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Decision No. 89149 JUL 25 1978

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Southwest Airlines for authority to increase passenger air fares.	Application No. 58001 (Filed April 14, 1978; amended June 14, 1978)
Application of Pacific Southwest Airlines for an ex parte order for expedited authority to increase its intrastate fares.	Application No. 57912 (Filed March 3, 1978)

Brownell Merrell, Jr., Attorney at Law, for applicant.
Perry H. Taft, Attorney at Law, for City of Stockton; and Ralph G. Tonseth, Airport Manager, for County of San Joaquin; protestants.
Robert Barnett, Attorney at Law, for Air California, interested party.
William J. Jennings, Attorney at Law, for the Commission staff.

INTERIM OPINION

Pacific Southwest Airlines (PSA) seeks authority to increase its passenger air fares. PSA is a passenger air carrier providing scheduled air passenger transportation wholly within the state of California. Its executive offices are located in San Diego, and it operates maintenance facilities in San Francisco and San Diego.

A prehearing conference was held before Administrative Law Judge Wright on May 22, 1978, at which time hearing dates for presentation of evidence were determined.

An agreement was reached that PSA and the Commission staff would present projected operating results for the test year commencing July 1, 1978 through June 30, 1979. PSA stated its readiness to proceed immediately on all issues relating to its request for an increase in fares, but the Commission staff indicated that it would be unable to complete its report on PSA's projected operating results until September 15, 1978 for mailing to all parties on October 1, 1978. At the prehearing conference the Commission staff set forth its position that it had no objection to an interim fare increase of 11.3 percent effective July 1, 1978, as portrayed under the heading "7/1/78" on Exhibit A, page 1 of 3, of the application, provided that PSA institute an off-peak discount fare program containing two essential elements: first, that PSA offer a discount fare of 25 percent from the proposed 11.3 percent interim fare level; and second, that the discount fare be available on a standby basis on all flights on PSA's system, Monday through Thursday, from 10:00 a.m. to 2:30 p.m.

On or about June 14, 1978 PSA filed an amendment to Application No. 58001. The amendment modified PSA's request for interim fare relief by proposing increased peak-hour fare levels of up to 15 percent and proposing an off-peak discount fare program with discounts from present fares as much as 35 percent for passengers who make their reservations five days in advance. In addition, by its amendment, PSA requests that the discount fares be available between the hours of 10:01 a.m. and 2:59 p.m., Monday through Thursday, so that all route segments operated by PSA would have at least one discount flight. A summary of PSA's fare proposal is contained in Exhibit A[1/] attached to this decision.

1/ Exhibit A is attached for illustrative purposes and does not indicate the actual fares authorized by this decision.

In this proceeding PSA has emphasized the need for immediate fare relief. At the same time PSA witnesses have affirmed that given sufficient flexibility PSA could achieve its short-term financial goals with higher fares accompanied by a discount fare program, even though off-peak fare reductions would result in an estimated 7.4 percent net interim increase in revenue rather than the requested 11.3 percent. Accordingly, based on the premises quoted above, we focus our attention on the ultimate issue of whether PSA's immediate revenue needs justify the overall fare levels set forth in Exhibit A to the first amendment to Application No. 58001.

PSA currently operates twenty-four Boeing 727-200 aircraft, six Boeing 727-100 aircraft, and four Lockheed L-188 (electra) aircraft. PSA has on order four Boeing 727-200 aircraft scheduled for delivery in July and December of 1978 and two in the spring of 1979. PSA is continuing its retrofit program, modifying aircraft engines to satisfy federal noise standards, which must be met by 1980. PSA forecasts that nineteen 727-200 aircraft acquired between 1968 and 1970 will be retired in the mid-1980's. However, PSA's 727-100 aircraft which experience higher maintenance costs have been earmarked for replacement by 1982. While the retrofit modification can be accomplished by the use of cash or short-term borrowing, substantial additional equity capital or debt financing would be required for the acquisition of new aircraft (see Decision No. 88180, page 8). In this connection PSA's chief operating officer testified that PSA, under current fares, does not have the financial capability to underwrite the replacement of twenty-five aircraft, six 727-100's, and nineteen 727-200's.

As we concluded in Decision No. 88180, PSA will have the ability to acquire additional long-term financing at a reasonable cost only if its fare levels allow adequate interest coverage and are sufficient to meet other financial criteria required by lenders. Obviously long-term financing will be required to give reality to PSA's expressed intention to acquire up to ten DC9-80 jet aircraft (at a cost of $15,000,000 per unit) commencing in 1980 in order to replace aging equipment with a more fuel efficient and quieter fleet. Although in 1978 and 1979 PSA will be acquiring three additional 727-200 aircraft, PSA does not contemplate taking delivery of DC9-80 aircraft during the test period. PSA's projected operating results do not include provisions for long-term interest or other financing expense attributable to new generation equipment. However, PSA witnesses stated their belief that interim fare relief is a key factor in long-range fleet planning to meet future fuel conservation, operating efficiency, and environmental and competitive concerns.

We do not intend at this stage of the proceeding to adopt findings as to a maximum reasonable rate of return or operating ratio. Similarly, although the policy of this Commission has been to make provision for state and federal income taxes in test year operating expenses, we do not believe it appropriate in this interim decision to depart from the reasoning in Decision No. 88180 which uses a before-tax measurement of earnings as a standard for authorizing an increase in fares. In adopting, for purposes of interim relief, the operating ratio method of determining PSA's revenue requirements, we reaffirm our finding in Decision No. 88180 that "using a full flow-through of accelerated depreciation and investment tax credit for federal income tax purposes...an operating ratio (after taxes) in the range of 86.6 to 89.0 percent would be reasonable." It is concluded that an operating ratio before taxes of 89.88 percent, as set forth by PSA in Exhibit 4a, is reasonable for the purposes of this interim proceeding.

We emphasize, however, that our decision is predicated wholly upon the PSA presentation of its direct evidence, unchallenged to date. In Exhibit B attached to this decision we have set forth the prima facie showing by PSA which establishes the 89.88 percent operating ratio. The first column shows the test year results we established for 1978 in Decision No. 88180; the second column shows PSA's projections of test year 1978-1979 results if we granted the 8.43 percent rate increase sought in Application No. 57912; and the third column shows the difference. PSA currently expects to receive $205,921,000 in the 1978-1979 test year without rate relief, or $24,169,800 over our 1978 test year projection. It expects a further $16,868,000 should an increase of 8.43 percent be granted. On the expense side, PSA projects increased expenses for test year 1978-1979 of $32,440,400, an approximate 20 percent increase over our expense projections for 1978 in Decision No. 88180.

In the past we have actively encouraged PSA to adopt innovative fare programs in California which would make air transportation available to segments of the California population that might not otherwise utilize air travel. We note that PSA has at various times instituted discount fares of limited scope, such as the "bargain bird," "midnight flyer," group fares, and Saturday discounts. In this proceeding PSA witnesses have testified that without significant fare relief, PSA could not aggressively pursue wide ranging discount fares. Moreover, PSA has commented on the need for flexibility on the part of management to experiment with various innovative fare programs without lengthy administrative or procedural delays. We are now going to give PSA that chance, and we trust PSA will accept the challenges implicit in this decision.

As part of our authorization for the institution of the discount fare program illustrated in Exhibit A, we have decided that in this interim decision we shall also provide PSA with the latitude to experiment with fare programs that it has asserted will benefit not only the airline but also the traveling public. We are going to authorize PSA to raise its rates between any pair of points within a zone of reasonableness--up to 15 percent above present fare levels and down 35 percent below the fares currently in effect. This authority will include the right to alter or modify the proposed off-peak fare program. PSA will have full latitude to experiment in different markets, at different times of the day, different days of the week, or different seasons of the year, with whatever capacity, reservations, or ticketing controls PSA deems appropriate, provided that PSA files tariffs reflecting any changes no later than 10 days in advance of the change. Based on the record to date, we expect that if PSA responds with an aggressive innovative discount marketing program, its net revenues will increase by the approximate 7.4 percent projected in its first amendment to Application No. 58001.

We also note that the "up 15 percent-down 35 percent" concept would allow PSA to establish fare discounts virtually identical to that set forth in PSA's first amendment to Application No. 58001. For example, Exhibit A shows that a passenger traveling between Los Angeles and San Francisco during peak hours would pay a one-way fare of $32.00 or an increase of 14 percent over the current $28.10 fare. The "after 10 and before 3" discount fare would be $20.00, or a 29 percent discount over the current $28.10 fare.

This decision demonstrates our willingness to continually re-examine and re-evaluate our policies and programs. The Commission recognizes that in those industries which are not natural monopolies, in the classic economic sense, there can be a wide latitude in the degree of regulation required so that industries' practices are in conformance with the public interest.

We believe that whenever free market forces can govern an industry in the public interest, they should be allowed to do so with as little government intrusion as necessary. We feel that regulation should encourage innovation and, therefore, an industry should be given as much flexibility and latitude to respond to changing conditions as is reasonable.

At the same time, we recognize our statutory and constitutional duty to protect the public. We will not abdicate this duty. We realize that market theory does not always conform to reality, and we will regulate so-called competitive industries to prevent objectionable results that can arise whenever any of the underlying assumptions of a perfectly competitive model are missing. Historically, unreasonable rates, discrimination, destructive competition, and inefficient excess capacity are examples of problems that call for regulatory attention. We recognize that in an imperfect environment regulated competition, rather than free market forces, can often reduce the total cost to society of providing a service by encouraging a more efficient use of an industry's resources.

This decision, whereby we allow PSA to adjust its rates, within certain stated limits, to reach a reasonable operating ratio without the burden of lengthy regulatory delays is consistent with our views above. PSA, one member of an industry which is not a natural monopoly, will be given every opportunity to put into effect innovative fare structures. It will be afforded great flexibility to respond to market conditions without the need to seek Commission approval for every change.

Naturally, this freedom also carries great responsibility for the carriers to act in a reasonable manner and not to engage in any anti-competitive or other objectionable practices. The authorization contained herein will terminate one year after the effective date of this decision or upon further order of the Commission. During the interim period, PSA will review the status of its discount fare programs with the Commission staff at intervals of not more than 90 days except that PSA at the time of the renewed hearings will furnish testimony as to the programs that are in effect, and the results thereof. The Commission will closely monitor PSA as to its earnings level and fare-setting activity within the limits we have authorized and will not hesitate to modify this Interim Opinion should it appear that the flexibility granted is operating to the detriment of PSA's customers.

Findings

1. PSA seeks to establish increased air fares as illustrated in Exhibit A which will result in an estimated net passenger revenue increase of 7.4 percent. If PSA is authorized to increase its air fares by a maximum of 15 percent and to decrease its current fares by up to 35 percent, and if PSA responds with a discount program as proposed in its first amendment to Application No. 58001, the net revenue increase would be in the range of 7.4 percent.

2. PSA should be given the latitude to reasonably experiment freely with fare programs within the authorized 15 percent increase and 35 percent decrease provided that PSA files tariffs reflecting any change no later than 10 days in advance of the change.

3. Based on the evidentiary record to date the increases in rates authorized herein are justified and the rates and charges authorized herein are reasonable.

4. The estimated operating results as adjusted in PSA's Exhibit 4a show that an interim fare increase of 7.4 percent produces an operating ratio before taxes of 89.88 percent. In Decision No. 88180 we stated that an after-tax ratio in the range of 86.6 percent to 89.0 percent would be reasonable. Accordingly, 89.88 percent is reasonable for the purposes of this interim decision.

5. In order to give the public the benefit of these experimental rates as soon as possible, the order should be made effective on the date hereof.

Conclusion

We conclude that experimental rates should be authorized as provided in the order which follows.

INTERIM ORDER

IT IS ORDERED that Pacific Southwest Airlines is authorized to establish increased air fares and discount fare programs as described in this decision, not to exceed 15 percent by way of increase over present fares and not to exceed 35 percent by way of discount under present fares, on not less than ten days' notice to the Commission and to the public and for the period of one year from the date of this order or until further order of the Commission.

The effective date of this order is the date hereof.

Dated at San Francisco, California, this 25th day of JULY, 1978.

Robert Batinovich
President

William Symons Jr.

Vernon L. Sturgeon

Richard D. Gravelle

Claire T. Dedrick

Commissioners

I concur:
see attached.
Richard D. Gravelle

JD-15

A. 58001
D.

RICHARD D. GRAVELLE, Commissioner, Concurring:

I concur. I wish to point out that PSA has been an active supporter of federal legislation which would lead to all of the intrastate ratesetting being regulated by bureaucrats housed in Washington. One of PSA's voiced contentions is that California's regulation is too rigid, strangling its ability to compete and attract new air traffic. I have been baffled and troubled by PSA's tale of woe before Congress. But perhaps it is understandable in one sense. For it is all too easy for a regulated industry to gripe and propose shifting regulatory oversight from one bureaucracy to another, with a vague hope of finding a more benign (in its view) regulatory parent. The experimental fare structure authorized by today's decision could have been in operation years ago. PSA was apparently content to grumble but not come forward with constructive innovative ideas. Entities we regulate have the obligation to propose regulatory programs they think will benefit the particular industry and the overall public interest. This Commission is certainly receptive to exploring new ideas, and I trust that passenger air carriers (and the regulated transportation companies) will view today's decision as such a signal.

Richard D. Gravelle

RICHARD D. GRAVELLE, Commissioner

San Francisco, California
July 25, 1978

EXHIBIT A

IMPACT OF PROPOSAL ON FARE STRUCTURE

(All fares include tax)

Market	Regular Fares Old	Regular Fares New	Percent Increase	Discount Fares Amount	Discount Fares Percent Decrease
Entry Mileage	$13.30	$15.00	12.8%	$10.00	33.0%
Los Angeles Basin to N. California	28.10	32.00	13.9	20.00	37.5
	29.60	32.00	8.1	20.00	37.5
	30.60	32.00	4.6	20.00	37.5
San Diego to N. California	35.00	40.00	14.3	25.00	37.5
	36.00	40.00	11.1	25.00	37.5
San Diego-Fresno	33.75	36.00	6.7	22.5	33.0
Los Angeles-Fresno San Francisco-Tahoe	22.00	25.00	13.6	16.00	36.0
Fresno-San Francisco	17.65	21.00	11.9	13.50	36.0
Los Angeles Basin-Lake Tahoe	36.75	41.00	11.2	26.00	37.0
San Diego-Lake Tahoe	41.85	47.00	12.3	30.00	36.0
Local	7.15	10.00	40.0	10.00	--

Note: Children to be carried at one-half the regular adult fare.

(A) The entry mileage markets referred to in Exhibit A are: San Diego-Los Angeles, San Diego-Ontario, San Diego-Burbank, San Diego-Long Beach, Stockton-San Francisco, Sacramento-San Francisco, Monterey-San Francisco and Stockton-Fresno.

EXHIBIT B
(+000, Except for the Flight Hours)

	Adopted 1978 Test Year	Test Year Ending 6-30-79	Difference
Statistics			
Passengers	7,200.0	8,088	888.0
Flight Hours	66,412.0	75,277	8,865.0
System-load Factor	60.7%	60.8%	0.1%
Revenues	$181,751.2	$222,789	$41,037.8
Expenses			
Aircraft Lease	$	$ 767	$ 767.0
Flying Operations	67,879.3	76,863	8,983.7
Direct and Indirect Maintenance	19,675.1	26,577	6,901.9
Passenger Service	10,764.4	13,484	2,719.6
Aircraft Servicing	9,893.1	10,437	543.9
Traffic Servicing	19,800.0	24,507	4,707.0
Servicing Administration	1,101.6	1,779	677.4
Reservations and Sales	13,459.8	15,967	2,507.2
Advertising and Publicity	3,447.4	3,601	153.6
General and Administrative	10,977.7	13,661	2,683.3
Depreciation	10,795.2	12,591	1,795.8
Total	$167,793.6	$200,234	$32,440.4
Operating Income	$ 13,957.6	$ 22,555	$ 8,597.4
Operating Ratio Before Income Taxes	92.32%	89.88%	(2.44)%
Before Tax Profit as Percentage of Gross Revenue	7.68%	10.12%	20.95%

(Red Figure)