than those sought in Application No. 56790. We will authorize the amount of the fares sought in Exhibit 2 of Application No. 56961 for Air Cal's Tahoe markets because no fare increases have been authorized in those markets since the inception of service, because present Tahoe operations are conducted at a loss, because we found in another proceeding that the Electra aircraft used to serve Tahoe markets are more costly to operate on a seat-mile basis than pure jet aircraft, and because PSA has been authorized to increase its Tahoe air fares by a greater percentage than that sought by Air Cal.

Adopted Test Year Operating Results

The following depicts the test year operating revenues and expenses found reasonable for the purpose of this proceeding:

TABLE 4

AIR CALIFORNIA

Adopted Estimated Results of Operations
Year Ending December 31, 1977

Item	Present Fares	Proposed Fares	Adopted Fares
Statistics			
Passengers	2,052,600	2,052,600	2,052,600
Flight Hours	27,989	27,989	27,989
Load Factor	66%	66%	66%
Revenue			
Scheduled Passengers	$49,008,000	$52,947,000	$50,547,000
Charter/Contract	265,000	265,000	265,000
Freight and Baggage	819,000	819,000	819,000
Beverages Net	287,000	287,000	287,000
Misc. & Non-Trans. Rev.	205,000	205,000	205,000
Total Revenue	$50,584,000	$54,523,000	$52,123,000
Expenses			
Flying Operations	$16,144,800	$16,144,800	$16,144,800
Aircraft Lease Cost	4,238,400	4,238,400	4,238,400
Direct Maintenance	4,395,000	4,395,000	4,395,000
Maintenance Burden	1,871,000	1,871,000	1,871,000
Passenger Services	3,514,000	3,514,000	3,514,000
Aircraft Services	2,829,000	2,843,000	2,840,000
Traffic Services	6,796,000	6,796,000	6,796,000
Sales and Promotion	3,777,000	3,803,000	3,690,800
Reservations	2,301,000	2,301,000	2,301,000
General Administration	2,152,000	2,152,000	2,152,000
Depreciation	666,000	666,000	666,000
Total Expenses	$48,684,200	$48,724,200	$48,609,000
Operating Income	$ 1,899,800	$ 5,798,800	$ 3,514,000
Provision for State Income Taxes	$ 171,000	$ 521,900	$ 316,300
Net Income	$ 1,728,800	$ 5,276,900	$ 3,197,700
Operating Ratio			
Before State Tax	96.2%	89.4%	93.3%
After State Tax	96.6%	90.3%	93.9%

Findings

1. Air Cal is a passenger air carrier operating over routes entirely within the State of California. It holds a permanent certificate of public convenience and necessity to provide service between Santa Ana (Orange County Airport), the hub of its operations, and airports located in San Francisco, Oakland, San Jose, San Diego, and Palm Springs. It also provides service between the latter points. Permanent service is provided with leased Boeing 737 aircraft. Air Cal holds a temporary certificate to provide passenger air service between South Lake Tahoe and airports in the San Francisco Bay Area. Such service is provided with Lockheed Electra (L-188) aircraft.

2. In Application No. 56790 Air Cal seeks a general increase in its air fares averaging 6.4 percent. Such fares are designed to yield $3,118,000 additional annual revenue. In Application No. 56961 Air Cal seeks to increase its Tahoe air fares by 10 percent. Proposed fares are designed to yield $427,000 additional annual revenue. Air Cal also seeks additional annual revenue of $354,685 to offset fuel cost increases incurred since the filing of Applications Nos. 56790 and 56961.

3. Air Cal projects (in Table 2) operating income for a 1977 test year of $1,884,000 under present fares and $5,615,000 under proposed fares. The resulting operating ratios are as follows:

	Present Fares	Proposed Fares
Before Provision for Income Taxes	96.3%	89.7%
After Provision for Income Taxes	97.9%	94.1%

4. The Commission staff projects (in Table 3) operating income for a 1977 test year under present fares of $4,094,300 and under proposed fares of $7,100,600. The resulting operating ratios are as follows:

	Present Fares	Proposed Fares
Before Provision for Income Taxes	92.0%	86.9%
After Provision for Income Taxes	95.8%	93.4%

The staff proposes an alternate fare structure designed to produce test year operating income of $6,037,600, and operating ratios of 88.6 percent (before provision for income taxes) and 94.25 percent (after provision for income taxes).

5. Operating ratio is a reasonable test of the earning requirements of Air Cal during the 1977 test year used herein. An operating ratio of 93.3 percent (before provision for state income taxes) and 93.9 percent (after provision for state income taxes) will be reasonable for a 1977 test year, in consideration of Air Cal's present healthy financial condition and its financial commitments expected in the test year.

6. Westgate owns 82 percent of Air Cal's equity. Westgate has elected to file income tax returns which include the tax liabilities of Air Cal and other Westgate subsidiaries. Because of prior year loss carry forwards Westgate expects to pay no federal income tax in the test year. Westgate expects to pay a California State income tax. In consideration of the fact that neither Westgate nor any of its subsidiaries will actually incur any 1977 federal income tax liability, Westgate and Air Cal entered into an agreement (Exhibit 11) which provides that Air Cal will pay to Westgate a sum equal to 82 percent of the federal income tax liability Air Cal would incur if it filed a separate return. The agreement does not apply to state income taxes.

7. Westgate is a bankrupt corporation and any payments by Air Cal to it under the agreement referred to above will be used to reduce Westgate's obligations to its creditors as a bankrupt corporation. None of the funds transferred to Westgate by Air Cal will increase the stockholder equity or reduce the debt of either Air Cal or its parent. None of such funds will be used for any purpose which furthers the interests of Air Cal or of its ratepayers, now or in the future. Therefore, no provision for federal income taxes or for payments by Air Cal to Westgate in lieu thereof should be incorporated in the test year operating results adopted for the purposes of this proceeding.

8. Air Cal and the Commission staff differ with respect to operating expenses, number of aircraft required, and other factors affecting estimates of test year operating results. The reasonable test year estimates of operating revenues and expenses which we adopt are set forth in Table 4.

9. Additional revenues are required in the test year. Increases in passenger fares averaging 3.14 percent which will result in estimated increased passenger revenues of $1,539,000 for a 1977 test year are required to produce the operating ratios found reasonable herein.

10. Alternate fares designed to produce the increased revenues found reasonable above are set forth in Appendix B. Such fares will be reasonable and are justified.

Conclusions

1. Applications Nos. 56790 and 56961 should be granted to the extent provided in the order which follows.

2. Air Cal should be authorized to establish the increased fares set forth in Appendix B.

A.56790, 56961 dz ***

ORDER

IT IS ORDERED that:

1. Air California is authorized to establish the increased fares set forth in Appendix B attached hereto.

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

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

4. Tariff filings made pursuant to this order shall comply with the regulations governing the construction and filing of tariffs set forth in General Order No. 105-Series.

5. Air California shall give notice to the public by posting in its terminals a printed explanation of its fares authorized herein. Such notice shall be posted not less than five days before the effective date of the fare changes and shall remain posted for a period of not less than thirty days.

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

Dated at San Francisco, California, this 4th day of OCTOBER, 1977.

Robert Batinovich
President

Vernon L. Sturgeon
Richard D. Gravelle

Commissioners

I will file a concurrence
Robert Batinovich

I will file a written concurrence
Vernon L. Sturgeon

Commissioner William Symons, Jr., being necessarily absent, did not participate in the disposition of this proceeding.

Commissioner Claire T. Dedrick, being necessarily absent, did not participate in the disposition of this proceeding.

APPENDIX A

AIR CALIFORNIA

Present and Proposed Fares
1977

Market	Present Fares Base	Present Fares With Tax	Proposed Fares Base	Proposed Fares With Tax	Increase Base	Increase With Tax
Oakland-Ontario	$25.69	$27.75	$28.01	$30.25	$2.32	$2.50
-Orange County	26.62	28.75	28.24	30.50	1.62	1.75
-Palm Springs	32.41	35.00	34.49	37.25	2.08	2.25
-San Diego	29.17	31.50	31.94	34.50	2.77	3.00
Ontario-Palm Springs	13.43	14.50	14.12	15.25	.69	.75
-Sacramento	25.93	28.00	28.94	31.25	3.01	3.25
-San Diego	12.78	13.80	14.12	15.25	1.34	1.45
-San Jose	25.69	27.75	28.01	30.25	2.32	2.50
Orange County-Palm Springs	13.43	14.50	14.12	15.25	.69	.75
-Sacramento	27.08	29.25	29.86	32.25	2.78	3.00
-San Diego	12.78	13.80	14.12	15.25	1.34	1.45
-San Francisco	26.62	28.75	28.24	30.50	1.62	1.75
-San Jose	26.62	28.75	28.24	30.50	1.62	1.75
Palm Springs-Sacramento	32.87	35.50	35.42	38.25	2.55	2.75
-San Francisco	32.41	35.00	34.49	37.25	2.08	2.25
-San Jose	32.41	35.00	34.49	37.25	2.08	2.25
Sacramento-San Diego	29.40	31.75	32.87	35.50	3.47	3.75
-San Jose	12.78	13.80	14.12	15.25	1.34	1.45
San Jose-Oakland	9.03	9.75	10.42	11.25	1.39	1.50
-San Diego	29.17	31.50	31.94	34.50	2.77	3.00
-San Francisco	8.98	9.70	10.42	11.25	1.44	1.55
Lake Tahoe-Oakland	17.59	19.00	19.68	21.25	2.09	2.25
-Ontario	29.63	32.00	33.56	36.25	3.93	4.25
-Orange County	29.63	32.00	33.56	36.25	3.93	4.25
-Palm Springs	35.19	38.00	37.27	40.25	2.08	2.25
-San Diego	32.40	35.00	38.19	41.25	5.79	6.25
-San Francisco	17.59	19.00	19.68	21.25	2.09	2.25
-San Jose	17.59	19.00	19.68	21.25	2.09	2.25

AIR CALIFORNIA

Authorized Fares

Market	Present Fares Base	Present Fares With Tax	Authorized Fares Base	Authorized Fares With Tax	Increase Base	Increase With Tax
Oakland-Ontario	$25.69	$27.75	$26.39	$28.50	$0.70	$0.75
-Orange County	26.62	28.75	27.27	29.45	0.65	0.70
-Palm Springs	32.41	35.00	33.24	35.90	0.83	0.90
-San Diego	29.17	31.50	29.91	32.30	0.74	0.80
Ontario-Palm Springs	13.43	14.50	13.89	15.00	0.46	0.50
-Sacramento	25.93	28.00	26.57	28.70	0.64	0.70
-San Diego	12.78	13.80	13.10	14.15	0.32	0.35
-San Jose	25.69	27.75	26.39	28.50	0.70	0.75
Orange County-Palm Springs	13.43	14.50	13.89	15.00	0.46	0.50
-Sacramento	27.08	29.25	27.78	30.00	0.70	0.75
-San Diego	12.78	13.80	13.10	14.15	0.32	0.35
-San Francisco	26.62	28.75	27.27	29.45	0.65	0.70
-San Jose	26.62	28.75	27.27	29.45	0.65	0.70
Palm Springs-Sacramento	32,87	35.50	33.70	36.40	0.83	0.90
-San Francisco	32.41	35.00	33.24	35.90	0.83	0.90
-San Jose	32.41	35.00	33.24	35.90	0.83	0.90
Sacramento-San Diego	29.40	31.75	30.14	32.55	0.74	0.80
-San Jose	12.78	13.80	13.10	14.15	0.32	0.35
San Jose-Oakland	9.03	9.75	9.26	10.00	0.23	0.25
-San Diego	29.17	31.50	29.91	32.30	0.74	0.80
-San Francisco	8.98	9.70	9.26	10.00	0.28	0.30
Lake Tahoe-Oakland	17.59	19.00	19.44	21.00	1.85	2.00
-Ontario	29.63	32.00	32.41	35.00	2.78	3.00
-Orange County	29.63	32.00	32.41	35.00	2.78	3.00
-Palm Springs	35.19	38.00	37.04	40.00	1.85	2.00
-San Diego	32.40	35.00	35.65	38.50	3.25	3.50
-San Francisco	17.59	19.00	19.44	21.00	1.85	2.00
-San Jose	17.59	19.00	19.44	21.00	1.85	2.00

AIR CALIFORNIA

Forecast of Passenger Revenue
Utilizing Present and Authorized Fares

Markets	Forecast Passengers 1977	Present Fares	Revenue With Present Fares (+ 000)	Authorized Staff Fares	Revenue With Authorized Fares (+ 000)
SNA-SFO/SJC/OAK	973,600	$26.62	$25,917	$27.27	$26,550
SNA-SMF	198,500	27.08	5,375	27.78	5,514
SAN-SJC/OAK	114,800	29.17	3,349	29.91	3,434
SAN-SMF	42,500	29.40	1,250	30.14	1,281
SAN-ONT/SNA	73,000	12.78	933	13.10	956
PSP-SFO/SJC/OAK	69,900	32.41	2,265	33.24	2,323
PSP-SMF	1,400	32.87	46	33.70	47
PSP-ONT/SNA	20,500	13.43	275	13.89	285
ONT-SJC/OAK	211,700	25.69	5,439	26.39	5,587
ONT-SMF	70,400	25.93	1,825	26.57	1,871
SJC-SMF	54,600	12.78	698	13.10	715
SJC-OAK/SFO	5,800	9.03	52	9.26	54
TVL-SFO/SJC/OAK	185,600	17.59	3,265	19.44	3,608
TVL-ONT/SNA	30,300	29.63	898	32.41	982
Total	2,052,600		$51,587		$53,207
Less Dilution at 5%			2,579		2,660
Total			$49,008		$50,547
Increase					3.14%

A. 56790 MM
D. 87938

COMMISSIONER BATINOVICH, Concurring:

I concur with the objective of the majority opinion which seeks to assure that taxes expensed for rate-making purposes realistically reflect those taxes incurred and actually paid.

However, this particular decision troubles me on two accounts (from two different perspectives).

First of all, from the perspective of a (sometimes) rational regulator, I am bothered by the fact that this decision creates a situation whereby a mere change in ownership, all other things being equal, could justify an increase in rates. The present rates reflect the fact that Air-Cal, a regulated company, is owned by and files a consolidated tax return with Westgate, a non-regulated company, who will pay no taxes due to a tax loss carry-over. However, a sale of Air-Cal to any tax-paying entity would require a rate increase. It seems incongruous to me that mere ownership should have such an effect.

Secondly, from the perspective of an investor, I am bothered by the fact that, according to the present opinion, one would be deprived of a recoupment of investment losses through tax offsets by virtue of the fact that one's profitable company is regulated

A. 56790 MM
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while one's unprofitable company is not.

Nevertheless, these apparently irrational impacts of the decision stem not from the mechanics of the decision, since it is sound rate-making to allow only the taxes actually incurred to be expensed, but from the quagmire of the IRS Codes which burden the rate-setting processes, with differing results for various industries.

My views on the substitution of the federal income tax for a usage or gross receipts tax for the natural monopolies of gas, electricity and telephone utilities are widely known, and I am not proposing that transportation companies be included.

However, this Commission might conceivably consider a different method of circumventing the regulatory encumbrances of the IRS Code, i.e., adopting operating ratios (pre-tax) for all transportation companies and ignoring the tax benefits or costs in rate-making. This method is appropriate in that government continues to inspire competition in the transportation industry, and this added feature should only enhance that goal.

Robert Batinovich

ROBERT BATINOVICH, President

Dated at San Francisco, California this
4th day of October, 1977.

COMMISSIONER VERNON L. STURGEON, Concurring

While I join in signing today's order, I am disturbed with the Commission's treatment of the federal tax expense issue. The Commission by choosing to disregard Air California's obligations under the Federal Tax Payment Allocation Agreement with Westgate ignores the fact that Air California will be required to fulfill the terms of that agreement. While we do not have completely adequate information on this subject,1/ it appears unlikely that either Westgate, or its creditors, will be dissuaded from asserting their rights under this agreement--an agreement approved as reasonable by the Bankruptcy Court.

Of course, our discussion of the allocation agreement would be unnecessary had we adopted the reasonable course of simply determining Air Cal's federal tax expense on the basis of its projected income without regard to the activities of its parent or affiliates. Had Air Cal filed a separate2/ return, we would have had no choice but to adopt such a course. Instead, Air Cal now finds itself with an enforceable tax allocation obligation to Westgate but nothing in today's authorized fares to cover that expense.

San Francisco, California
October 4, 1977

Vernon L. Sturgeon
VERNON L. STURGEON
Commissioner

1/ I would hope that the Commission would grant rehearing on this question should an application be filed. The circumstances under which the Federal Tax Payment Allocation Agreement was entered into are highly relevant to the equity of today's decision.

2/ Note that consolidated returns are optional. I.R.C. Section 1501.