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Decision No. 88180 NOV 29 1977

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Southwest Airlines for Authority to Increase Passenger Air Fares.	Application No. 56973 (Filed December 30, 1976; amended May 26, 1977)

Brownell Merrell, Jr., Attorney at Law, for Pacific Southwest Airlines, applicant.
William J. Jennings, Attorney at Law, Edward C. Cole, and Milton DeBarr, for the Commission staff.

OPINION

Pacific Southwest Airlines (PSA) seeks authority to increase its passenger air fares. PSA is a passenger air carrier providing scheduled air transportation wholly within the State of California. PSA utilizes Boeing 727-100, Boeing 727-200, and Lockheed 188 (Electra) aircraft. Its maintenance facilities and its executive offices are located in San Diego.

A prehearing conference was held before President Batinovich and Administrative Law Judge Mallory on February 22, 1977 at which hearing dates for presentation of evidence were determined and advance distribution of exhibits was ordered. Agreement was reached that applicant and the staff would present projected operating results for a test year entirely in the future, i.e., a 1978 test year. Applicant and the staff were requested to develop evidence on the following issues:

1. What is the best measure to use in determining a reasonable level of earnings for PSA (rate of return, operating ratio, or other method)?

2. What is the minimum level of earnings necessary to attract capital for current needs and for future needs?

3. Whether federal income taxes should be computed on a normalized, flow-through, or other basis?

4. Whether aircraft depreciation expense should be adjusted to reflect the actual use of aircraft?

5. Whether present 727 aircraft can be retrofitted to meet lower noise standards required by federal agencies?

6. Whether present 727 aircraft can be modified to provide more efficient operations by a reduction in fuel consumption and an increase in seating capacity or whether present aircraft should be replaced with more efficient aircraft?

The application, as filed, sought an increase of 8.34 percent. Included therein were increases sought in two other applications. Decision No. 87378 in Application No. 56858 granted an increase in Tahoe air fares, which increased PSA's overall revenues by 0.51 percent. Decision No. 87207 in Application No. 56907 granted a partial fuel offset increase, which raised overall revenues by 1.68 percent. That decision indicated the balance of the fuel offset request would be considered herein. The amendment filed May 26, 1977, seeks to recover the fuel cost increase not granted by Decision No. 87207 and the additional fuel cost increases incurred since the date of that decision.[1/] As a result of the amendment to the application, PSA seeks an increase of 8.37 percent, broken down as follows:

1/ The present fares and fares proposed in the amended application are set forth in Appendix A.

General fare increase	6.05%
Fuel offset increase	2.32%
	8.37%

Seven days of public hearings were held commencing June 7, 1977. The matter was submitted on June 17, 1977. Evidence was presented by PSA and our staff.

The Evidence in General

PSA presented a total of ten witnesses and 23 exhibits. The names of the witnesses and the subject matter testified to by each are set forth in Appendix B. The evidence adduced by PSA covers all of the areas for which data were requested at the prehearing conference.

The Commission staff presented eight exhibits through three witnesses.

The Commission's Finance Division did not complete its exhibits until the hearings were in progress. The Finance Division's exhibits contain the results of an audit of PSA's books and records for the calendar years 1974, 1975, and 1976. The Finance Division recommends that recorded data be adjusted as follows:

1. Reflect aircraft leases from an affiliate, JetAir Leasing, Inc., on an "as owned" basis.
2. Adjust air frame and engine depreciation expenses based upon a depreciable life of 12 years and a salvage value of 16 percent.
3. Transfer unearned transportation revenue to operating revenues.
4. Adjust repair expenses paid to Pacific Southwest Airmotive (an affiliate) to eliminate expenses resulting from asserted excess capacity.

5. Adjust allocation of general and administrative expenses between PSA and affiliated companies on a cost-follows-cost basis.
6. Amortize capital gains from the sale of aircraft and adjust rate base in the same manner as prior proceedings.

The Finance Division witness recommended that PSA be authorized to increase passenger fares sufficiently to produce an operating ratio after taxes of 94 percent and a rate of return of approximately 12 percent. No study was incorporated in the staff report which supports the recommended earnings levels. Based on its analyses of the consequences of using flow-through versus normalization of the tax savings resulting from the use of accelerated depreciation of assets for determination of federal income taxes in the projected rate year, the Finance Division recommended that flow-through continue to be used in arriving at test year estimates of earnings.

PSA and the Transportation Division staff presented projected results of operations for a 1978 test year. The staff's operating results make no provision for income taxes because the necessary underlying data were not available from the Commission's Finance Division before the commencement of the hearings. The Transportation Division staff also presented analyses of different measurements of earnings, expenses trended for inflation, reasonableness of fare levels based on costs of alternative means of transportation, allocations of revenues and expenses by route segments, informal complaints, and other data.

Because the principal Finance Division study and recommendations in Exhibit 16 were not completed before the hearings began, most of the recommendations contained in that exhibit were not adopted in the test year results of operations estimates presented by the Transportation Division.

Based on its analyses, the Transportation Division recommended that the application, as originally filed, be granted.

The Commission appreciates the breadth and depth of the showing made by applicant and the staff in response to the request of the presiding Commissioner. The combined presentation is the most complete of any presentation heretofore received in an airline fare increase proceeding. A detailed discussion of all facets of the evidence of record is not required. For the sake of brevity, only those contested issues having a bearing on our ultimate findings will be discussed in detail in our commentary.

Rate Spread

Exhibit 16 of the Finance Division contains a recommendation that the Commission require that PSA, in future hearings involving fares or new routes, present data showing the costs of service over each route segment operated by it. This recommendation was supported by a comparison of fare groupings with allocated costs of services over the associate route segments. Separate analyses were presented by PSA and by the Transportation Division. Each analysis shows substantially different results. None of the analyses correctly segregate route segments or fare groups operating costs. These analyses do not support the contention of the staff finance witness that certain fare groups are operating on a substantial below-cost basis. We will not adopt the recommendation in the Finance Division report that subsequent fare increase and route proceedings contain cost-of-service studies by fare groupings.

According to the staff financial witness, the shortest route segments operated by PSA are where the greatest disparity exists between operating costs and fare levels. We do not accept the methods adopted by witness to arrive at the costs shown in his exhibit. But even if the alleged disparity exists, it is in those short-haul markets that other ratemaking considerations have a much greater influence on fare levels than operating costs. In its short-haul markets PSA experiences competition from all modes of transportation, including the private automobile. Personal convenience; the time factors involved in getting to and from airports; and the cost of alternate means of transportation, such as buses, rental automobiles, and other airlines all are considered in establishing PSA's fare levels. Moreover, fare relationships between communities must be maintained even though each market that has the same fare does not contribute equally to the carrier's revenue needs.

The short-haul markets in which PSA flies the greatest number of seat miles are between Los Angeles International Airport (LAX) and Hollywood Burbank Airport (HWB), on the one hand, and San Diego International Airport (SAN), on the other hand. PSA's headquarters and its principal aircraft maintenance facilities are located in San Diego. Many of the seat miles between SAN and LAX or HWB would be flown even if no passenger service is offered, in order to position aircraft for flights between LAX or HWB and northern California points. The load factor for SAN-LAX/HWB is about 40 percent. It is unreasonable to expect that fares for those markets will recover all costs associated with such operations because part of those costs are incurred in positioning aircraft for more distant flight operations.

We are convinced that PSA and other intrastate airlines attempt to maximize their revenues by assessing what the traffic will bear based on their analyses of all relevant factors. We consider it our duty to determine the overall revenue needs of an air carrier and to permit the air carrier to assess fares determined by the competitive forces of the market place as long as no fare discrimination results.

Retrofit or Replacement of Aircraft

This subject is discussed first because of its effect on PSA's future operations.

PSA strongly competes in the California corridor with Air California, an intrastate airline, and with United Air Lines, Inc. (United) and Western Air Lines, Inc. (Western), which are interstate airlines.[2] The record shows that in the period when PSA had the same or lower fares than United and Western but operated a less modern type of aircraft than those airlines, PSA lost its predominant position in the San Francisco Bay Area-Los Angeles Metropolitan Area market. Similarly, when Western operated piston aircraft in corridor markets and maintained a lower fare than United and PSA, while the latter operated propjet aircraft, Western lost business to PSA and United. More recently, PSA's offer of lower fares at off-peak hours using propjet aircraft did not attract sufficient new patrons to maintain that service. The conclusion reached is that the majority of the public prefers to use the most modern aircraft available even though higher fares are assessed. Based on the foregoing conclusion, PSA believes that it can maintain its current share of the corridor market only if it continues to operate a substantially similar type of aircraft as its principal competitors.

The evidence shows that Boeing Aircraft Manufacturing Company plans to introduce two modifications of its 727-200 aircraft which will reduce fuel requirements by eliminating one engine and which will increase passenger capacity by modifying wing and tail design and by extending the fuselage. The 7N7 would incorporate engine changes necessary to satisfy new federal noise standards which must be met by 1980. PSA's present fleet of 727 aircraft must be modified by that date to meet such noise standards. The evidence shows that Boeing is prepared to manufacture and market the redesigned intermediate-range (7N7) and long-range (7X7) aircraft when sufficient orders have been received. To date no orders have

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2/ Delta Airlines, Trans World Airlines, and National Airlines also possess authority and operate in the corridor but do not strongly complete in the LAX-SFO or SAN-SFO markets.

been placed. The 7N7 and 7X7 will cost approximately $18,000 per seat at today's prices, which is considerably more than the cost of aircraft in PSA's current fleet. A consulting economist testified that inflation, noise standards at airports, and other factors will cause the cost per seat of existing types of aircraft, such as the 727-200, to rise in the near future to approximately the level estimated for the new type aircraft.3/

It is PSA's current plan to retrofit its existing jet engines to meet federal noise standards and to refurbish the interior of its aircraft to give them the so-called "wide body" appearance. Such modifications would be accomplished by use of cash or short-term borrowing.

However, if new generation aircraft suitable to PSA's operations become generally available in the near future, PSA probably will begin a program of aircraft replacement in order to receive the benefits of greater fuel economy and larger payloads. An impetus to any replacement program by PSA would be the operation of any new generation aircraft in the corridor by competing carriers. If new aircraft are acquired by PSA, substantial additional equity capital or debt financing would be required.

Our conclusion, based on the evidence of record, is that PSA will retrofit its existing jet engines to meet federal noise standards and will refurbish the interiors of its existing 727 equipment inasmuch as no new types of aircraft suitable to use in PSA's short-haul markets will be commercially available before the mid-1980's.

3/ The effect of inflation on aircraft prices is discussed in prior decisions in relationship to proper methods for the accounting for gains from the sale of aircraft. Aircraft sold by PSA or its affiliates have been at amounts greater than the recorded depreciated value of the aircraft. Such gains have been amortized over a period of years. The unamortized portion has been deducted from rate base.

The foregoing bears upon PSA's need for additional equity capital or debt financing and upon the use of flow-through versus normalization in tax calculation, which in turn has a bearing on the reasonable level of earnings to be authorized.

Ability to Acquire New Capital

The record shows that any substantial new capital requirements will be met through long-term borrowing. PSA has the ability to acquire additional long-term debt at a reasonable cost if its fare levels allow adequate interest coverage and are sufficient to meet other financial criteria required by lenders.

Staff Exhibit 16 shows that, based on current long-term debt, PSA had net earnings which provided 2.0 times interest expense in 1975 and 4.2 times interest expense in 1976, or marginal safety factors of 50.7 percent and 76.3 percent, respectively. Such interest coverage was low in 1975 but improved in 1976. The fare levels authorized herein should permit interest coverage on the order of that achieved in 1976, as a minimum, so that PSA's future debt offerings will be attractive to potential lenders and lowest possible interest rates may be obtained. Inasmuch as we expect no need for large-scale debt financing for new equipment in the test year, we expect that PSA will experience test year debt levels similar to historical periods.

Measure of Earnings Requirement

Several methods of determining the measure of earnings required by PSA in the test year were advanced. We have analyzed such methods and, without describing each in detail, have determined that no adequate substitute to the alternative tests of rate of return on rate base and operating ratio (after taxes) has been offered. We have selected operating ratio as a test of earnings required for this proceeding for the reasons hereinafter explained.

Approved Operating Ratio

PSA and the staff recommend widely divergent rates of return and operating ratios. The level of the recommended rates of return and operating ratios is related to the recommended methods of determining federal income taxes.

PSA's rate of return witness recommended that a rate of return of 16.85 percent based on normalization of federal income tax benefits of accelerated depreciation be adopted as reasonable for a 1978 test year. Such rate of return was designed to produce a return on equity of 24 percent on an assumed capitalization of 45 percent debt and 55 percent equity.

On the other hand, our Finance Division recommended a rate of return of approximately 12 percent and operating ratio of 94 percent (after taxes) whichever produces the greater net income. This recommendation contemplates full flow-through of the tax benefits of accelerated depreciation. The staff estimated that a rate of return of 12 percent would yield a return on equity of approximately 16 percent on the capital structure of 46.3 percent debt and 53 percent equity set forth in Table 2 (infra).

We adopt for ratemaking purposes the full flow-through method of determining federal income taxes recommended by our staff as hereinafter discussed.

In recent prior proceedings, we authorized the following rates of return:

TABLE 1

Decision No.	Application No.	Year	Rate of Return	Authorized Operating Ratio (After Taxes)
85339	55160	1976	9.39	95.27
81793	53535	1973	12.10	88.47
80322	52970	1972	11.89	86.60
77991	52016	1970	8.80	87.20
75899	50847	1969	9.35	83.80

In approving a rate of return of 9.39 percent and an operating ratio (after taxes) of 95.27 percent in PSA's last fare proceeding (D.85339), we found that such earnings are less favorable than corresponding operating ratios and rates of return adopted in prior PSA fare increase proceedings and thus did not represent a maximum reasonable rate of return or operating ratio.

In denying a fare increase to PSA in Decision No. 80322 (1972) 73 CPUC 697, 713, we found that a rate of return of 15.5 percent based on full flow-through of accelerated depreciation and investment tax credits produced excessive earnings for PSA's operations. In denying the fare increase, we found an operating ratio (after taxes) of 83.4 percent and a rate of return of 15.5 percent exceeds maximum reasonable earnings for PSA.

As may be seen from the above table, authorized rates of return range from 8.80 percent to 12.10 percent and authorized operating ratios (after taxes) range from 95.27 percent to 83.80 percent. In each of the above proceedings, federal income tax was computed on a full flow-through basis. Operating ratio has deteriorated in relation to the corresponding rate of return in Decision No. 85339 as compared to Decision No. 75899. Under the alternatives proposed by the staff, its recommended rate of return of 12 percent would produce higher after tax earnings than its recommended 94 percent operating ratio. The after-tax operating ratio that is equivalent to a 12 percent rate of return is approximately 89 percent.

In this proceeding, using a full flow-through of accelerated depreciation and investment tax credit for federal income tax purposes, a rate of return in the range of 11.0 to 12.1 percent and an operating ratio (after taxes) in the range of 86.6 to 89.0 percent would be reasonable. Such rates of return and operating ratios are comparable to those previously authorized under the full flow-through taxing method and are sufficient to provide adequate earnings. As hereinafter indicated, we adopt an operating ratio method of determining PSA's revenue requirements under the fares authorized herein. Table 3 (infra) sets forth the adopted results of operation under PSA's proposed fares for the 1978 test year. The operating ratio before taxes of 92.32 percent set forth in Table 3 is less favorable than the operating ratio of 89 percent that would result from the staff's recommendation. That operating ratio is reasonable for the purposes of this proceeding.

The ranges found reasonable above should provide estimated returns on common equity in the range of 13 to 16 percent based on the assumed capitalization and cost of debt set forth below:

TABLE 2

ESTIMATED CAPITAL STRUCTURE - 1978

	Capital Ratios	Cost of Debt	Rate of Return 10.4%	11.0%	11.5%	12.0%
Long-Term Debt	46.28%	7.42%	3.43%	3.43%	3.43%	3.43%
Stockholders Equity	53.72%	-	6.97%	7.57%	8.07%	8.57%
Return on Equity	-	-	13.30%	14.90%	15.02%	15.95%

A return on equity of at least 13 percent is required to produce minimum earnings necessary to provide a future market for PSA's equity issues at a reasonable cost.

Future Fuel Offsets

Decision No. 87207 dated April 12, 1977 in Application No. 56907 partially granted PSA's request for a fuel offset increase. Commission Gravelle's concurring opinion read as follows:

> "As a matter of future policy, I believe that increased fuel expense is not a proper subject for offset rate relief for airlines and that the added expense should be handled in general rate proceedings which can be heard on an expedited basis.
>
> "I sign this order only because applicant was in no way advised of such a policy at any time in the processing of this application. To the contrary, the recent past policy of this Commission has been to consider fuel as an offset expense item. The industry should be on notice from this date forward that such applications are in imminent danger of dismissal."

PSA requested that the Commission establish a mechanism for expedited handling of future fuel offsets. In support of this request, PSA showed that fuel increases by PSA's principal supplier (Shell Oil Company) are made on very short notice, and that such increases become effective almost immediately. According to PSA, each one-cent increase per gallon in the price of aircraft fuel increases PSA's operating expenses by over $1 million per year. PSA asserts that fuel cost increases are not controllable by it, and that the mechanism of a general fare increase proceeding is too cumbersome and not responsive to its needs to promptly recover the added expenses resulting from uncontrollable fuel increases.

PSA asks that the Commission accept a petition for modification in the latest general fare increase proceeding as a vehicle for receiving evidence for offset fuel cost increases. The results of operation adopted in the general fare proceeding would be modified to reflect the increased fuel expense and the balance of the operating expenses would not be revised. Fares would be increased to the extent necessary to produce the previously authorized rate of return and/or after-tax operating ratio.

The position of the Commission staff is that no expedited or fuel offset relief should be granted to PSA until the price of fuel exceeds 41 cents per gallon. May 31, 1977 fuel costs are 38.3935 cents per gallon. The staff's trended fuel cost for the test year is 42 cents per gallon.4/ It is apparent that based on fuel costs recently experienced by PSA, fuel costs will probably exceed 41 cents per gallon before the end of the 1978 test year.

The instant application is representative of airline general fare increase proceedings. It is apparent that such a proceeding does not lend itself to expedited handling.5/ Therefore, we believe some form of procedure is required to reflect major fuel cost increases in airline fares.

Meanwhile, we recognize that it is almost certain that higher fuel costs than the current cost of 0.38395 cent per gallon will be experienced by PSA before the end of the 1978 test year. Therefore, we will make provision for fuel costs of 42 cents per gallon in the test year operating expenses adopted herein in order to avoid the necessity of a fuel offset. We fully expect that by providing for fuel costs on a trended basis, the permanent fares resulting from this proceeding will remain in effect through 1978 and beyond. In the next general fare proceeding we will expect the applicant to make a specific showing regarding the availability of fuel from various suppliers. We are particularly concerned about applicant's inability to bargain for stable prices with increases at regular intervals. We intend to go into the matter of fuel supply for airlines (as has been done by this Commission for electric utilities) so as to have a complete record on which to base our final determination as to a procedure for recovery of fuel costs. We may also need the assistance of the Attorney General of the State of California and various federal agencies in order to develop the record fully. We expect our staff to arrange for such participation as is required.

4/ The staff's trended cost is an extrapolation into the test year of fuel cost increases experienced in the recent past.

5/ A.56973 was filed December 30, 1976. The first day of hearing was June 7, 1977. A total of 32 exhibits was received, and 13 witnesses presented testimony on economic issues.

Results of Operation for 1978 Test Year

PSA and the Commission staff presented projected results of operation for 1978 developed by adjusting revenues and expenses for a historical period to reflect known changes. In addition, the staff presented a separate projection developed by trending expenses based on historical changes in price indices. The latter method takes into consideration the effects of inflation on operating expenses and provides for changes in future operating expenses which can be expected to occur but which are not known at this time.

We will use the traditional method of projecting operating expenses to a future year by using historical expense data adjusted for known increases and reductions (with the exception of fuel costs).

As a basis for reconciling the differences between PSA and staff estimates, we will use the staff's projections and discuss PSA's proposed adjustments thereto.

Fleet Composition

PSA estimates in Exhibit 7 that its fleet will be composed of the following aircraft in the 1978 test year; the new 727-200 aircraft for spring 1978 delivery will come with JT8D-7 engines supplied by PSA.

	Beginning	Additions	Ending
727-200 Owned	19	2*	21
727-200 Leased:			
Armco Boothe	1		1
JetAir Leasing, Inc.	3		3
727-100 Owned	6		6
L-188 Owned	2		2
	31		33

*On April 1, 1978 and May 1, 1978.

The Commission staff test estimates for 1978 also are based on the operation of 33 aircraft.

The average number of aircraft in service in 1978 will be 32.25. This compares with an average fleet composition of 27.42 aircraft in 1976.

L-1011 Aircraft

Two L-1011 aircraft are leased by PSA from Security Pacific Leasing Company. These aircraft proved unsuitable to PSA's operations and were removed from service.[6/] Contracts with Lockheed Aircraft Corporation under which PSA would take delivery of three additional L-1011's were canceled. In the last fare proceeding (Decision No. 85339, supra), L-1011's were excluded from test year results of operations, including rate base.

PSA estimates that the settlement of its canceled contract to purchase three L-1011's and the lease costs of two L-1011's incurred after removal from service will result in a net loss of $16,435,000 (Exhibit 7, Appendix B). The average balance of that unamortized loss requested to be included in test year rate base is $15,921,000.

PSA alleges that it will suffer a substantial loss on the retirement of the L-1011's from its fleet and requests that the Commission include such a loss in rate base in the same manner that we now include the gains from sales of operational aircraft.[7/]

6/ PSA's Exhibit 7 (p. 8) states that the events that led to discontinuance of PSA's use of L-1011's were the following: turndown of the economy resulting in recession; the fuel crisis resulting in a 200 percent increase in fuel prices; static PSA passenger totals; decline in passengers in the LAX-SFO market where L-1011's were being used; and operational time and cost penalties due to the required use by L-1011's of the north runway at LAX.

7/ The gains and losses on retirement of aircraft used and useful in PSA's fleet are amortized over a 12-year period, and the unamortized portion of the gain or loss is included in rate base. Principally because of inflation, which forced upward the sales price of new aircraft, substantial gains were recorded on used aircraft sold by PSA.

We concluded in Decisions Nos. 85444 and 85339 that L-1011's were not the most efficient aircraft for PSA's operations, and that L-1011 aircraft leases and purchase contracts were imprudently made; therefore, we eliminated L-1011 aircraft from test year operations adopted in Decision No. 85339. We affirm our conclusions reached in the prior proceeding concerning L-1011 aircraft and, following the same rationale, exclude all consideration of L-1011 aircraft in the determination of reasonable projected results of operations for a 1978 test year.

Load Factor and Passenger Estimates

In 1976 PSA carried 6,591,055 passengers, operated 59,281 flight hours, and achieved a load factor of 60.7 percent.

PSA estimates that it will transport 7,210,104 passengers in 1978. PSA's projected operating results for 1978 are based on 69,810 flight hours and a load factor of 60.0 percent.

The staff estimates that PSA will carry 7,200,000 passengers in 1978. Its test year projections are based on 65,356 flight hours and a 60.7 percent load factor.

The difference in test year passengers is less than two-tenths of one percent and results in an insignificant difference in test-year passenger revenue estimates. However, the difference in estimated flight hours and load factors is significant and results in substantially different estimated expenses for the test year.

We will use the staff's estimates of flight hours and load factors and make appropriate adjustments thereto as hereinafter indicated.

Operating Revenues

The following is the operating revenues we find reasonable for the test year under proposed fares:

OPERATING REVENUES
(+ 000)

Revenues	Proposed Fares
Passenger	$177,700.0
Beverage (net)	878.4
Freight	2,858.3
Mail	261.2
Baggage and Other	53.3
	$181,751.2

Operating Expenses

Adjustments to Load Factor and Flight Hours

PSA showed that it would operate more 727-100 aircraft with lesser seating capacity than 727-200 aircraft in 1978 as compared to 1976. In order to achieve a system load factor of 60.7 percent, PSA contends that the number of flight hours must be increased to provide the same ratio of available seats per hour in the test year as in the historical year. In order to achieve a load factor of 60.7 percent in 1978, estimated flight hours should be increased to 66,412. The increase in flight hours is reasonable and is adopted. Such increase affects the staff's estimated expenses for flying operations, direct maintenance, indirect maintenance, and aircraft servicing, which are based on projected costs per flight hour.

Flying Operation Expenses

PSA showed that certain known contractual increases in wages had not been included, that fuel costs did not reflect the Shell Oil Company increase of May 31, 1977 of 0.982 cents per gallon, and that hull insurance did not reflect the higher values of equipment to be operated in 1978.

PSA's proposed adjustments, other than fuel costs, are appropriate and should be adopted. As indicated under the heading "Future Fuel Offsets", fuel costs included in flying operation expense for 1978 are 42 cents per gallon (including sales tax).

The reasonable flying operation expense for 1978 is $1,022.11 per hour.

Direct Maintenance

Pacific Southwest Airmotive (Airmotive) is a wholly owned subsidiary of PSA. Airmotive engages in overhaul of jet engines for PSA and for other airlines. Airmotive charges PSA based on an hourly rate of $27.70 per hour, plus parts. The five airline customers of Airmotive are assessed on a different basis than PSA. The hourly rates assessed range from $17.25 to $22.00 per hour, plus parts. In addition, Airmotive assesses handling fees ranging from 11 to 15 percent of the cost of materials handled. Handling fees are not assessed to PSA.

The Finance Division recommended that an adjustment to the charges of Airmotive to its parent be made because the staff believes that Airmotive is operating at only 60 percent of capacity. This percentage figure was determined from the minutes of a PSA, Inc. director's meeting in 1975. The staff was not able to substantiate whether that capacity figure was correct nor whether Airmotive continued to operate at 60 percent of capacity in 1976 or at the present time. No attempt was made by the Finance Division staff to determine the percent of full capacity that Airmotive would operate at in the test year. The adjustment proposed by the Finance Division was not carried forward into the estimated 1978 test year results of operations presented in staff Exhibit 5. The adjustment to the repair and maintenance expenses of applicant proposed in Finance Division Exhibits 11 and 16 will not be adopted.[8/]

8/ However, it appears that the capacity and usage of Airmotive's facilities should be explored by the staff in the subsequent phase of this proceeding or in the next PSA fare proceeding.

PSA suggests that labor and overhead costs for jet-engine maintenance used in the staff projections should be adjusted from $26.63 per hour to $27.33 per hour to reflect the increase in Airmotive's billing rate to PSA. It also suggests that parts and materials costs should be increased by 7 percent to reflect the increases in costs of parts put in effect on January 1, 1977 and April 1, 1977 by the parts manufacturers. Such cost increases are now in effect and test year expenses should be adjusted accordingly. Direct maintenance expense should be based on $209.53 per hour.

Passenger Service Expense

PSA asks that the staff's test year estimate of passenger service costs be adjusted by $2.23 per passenger to reflect labor contract terms agreed to subsequent to the completion of the staff study. Those contract provisions will be in effect in 1978, and the wages should be reflected in test year estimates. The reasonable passenger service expense for 1978 is $10,764,400.

Reservations and Sales Expense

PSA stated that the Transportation Division had not included January 1, 1978 wage increases for reservations and sales personnel. Such employees are not subject to wage contracts. PSA stated that it will place an increase in effect on that date of not less than 6 percent. PSA asked that wages and fringe benefits be adjusted accordingly. Such revision is appropriate. The reasonable 1978 reservations and sales expense is $13,459,800.

Allocation of General and Administrative Expenses

PSA is a wholly owned subsidiary of PSA, Inc. PSA, Inc. also has active subsidiary companies as follows:

Airlines Training Center	-	Pilot training for light aircraft, Litchfield, Arizona. Aircraft sales and service - San Diego.
JetAir Domestic Leasing	-	Owns and leases aircraft to other airlines.
JetAir Leasing, Inc.	-	Owns and leases aircraft to PSA.
PSA Antihighjacking Security Guards, Inc.	-	Operates airport security services.
PSA Hotels, Inc.	-	In the process of being dissolved.

PSA also has a subsidiary, Airmotive. The above companies are under a common corporate management; the principal officers of PSA, Inc. are also the principal officers of PSA, Airmotive, and other affiliates.

The Finance Division proposed that an adjustment be made to reallocate a portion of recorded general and administrative expenses from PSA to Airmotive and to other affiliated companies based on the "cost-follows-cost" method. Under the staff method, common general and administrative (G&A) expense for 1976 would be allocated at 86 percent to PSA and 14 percent to PSA, Inc. and other affiliates. Under the staff procedure, $592,000 would be deducted from PSA's recorded G&A expense for 1976 and that amount would be assigned to PSA, Inc. and other affiliates.

PSA presented evidence through an independent certified public accountant to the effect that PSA's 1976 recorded G&A expense should be adjusted by reallocation of $220,300 to affiliates, in lieu of $114,300 actually allocated by PSA. The witness made separate analyses of the following categories of expenses: accounting services, company officers, general management personnel, data processing services, insurance, and miscellaneous. The witness allocated salary and benefits expense in each category based on the amount of time spent by employees performing each function for PSA or the affiliates.

The method employed by PSA's certified public accountant witness appears to be more comprehensive than the method employed by the staff financial examiner. PSA's proposed adjustment is reasonable and will be adopted.

Other General and Administrative Expenses Adjustments

PSA pointed out that no January 1, 1978 increase is provided in wages for administrative employees. These noncontract employees also will be granted wage increases of not less than 6 percent, and an adjustment in wages will also be made to provide for longevity increases.

PSA urged that G&A expenses do not fully reflect the increased manning levels for data processing personnel which occurred in late 1976. PSA also proposed a revision in staffing based on increased traffic in the test year. Provision should also be made for increased staffing and for longevity and wage increases. Those increases should be reflected in test year expenses.

PSA showed that provision for property taxes would be greater than estimated by the staff because of higher assessed values of property and additional equipment. The total adjustment proposed is $1,159,000. That adjustment is reasonable.

Depreciation of Airframes and Engines

In response to the request at the prehearing conference, proposals were made by PSA and the staff to revise the service lives and residual (salvage) values of PSA's flight equipment.

The following tabulation sets forth the service lives and salvage values adopted for ratemaking purposes in prior decisions, and the revisions proposed by PSA and the Commission staff for 1977 and thereafter.

Depreciation of Airframes and Engines

	Service Life (Years)	Annual Deprec. Rate	Residual Value
PSA Recorded - prior to 1975	8	7.5%	40%
PSA Recorded - 1975 to date	12	7.1	15
Commission adopted - D.81793 (1973)	12	7.0	16
PSA proposed - (1)	16	6.0	4
Staff proposed - (1) (2)	16	5.25	16

(1) On amount of asset not yet depreciated (remaining life basis).

(2) Does not apply on engines acquired prior to 12-31-76. Current rate applies.

As may be seen from the above computation, PSA and the staff agree that the service life of current and new airframes and new engines should be adjusted to 16 years. The difference in annual depreciation rates results from the difference in recommended residual values.

Up to this time PSA and JetAir generally have been able to dispose of 727 aircraft at prices which exceeded their recorded depreciated values. Substantial gains on aircraft sales were made in the past.[9/] The residual value proposed by the staff was made in recognition that actual sale prices generally have exceeded recorded values. PSA believes that the new generation aircraft will be available before the end of the service lives of existing equipment; that such new aircraft will be substantially more fuel efficient, quieter, and will have large seating capacities; and, therefore, that the market for 727 aircraft will be substantially reduced.

9/ The Commission has adjusted rate base in prior proceedings to deduct the unamortized portion of gains from sales of aircraft.

We believe retrofitting techniques or replacement will soon be available which will make 727 jet engines quieter and more fuel efficient and, thus, will prolong the operating lives of 727 equipment. We do not agree with PSA that the new generation aircraft will make 727 airframes obsolete. We adopt for ratemaking purposes the service lives and residual values of airframes and engines set forth in Exhibit 5 of the staff engineer.

Other Depreciation Expense Adjustments

PSA showed that asset additions for the fourth quarter of 1976 were not reflected in the staff report. These additions total $1,060,000, and the test year depreciation thereon is $118,000. The assets should be included in test year operating results.

PSA also showed that the staff exhibit failed to include certain buildings, equipment, and furnishings that PSA intends to use in its common carrier operations in 1978. The total amount of such assets is $5,654,000. The test year depreciation on such assets is $586,000. Depreciation expense should be adjusted by that amount. The balance of PSA's proposed adjustments to depreciation expense is not appropriate and should not be adopted.

The total test year depreciation adjustment is $704,000.

Aircraft Leases

In past proceedings, we have substituted ownership costs in lieu of lease expenses in connection with aircraft leased by PSA from its affiliate JetAir.10/ In this proceeding the staff proposed that we continue that practice. PSA opposed this adjustment. PSA recited the history of aircraft acquired from JetAir. Three 727-200's are leased from JetAir, and two 727-200's were "dividended" to PSA by JetAir when short-term leases of such aircraft by a foreign airline were terminated. The two aircraft whose ownership was transferred from JetAir to PSA are recorded on PSA's books at original-cost-less-accrued depreciation.

PSA contends the short-term lease of cost of $75,000 paid by it to JetAir compares favorably with the lease cost of $98,860 per month paid to National Aircraft Leasing (NAL) with respect to an agreement in effect during the period 1973-1975 and compared with a long-term fully levered lease cost of $62,000 per month with ARMCO-Boothe entered in 1969. PSA also compared lease costs of Eastern Airlines and American Airlines.

PSA argued that the aircraft leased from JetAir were not originally acquired for use by PSA, and that PSA should not be the beneficiary of a low 1969 acquisition cost which would result from the substitution of current net book value of the aircraft in PSA's rate base. It is precisely for this reason that affiliate ownership costs are substituted for lease expense in order that the nonregulated part of a conglomerate company should not receive profits in excess of those which the regulated utility would be allowed to earn on the same assets.

10/ Ownership costs are the original cost of the aircraft, including engines and electronic equipment, less accrued depreciation. Depreciation is computed on leased aircraft using the same service life and residual value as for owned aircraft. Ownership costs customarily are substituted for lease costs in utility rate proceedings because agreements between affiliates generally are not arm's-length transactions.

In this proceeding, substitution of ownership costs for lease expense of aircraft leased to PSA by JetAir is reasonable and will be adopted.

Provision for Income Taxes

PSA requested that provision for federal and state income taxes in the future be imputed solely on the income tax factors affecting airline operations and asked that federal income taxes be computed on a normalized basis with retention of investment tax credits (ITC) by PSA rather than using such credits to reduce tax allowances.

The Transportation Division's test year estimates in Exhibits 5 and 14 made no provisions for income taxes. PSA's adjustment of staff projections in Exhibit 14 gives effect to income taxes.

The Finance Division recommended that federal and state income taxes be imputed solely on airline operations and that federal income taxes be based on full flow-through of accelerated depreciation and ITC. The position of the Finance Division staff set forth in its Exhibit 16 is as follows:

> The staff of the Finance Division has considered the pros and cons of changing to a normalized basis for computing income taxes for PSA. We have carefully weighed the impact of the projected "turn around" in depreciation in the immediate future as a result of which straight-line depreciation as recorded will exceed tax depreciation. This would mean that in the test year 1978 recognition of the "turn around" in depreciation would increase taxable income for PSA by approximately $6.5 million. We also have considered the low market value of the company stock in relation to its book value and the need that PSA will have to generate huge amounts of cash to purchase new aircraft in the future.
>
> We have concluded that the Commission should continue to compute an income tax allowance for PSA using accelerated depreciation flow-through for this proceeding.

According to the staff exhibit, other factors, such as the tax effect on PSA, Inc. of disposal of hotels and radio stations, settlement of claims for failure to complete the purchase of L-1011 aircraft, and of an Internal Revenue Service (IRS) audit involving possible excess tax depreciation claimed in prior years, also affected the above staff recommendation.[11/] The staff also considered that PSA files a consolidated tax return with its parent, PSA, Inc.; and that in 1976 PSA, Inc. recorded a tax expense of $3,382,000 with a contra credit of $3,239,000 to deferred federal income taxes, i.e., PSA, Inc. will pay virtually no income taxes for 1976.

At the time of the hearing the 1976 income tax return of PSA, Inc. had not been filed, and the record does not disclose its actual federal income tax liability for that year. Similarly, there is no information in the record concerning the estimated federal income tax liability of PSA, Inc. for the 1978 test year.

The policy of this Commission is to make provisions for state and federal income taxes in test year operating expenses. In the event that the utility is not the tax-filing entity, we have looked beyond the utility and attempted to determine the actual tax liability of the parent or affiliate that files the return. Such factors as the profitability of other operations and the availability of tax deductions not related to the utility's operation may reduce the taxes actually paid by the tax-filing entity. In such event, the actual tax liability of the tax-filing entity is considered before determining the amount of income taxes to provide in the utility's test year operating expenses.

11/ (a) The tax effect of an IRS audit of PSA for 1971-1974; maximum back taxes - $4.4 million additional taxes.

(b) Ultimate disposition of liability to Lockheed Aircraft Corporation on losses on L-1011 aircraft. Charges to operations of $14.750 million in 1975 and $3.309 million in 1976 not yet reflected on tax returns.

(c) Capital expenditures in 1977 and 1978 for five additional 727 aircraft expected to generate additional tax depreciation. Investment tax credit for purchase of used equipment is limited to $100,000 per year. Depreciation is limited to 150 percent of straight-line.

From the information before us, it would appear actual tax liability of PSA's parent, PSA, Inc., for 1978 will be substantially less than the imputed tax liability for PSA operations.

By Decision No. 87938 issued on October 4, 1977 in Applications Nos. 56790 and 56961, the Commission granted fare increases to Air California. However, we refused to recognize, for ratemaking purposes, an agreement whereby Air California obligated itself to pay to Westgate-California Corporation (Westgate) 82 percent of the amount of federal income tax liability it would have incurred had the carrier not been a subsidiary of Westgate. The rationale for this aspect of the decision was that, by reason of tax loss carry forwards available to Westgate on its consolidated return, no tax would actually be paid for income earned by Air California. Rehearing of Decision No. 87938 has been granted. We will determine policy in that proceeding. There is no need to keep this proceeding open until that policy is determined inasmuch as the full amount of the increase sought will be authorized based on the use of a before-tax measurement of earnings.

We will authorize a fare increase designed to produce an operating ratio of 92.32 percent without providing for income taxes. The after-tax operating ratio is less favorable than that which we determined to be reasonable under the heading "Approved Operating Ratio". By basing the increase on that operating ratio, we can be certain that we will not exceed any provision for test year income taxes that may be determined to be appropriate.

For the purposes of the next PSA general fare increase proceeding, we request applicant to furnish PSA, Inc.'s actual federal tax return for the most recent period. In addition, we ask that applicant and the staff develop separate estimates of the test year federal income tax liability for PSA, Inc., including and excluding the data pertaining to L-1011's. All of the data described in Footnote 11 should be considered in the test year federal tax estimates to the extent such data are available.

Adopted Results of Operations

Based on the foregoing discussion, the following are the 1978 test year operating revenues under PSA's proposed fares, and the operating expenses (excluding income taxes) adopted for the purpose of this proceeding.

TABLE 3

Pacific Southwest Airlines

Adopted 1978 Test Year
Results of Operations under
Proposed Fares
(+ 000)

Statistics	
Passengers	7,200.0
Flight Hours	66,412.0
System Load Factor	60.7%
Revenues	$181,751.2
Expenses	
Flying Operations	$ 67,879.3
Direct Maintenance	13,910.9
Indirect Maintenance	5,764.2
Passenger Service	10,764.4
Aircraft Servicing	9,893.1
Traffic Servicing	19,800.0
Servicing Administration	1,101.6
Reservations and Sales	13,459.8
Advertising and Publicity	3,447.4
General and Administrative	10,977.7
Depreciation	10,795.2
Total	$167,793.6
Operating Income	$ 13,957.6
Operating Ratio	
Before Income Taxes	92.32%

Findings

1. PSA seeks to establish increased air fares as set forth in Appendix A. A revenue increase of 8.37 percent, or $13,847,000 annually, is sought.

2. Evidence concerning the reasonableness of the proposed fare increase was presented by PSA and the Commission staff as indicated in the preceding opinion.

3. The estimated operating revenues under proposed fares, operating expenses (excluding income taxes), net operating revenues, and operating ratio set forth in Table 3 are reasonable for a 1978 test year and are adopted for the purpose of this proceeding.

4. The adopted test year operating results indicate that PSA would experience an operating ratio (before taxes) of 92.32 percent under the fares proposed. That operating ratio is reasonable for PSA's operations considering the fact that no federal income tax determination is imputed for PSA's 1978 test year operations. The authorized operating ratio of 92.3 percent produces a return on equity of approximately 13.0 percent.

5. The proposed fares set forth in Appendix A hereto will not result in excessive earnings; such fares are reasonable, and the increases resulting from the establishment of such fares are justified.

Conclusion

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

A.56973 ddb **

O R D E R

IT IS ORDERED that:

1. Pacific Southwest Airlines is authorized to establish the increased passenger air fares set forth in Appendix A attached hereto and made a part hereof.

2. Tariff publications authorized to be made as a result of this order may be made effective not earlier than January 1, 1978 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 of the date hereof.

4. In addition to the required posting and filing of tariffs, applicant shall give notice to the public by posting in its terminals a printed explanation of its proposed fares. 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 is the date hereof.

Dated at San Francisco, California, this 29th day of December, 1977.

Robert Batinovich
President

I concur - see attached
Robert Batinovich

I concur. see attached
William Symons

Vernon L. Sturgeon
Richard D. Gravelle
Claire T. Dedrick
Commissioners

APPENDIX A

Pacific Southwest Airlines
Present and Proposed Fares
(Including Fuel Offsets)

Route/Between Points (either direction) Regular Fares*	Present Fare		Proposed Fare		Increase	
	Excluding tax	Including tax	Excluding tax	Including tax	Excluding tax	Including tax
San Diego — Los Angeles, Burbank, Ontario, Long Beach	$11.53	$12.45	$12.32	$13.30	$ .79	$ .85
San Francisco — Sacramento, Stockton	11.53	12.45	12.32	13.30	.79	.85
Fresno — Stockton	11.53	12.45	12.32	13.30	.79	.85
Oakland — Sacramento	11.53	12.45	12.32	13.30	.79	.85
Fresno — San Francisco	15.05	16.25	16.34	17.65	1.29	1.40
Los Angeles — Fresno	18.84	20.35	20.37	22.00	1.53	1.65
Los Angeles/Burbank — San Francisco, Oakland, San Jose, Stockton	24.03	25.95	26.02	28.10	1.99	2.15
Long Beach — San Francisco, Oakland, San Jose	24.95	26.95	27.41	29.60	2.46	2.65
Ontario — San Francisco	24.95	26.95	27.41	29.60	2.46	2.65
Los Angeles/Burbank — Sacramento	24.95	26.95	27.41	29.60	2.46	2.65
Ontario/Long Beach — Sacramento	25.88	27.95	28.33	30.60	2.45	2.65
San Diego — Fresno	28.75	31.05	31.25	33.75	2.50	2.70
San Diego — San Francisco, Oakland, Stockton	29.91	32.30	32.41	35.00	2.50	2.70
San Diego — San Jose	29.68	32.05	32.41	35.00	2.73	2.95
San Diego — Sacramento	29.91	32.30	33.33	36.00	3.42	3.70
San Jose — Oakland	6.20	6.70	6.62	7.15	.42	.45
Los Angeles — Burbank	6.20	6.70	6.62	7.15	.42	.45
Los Angeles/Burbank — Lake Tahoe	33.33	36.00	34.03	36.75	.70	.75
San Diego — Lake Tahoe	37.96	41.00	38.75	41.85	.79	.85
Special Fares – Midnight Flyer Flights Only						
San Diego — Los Angeles	9.21	9.95	9.95	10.75	.74	.80
San Francisco — Sacramento	9.21	9.95	9.95	10.75	.74	.80
Los Angeles — San Francisco	16.76	18.10	18.01	19.45	1.25	1.35
Los Angeles — Sacramento	20.46	22.10	19.49	21.05	(.97)	(1.05)
San Diego — San Francisco, Sacramento	23.19	25.05	23.70	25.60	.51	.55
Experimental Standby Fare Designated Flights Only						
Los Angeles/ Burbank — San Francisco	15.74	17.00	17.96	19.40	2.22	2.40
Los Angeles — San Jose Oakland	15.74	17.00	17.96	19.40	2.22	2.40

*Children's fares at 50 percent of regular fares.

(End Figure)

Evidence Introduced By PSA

Exhibit No.	Witness	Subject
1	Eicher (Economic Consultant)	Rate of return. Cost of equity capital. Cost of replacement aircraft.
2	Barkley (PSA Vice President, Finance)	General information, including: (a) Efficiency of PSA vs other airlines. (b) Stock prices vs fares. (c) Competition and innovations marketing program. (d) Equipment replacement and its effect on ratemaking. (e) Operating ratio - "Pros and Cons". (f) Inflation and its effects on PSA. (g) L-1011 status.
3	Williams (Director of Product Development-Boeing)	Aircraft development (7N7 and 7X7 experimental aircraft).
4	Mitchell (PSA Asst. Vice President Operations)	(a) Traffic forecast. (b) Efficiency. (c) Competition. (d) Fleet modernization. (e) Regulatory reform - flexibility in authorized fare levels.
7	Guske (PSA Controller)	Projected operating results under present and proposed fares.
10	Michel (CPA)	Allocation of general and administrative expense; and costs per seat mile allocated to route segments.

Evidence Introduced By PSA

Exhibit No.	Witness	Subject
11	Dargie (Manager - Pacific Southwest Airmotive)	Results of operations - Pacific Southwest Airmotive.
17	Weston (CPA)	Accounting for deferred income tax treatment for ratemaking purposes based on an inflationary environment.
20	Michael (rebuttal)	Costing methodologies - route segment analysis.
21	Chandraselchar (rebuttal)	Statistical analysis methods.
23 through 31	Guske (rebuttal)	Adjustments to staff exhibits.

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ROBERT BATINOVICH, Commissioner, Concurring:

It has recently come to my attention that Shell Oil Company may be the only major supplier of jet fuel on the West Coast. If one of PSA's major cost items comes from a single supplier, then the Commission's attempt to give rhyme and reason to PSA rates is surely akin to playing poker with a stacked deck.

While the oil companies have gone to great lengths to convince people that there is true competition within the oil industry, the existence of a sole jet fuel supplier for the West Coast would not lend credence to such argument.

I hope that PSA's next application will show evidence of alternate suppliers as a showing of the company's desire to cooperate with the Commission's efforts to make rates which are fair to both PSA and the ratepayers.

Robert Batinovich

ROBERT BATINOVICH, President

San Francisco, California
November 29, 1977

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Commissioner William Symons, Jr., Concurring:

I concur with today's order in that the authorized air fare increase is more than justified by the facts presented in the record before us. Yet I am concerned with the discussion of the intended procedure for inquiry into the "matter of fuel supply for airlines." The issue should not be held until PSA's next general fare proceeding because the question clearly holds the potential for unfairly causing regulatory delay. Instead we should proceed by way of a generic Order Instituting Investigation. This is the course we followed with regard to the matter of "fuel supply" for electric utilities. Such a course has twin benefits: (1) we may begin the inquiry promptly and (2) additional air carriers who are as closely affected as PSA can be made party-respondents.

William Symons Jr.
WILLIAM SYMONS, JR., Commissioner

San Francisco, California
November 29, 1977