

COMMENT ON AIR MAIL SUBSIDY

RICHARD HELLMAN*

I. POLICY OF THE CIVIL AERONAUTICS ACT

In order to provide a frame of reference for our comment on the preceding article, we first outline our concept of the Civil Aeronautics Act's subsidy fundamentals.¹

The defense or military function. The aim of the subsidy is to accelerate a maximum civilian scheduled airline industry. (a) In passenger service, it should be used to encourage the greatest patronage and therefore the greatest number of planes, pilots, etc. This requires the lowest possible cost structure for the industry, making possible the lowest fares; that is, it calls for air coach service. Luxury service should be secondary. Since the greater return to the military function per dollar of subsidy would come through coach service, it perhaps follows that luxury service (which was the sole domestic scheduled service prior to November 1948) should pay its way entirely without subsidy.

(b) Cargo planes are immediately convertible to military use in an emergency, and for this reason are preferred by the military to passenger planes. By the use of bucket seats or removable reclining seats, as in the last war, cargo planes are also used to carry passengers. On military grounds, therefore, subsidy is equally, and, logically, more justifiable for cargo than for coach service. Cargo service is equally eligible with passenger service for subsidy under the Act.

The commerce function. Subsidy should be used to accelerate maximum passenger-cargo service and, when so used, is entirely harmonious with the military function. Coach service to reach the broadcast population base is a more appropriate use of subsidy than first-class service which generally reaches only the minor fraction of population which can afford to pay first-class fares.

The mail function. The establishment of an adequate system of routes and schedules for the carriage of mail having been substantially achieved as of today, the prime objective now is to carry the mail in the future at the cheapest cost to the post office.

The mail and passenger functions have developed to the point where a good case can be made out that they are able to stand on their own feet un-

* A.B. 1934, Columbia College. Economist with Federal Power Commission, March 1941 to November 1949. Testified on airline finances by invitation before current AIRLINE INDUSTRY INVESTIGATION of Senate Committee on Interstate and Foreign Commerce. Author of the chapter on "Air Transport" in textbook, STRUCTURE OF AMERICAN INDUSTRY, edited by Walter Adams, to be published in January, 1949.

1. 52 STAT. 980 (1938), 49 U. S. C. § 402 (1946).

supported;² and therefore the chief, if not entire, justification for continued subsidy is the military function.³ In setting forth the three objectives of subsidy, the Act does not give the CAB a blank check; the achievement of the purposes must be marked by orderly economy. The expense of subsidizing one function, for example, feeders, must be evaluated in terms both of furthering that function, and of the good to be derived from alternate use of the same funds for other functions, for example, coach service.

The Act is broadly drawn to endow the Board with great discretion and a multiplicity of powers to fulfill its functions successfully. Implicit is the corollary that the Board members exercise boldness and initiative in administering the severe responsibilities of the law.

II. ADMINISTRATION OF THE ACT

The various problems of the CAB, as outlined by Mr. O'Connell, are now discussed *seriatim*, proceeding from the concept of the subsidized airline businessman to the helplessness of the CAB in the face of the protective rate petition, the insoluble problem of excess capacity, the impossibility of disallowances for uneconomic costs, the CAB's despair with the route problem, poor capital structures, the unavailability of bankruptcy to the Board as an incentive to efficiency, and the good intentions for the Economic Program of 1949.

The Subsidized Businessman. After disclosing that the subsidy element in the mail pay is grossly unknown, that "the exact amount . . . is not of great significance,"⁴ and that it is more important to know the benefits, the Chairman concludes with a crucial concept: "the basic concern over mail pay is whether or not it leads all management to behave like businessmen and to make their decisions as businessmen normally do."

Here we have a fundamental misconception of the Board regarding its entelechy. For its "basic concern" should be to see that airline managements behave in a way to carry out the functions of the Act best. The businessman's preoccupation is to survive and to make the most profits. Any businessman who acted otherwise would be considered abnormal. His decisions, made in accordance with this primary drive, will not necessarily be the decisions best fitted to achieve the purposes of the Act and the subsidy; the harmonization of the two is the concern of the CAB. The Act lays a two-fold mandate on the Board: To fulfill the functions and to support airlines in doing so. But the *raison d'etre* of the subsidy is in the functions. However, the Board has

2. For a detailed development of this point by the author, see his testimony in *Air-Line Industry Investigation, Hearings, Part 2, Senate Committee on Interstate and Foreign Commerce*, pp. 927-977 (May 19, 1949).

3. The larger issue of whether continued subsidy for domestic service is necessary or desirable is not touched upon in this comment.

4. O'Connell, *Air Mail Subsidy*, 25 *IND. L. J.* 27, 28 (1949).

dispensed the subsidy primarily to support needy airlines and *not* to further a maximum transport system.⁵

For instance, Mr. C. R. Smith and Mr. W. A. Patterson are businessmen who respectively head the two largest domestic carriers, United and American Airlines. (They account for two-fifths of passenger traffic.) Both have concentrated their business acumen on building up luxury air service generally available only to upper income families. Both have been subsidized (*e.g.*, for grounding of the DC-6's).⁶ Until recently both stood adamant against coach service on the ground that it would not be a good business decision. The CAB did not differ. Yet, if the defense-commerce functions of the Act had been given first priority, the CAB would have taken bold initiative in favoring coach service, and in attempting to bring the businessman decisions of these airlines into line with the basic objectives of the Act and of subsidy. The fact that Mr. Smith, late in October, announced coach service plans should in no way be attributed to Board endeavors, but rather to competitive coach services already established.⁷

We would expect subsidy to be used to permit lower fares, and even to underwrite a dynamic fare policy, in order to accelerate expansion of demand. On the contrary, we find the initiative for lower first-class fares taken by the airlines least supported by mail pay, with subsidy used to buttress the deficits of higher-cost competing lines.

The Inevitability of Cost-Plus. A carrier can file a protective rate petition, we are told, and "It can then sit back, secure in the knowledge that if it loses money, it can get it back in mail pay except to the extent that such costs are reduced by disallowances."⁸ But, we are informed such disallowances have been difficult to make and unimportant on the whole. *Ergo* the CAB's pressing sense of futility. The Board's helplessness, however, is its own doing. In a permanent domestic mail pay rate for the future, which puts the airline on its own to develop business prowess and profits, the Board allows a return on investment of 8 per cent.⁹ However, in giving a rate to cover a past period previously under a temporary rate the Board awards 7 per cent.¹⁰ When

5. A normal businessman *sans* subsidy is, arithmetically, not the same as a normal businessman *cum* subsidy. Mr. O'Connell appears to want them to act the same, although his article attests to the real difference in norms. True, Rickenbacker of Eastern may act like one *sans* subsidy, but is he the norm or the exception?

6. CAB, American Airlines, Inc. et al, Serial Order No. E-2862, Docket No. 2849, May 25, 1949.

7. In submitting its proposed coach tariff to CAB, American indicated that the competition of irregular, non-scheduled carriers for transcontinental traffic was a strong factor in its action. See *Wall Street Journal*, November 14, 1949.

8. O'Connell, *supra* note 4, at 32.

9. CAB, Capital Airlines Inc., Serial Order No. E-2675, Docket No. 484, April 1, 1949, p. 59.

10. CAB, Northeast Airlines Inc., Serial Order No. E-1230, Docket No. 1932 and 1890, February 26, 1949, p. 34.

the Board, early in 1949, adopted a policy of allowing the specific cost of groundings, it eliminated the principal item of risk under temporary rates. If, then, as Mr. O'Connell says, airlines are on a true cost-plus under temporary rates (whether or not protective), is not 7 per cent too high a return? Or, if not too high, is not the 8 per cent too low for a permanent rate? For 1 per cent, a normal businessman would be a fool not to eliminate the risks of doing business by remaining perpetually under protective petitions, at least when the odds were against profits much above 8 per cent. The CAB, by establishing this slight differential, is itself responsible for the attractiveness of the protective petition. What if the Board allowed only 5 per cent on equity capital? Would it be inequitable for a cost-plus operation? Might there then not be an adequate incentive for the airline to stay off cost-plus? A current rate docket would be desirable. But, still, if the carrier is truly under cost-plus as the Chairman says, it would be no injustice to allow 5 per cent. The significance of the current docket then lies in the speed with which carriers can escape from the low returns of cost-plus to the 8 per cent of a risk operation. A 5 per cent return would make any carrier think twice before entering a protective petition. It is within the discretion of the Board,¹¹ and should obtain court approval without difficulty if contested.¹²

Excess Capacity. This major dilemma, which we are told is virtually impossible for the Board to solve, seems to be another case of stewing in its own juices. Exactly how does the Board view the problem? "The Board until recent periods has been fairly liberal with regard to this type of disallowance."¹³ Is this not an open invitation to businessmen to risk excess capacity?

"But there may well be a tightening up in this area as load factors decline and more and more excess capacity appears in the industry."¹⁴ How are we to reconcile this promise, however, with the later statement that, due to the protective petition, "The inevitable result has been, is, and promises to be, the operation of excess capacity the costs of which are borne by the Government?"¹⁵ The Board disallows only "flagrant" overscheduling. Is not this

11. 52 STAT. 980 (1938), 49 U. S. C. § 406 (1946).

12. There has been no court contest of any rate of return thus far allowed by CAB. Of the 5 per cent return allowed by Federal Power Commission to Safe Harbor Water Power Corp. because of the assured nature of the return. In the Matter of Safe Harbor Water Power Corp., 5 F. P. C. 221 (1946). This case is now pending on direct review in the U. S. Circuit Court of Appeals, 3d Circuit, as Safe Harbor Water Power Corp. v. Federal Power Commission. Compare the 5½ per cent return allowed to Chicago District Electric Generating Corp., 2 F. P. C. 412 (1941), which was uncontested. For an enlightened discussion of comparative trends of rate of return of different utilities see Freeman, *An Enlightened Judgment Approach to Rate of Return*, 61 HARV. L. REV. 1380 (1948).

13. O'Connell, *supra* note 4 at 33.

14. O'Connell, *supra* note 4, at 33.

15. O'Connell, *supra* note 4, at 35.

too an open invitation to airline management, acting like normal businessmen, to take fullest advantage of this definition to risk excess capacity in the future?

There is in this conflict of words a reflection of a characteristic of the Board, noted in several quarters, to say one thing and do another. A most obvious example at hand is the Board's famous "Blank Check" pronouncement of April 19, 1949, in the transatlantic mail pay awards to American Overseas Airlines and Pan American Airways. Having in mind that these carriers might be acquiring excess capacity in the Boeing Stratocruisers, the Board warned that "Section 406(b) of the Civil Aeronautics Act is not a blank check which air line management may fill in for any amount which it finds necessary to support whatever quantity or type of service which that management may see fit to operate."¹⁶ Shortly thereafter, however, the Board approved a request of Northwest Airlines for an RFC loan to acquire 10 Stratocruisers,¹⁷ half for use on its low-traffic transpacific operations where the question of excess capacity is certainly substantially greater than on the operations of the former two carriers. How, then, can it subsequently disallow the capacity of PAA and AOA retroactively, particularly when it, implicitly approved NWA's capacity in advance?

Apart from thus inviting and mayhap even sponsoring excess capacity, the Board has been allowing mail pay, on its own, for excess scheduling—which is closely akin to creating excess capacity. The Board, for example, gave NWA a route from Seattle-Portland to Honolulu, although an examiner had recommended against any such route on the ground of inadequate traffic, and added PAA on the President's order.¹⁸ The Board thereupon underwrote a combined total of five round trips weekly for both carriers. It could just as well have ordered two or three initially, until the traffic pattern was proved. This would have met the requirement of national defense and saved much mail pay.

Route System Defects. Under a cost-plus operation, the CAB Chairman asks, why should a carrier care whether its route pattern is the best one from the national viewpoint? The Board is responsible for a sound route system, "but the Board cannot discharge this responsibility unless the carriers assist it.

16. CAB, American Overseas Airlines, Inc., Serial Order No. E-2731, Docket No. 1666, p. 40. Also, Pan American Airways, Inc., Transatlantic Services, Serial Order No. E-2728, Docket No. 1706, p. 45.

17. CAB, Northeast Airlines, Inc.—Reconstruction Finance Corporation Loan, Serial Order No. E-3081, July 28, 1949. For a detailed analysis of the implications of this important decision, see the author's testimony in Reconstruction Finance Corporation Loan Policy, *Hearings, Senate Committee on Banking and Currency*, pp. 84-128, June 23, 1949; see also testimony of representatives of CAB and NWA in same.

18. Serial Order No. E-1832, Dockets Nos. 2537 et al, March 17, 1948; and Supplemental Serial Order No. 2048 in same Dockets, October 1, 1948.

The carriers are not likely to assist so long as they are not provided with any economic incentive for so doing." But, "There are no such incentives!"¹⁹

We are thus given three choices for the blame for this situation: (1) the Act, (2) "the present concept of establishing mail rates," meaning the Board, and (3) the carriers without whom the Board cannot discharge its responsibility for a route system. The carriers are acting like normal businessmen and perhaps should not be asked to bear the onus. We would not blame the Act, for Section 401(h) gives the Board ample power, except on grandfather routes, to alter, amend, modify, or suspend any certificate of convenience and necessity. No, it is the Board which must take the bow. It created the route system. Within wide vistas, it can uncreate and re-create, the better to serve the purposes of the Act. Moreover, the support of this route system by substantial subsidy should add to the Board's responsibility and initiative. But has the Board ever tested 401(h) boldly and forthrightly? How else can it know its powers and what the courts will sustain?

Airline Financial Structure. It is true that the Act does not give the CAB direct jurisdiction over airline capital structures, as have the ICC, the Federal Power Commission and the SEC in their utility fields.²⁰ However, there are more ways to skin a cat than one, and the Board has an excellent device in the rate of return allowed to subsidized airlines. Paradoxically, however, the Board has used this device to penalize good financial structures and put a premium on bad ones. It has invited and encouraged bad capital structures. For instance: TWA has about four-fifths debt and one-fifth equity capital, yet it will receive the same 10 per cent (future) or 7 per cent (retroactive) rate of return on its foreign operations as PAA which has three-quarters equity capital and only one-quarter debt. Due to leverage, the common stockholders of TWA will receive a much greater specific return than those of PAA, although they have the poorer structure. In the Capital Airlines permanent mail pay decision early in 1949,²¹ the Board pointed the way to encouragement of better capital structures by allowing only a 6 per cent retroactive return, rather than the usual 7 per cent, and 7 per cent for the future rather than 8 per cent, because of the distorted amount of debt in the capitalization. The quickest way to correct capital structures—something which cannot be done retroactively by new legislation without the greatest difficulty and delay—would be for the Board to allow a subsidized carrier the actual cost of borrowed money and preferred stocks, plus a liberal return on

19. O'Connell, *supra* note 4, at 36.

20. Interstate Commerce Act, 24 STAT. 379 (1881); 49 U. S. C. § 20a(2)(3)(11) (1940). 49 STAT. 453 (1935), 49 U. S. C. § 314 (1940); Securities Exchange Act, 48 STAT. 881 (1934), 15 U. S. C. §§ 78f, 78g, 78h (1940); Federal Power Act, 41 STAT. 1077 (1920), 16 U. S. C. §§ 803d, 824c (1940).

21. CAB, Capital Airlines Inc., Serial Order No. E-2675, *supra* note 9, pp. 37 and 59.

common stock. This would instantly provide an incentive to convert debt and preferred stock (which perhaps do not belong in airline capital structures at all) into common stock. In the subsidy feature of the Act, the Board has a stronger weapon for sound capital structures than it realizes; stronger, possibly, than direct security regulation (which, nevertheless, it should have).

Lack of Incentives to Economy and Efficiency. The Board is worried about the economy and efficiency of airline managements. Unless incentives are found promptly, we are told, mail pay will climb.

But what is far more important, the economic soundness of our air transportation system may be seriously and permanently undermined because of the atrophy of the ability of airline management to behave like businessmen.²²

Here again the left hand seemeth not to know what the right hand doeth. For if the Board desires efficiency and economy, it must penalize the opposite. If a carrier, by being inefficient or uneconomical, improvident or imprudent, finds itself on the verge of stress or even bankruptcy, and if the Board then forbears to make the companion disallowances in order to stave off stress or bankruptcy, what then remains of that most powerful of all incentives to efficiency and economy—the fear of bankruptcy? And yet we find the Board's philosophy and actions doing just so.

Disallowances which are too large tend to defeat the purposes of the Act in that they may so weaken the carrier that it may no longer be in financial position to develop their routes and services in the soundest and most expeditious manner.²³

Again,

The total of the disallowances which have been made in recent rate cases is relatively small and those which have been made have had to do more with the economics of the carrier than with its efficiency . . .²⁴

Further,

Under the Act *and the present concept of establishing mail rates* a carrier is virtually assured that the Government will make up any losses involved in operating a given route pattern, provided there is not flagrant overscheduling.²⁵

Of bankruptcy, we are told that "In the air transportation business, *as it is conducted today*, this astringent is no stronger than water."²⁶

22. O'Connell, *supra* note 4, at 37.

23. O'Connell, *supra* note 4, at 34.

24. O'Connell, *supra* note 4, at 34.

25. O'Connell, *supra* note 4, at 35.

26. O'Connell, *supra* note 4, at 37.

We have here a circular trap of the Board's own doing. If airlines are to be preserved against inefficiency, ineconomy and bankruptcy, may they not test inefficiency and ineconomy with impunity? Has the Board perhaps lost sight of the function of subsidy, in attempting to live with airline managements?

There is more than theory in these questions. In approving the RFC loan to NWA in 1949, to cite one instance, the Board did so *in toto* as submitted.²⁷ Even had the Board not wished to reject the loan entirely, it could have approved with salutary conditions substantially short of everything requested.

The Economic Program of 1949. About a third of Mr. O'Connell's manuscript is devoted to the importance of this program of investigations in shoring up the industry. Yet the program is characterized as "Barely a start . . . barely more than a statement of good intentions."²⁸ This is eleven months after the program was announced in February, 1949. In advancing its program, the Board expected to receive an increase in appropriations for the fiscal year 1949-50, instead of which it received a disappointing cut. It is difficult to see, therefore, how the program can be relied upon in the coming year to make fundamental changes for the better in achieving the functions of the Act. Mr. O'Connell obviously is dissatisfied with the Board's work to date, for in the closing paragraph of his manuscript he rejects the idea that "the Government and the industry can continue along the same lines in which it has been moving since the war, no matter how comforting to the airlines that course of action might be."²⁹ Yet when we are told "There is little doubt that we can and will succeed in recreating an atmosphere and a legislative framework in which air transportation can move forward on sound economical lines,"³⁰ why are we not also told where this will come from? The Economic Program is scarcely more than a good intention. The past record of the Board casts no hope for the future before it. When, then, the change?

Separation of Subsidy and Service Mail Pay. Fundamental to the problem of efficiency and economy among airlines is the separation of the subsidy element in mail pay. The problem is more urgent, strange as it may seem, for the Big Four than for the other definitely subsidized airlines. For in many respects, action is difficult to take with the latter unless it can also be taken with the former. For instance, the Board may become convinced that subsidy should not be paid out for luxury service. It may want to tell National Airlines that subsidy is not intended to finance its super-luxury Miami service, and that it will have to spartanize its first-class service or foot the

27. See note 17 *supra*.

28. O'Connell, *supra* note 4, at 37.

29. O'Connell, *supra* note 4, at 41.

30. O'Connell, *supra* note 4, at 40.

bill out of its own pocket. However, National competes with Eastern, which may continue to offer a deluxe service. The Board's grip on National's service is through subsidy. But if Eastern is not subsidized, the Board has no control over the degree of luxury of its service.

Similar considerations govern and complicate the Board's control over scheduling, equipment and capital structures. Its power is greater where the airlines involved are all subsidized. A mixed situation is harder to handle. But until there is some kind of subsidy separation, the Board does not know what it has on its hands.

Regarding the Big Four investigation, Mr. O'Connell may not have stated the purpose accurately. The aims, he says, are (1) to determine how far the lack of economy and efficiency may have caused losses (Eastern Airlines made money all along), or (2) whether, alternately, the Four are "need" carriers to be given subsidy. However, they could be inefficient and uneconomical and still require no subsidy; or they could be efficient and economical, and still require subsidy. Therefore, the aim should be to determine the amount of subsidy present in their mail pay, if any; or, more properly, to determine their efficient costs for carrying the mail.

It does not seem possible, incidentally, that after 11 years of existence the Board should not yet know whether priority of mail over passengers costs nothing, or much, or mail is easy or hard to handle, or the variability of its volume, or the proportion of ground handling costs borne by the post office.

Freight Subsidy. The CAB "is convinced that the freight business should be entirely self-supporting. . . ." ³¹ We share this view. But may we raise a question which has puzzled us for some time? As noted in our frame of reference at the very start of this comment, the Act does not ban or favor subsidy to air cargo any more than to passenger service, but a better case can be made out in behalf of the military function for subsidizing freight. How consistent, therefore, is the favoring of luxury passenger service with subsidy, and the denial of it to freight?

III. CONCLUSION

It would be an error of omission not to grasp the opportunity to comment on the Board's accounting and statistical reporting. To one acquainted with the careful and specific requirements of mature regulatory agencies, and with the potency and indeed the *sine qua non* of these weapons in regulation, the Board's requirements seem cavalier in their nonchalance. Why, for example, should Eastern Airlines depreciate her new four-engine equipment in four years, as against seven years for other carriers? Why should PAA and NWA use five years for new two-engine planes, compared with the seven years of

31. O'Connell, *supra* note 4, at 39.

AA and other airlines? Regardless of the fact that the Board, in mail pay decisions, uses seven years uniformly,³² how is it that the uniform principles of accounts do not specify the rates of depreciation so that at least the interested public and investors will find the carrier reports comparable and to that extent meaningful? In statistics, the reporting is by esoteric breakdowns which bar rather than assist critical analysis. For instance, if one wished to evaluate the load factors on the Seattle-Hawaii route, the passenger-miles by good fortune are available for NWA, but are lumped with Los Angeles and San Francisco traffic by PAA, thus preventing the necessary analysis; load factors, which should be reported directly, moreover, can only be derived by complex, lengthy and uncertain improvisations. Coach service traffic and financial results, at least in the regular reports available to the public, are not reported separately, thus frustrating analysis either of coach service itself or of its effects on first-class service. There are numerous other instances, but we shall not labor the point beyond asking how these practices can be reconciled with an effective system of regulation and evaluation of subsidy results.

One vital item ought to be noted here which Mr. O'Connell's article has not developed to any extent—coach service. In our frame of reference we have outlined our views on the priority that coach should be given over first-class service. It is understandable that the Board, confronted with the very real problem of integrating coach service into a network which historically has been entirely first-class, should move cautiously, and with this we have no quarrel. We find it difficult to understand, however, why the Board should allow many of our subsidized airlines to offer super-luxury service and, indeed, to outdo "service" rate carriers and set the pace for luxury.³³

To conclude and summarize this comment, many major deficiencies of the airline complex can be cured more or less readily by powers and discretion already in the hands of the Board, if the Board will but use them. With regard to feeders, the benefits either to defense, commerce or mail in general seem so inconsequential relative to the subsidy required, that they do not

32. The Board notes the disparity of depreciation rates for 4-engine equipment in American Airlines, Inc. et al, Serial Order Nos. E-1351 et al, Dockets Nos. 3309 et al, March 29, 1948, p. 10, and assigns its 7-year basis on p. 50. Similarly, for the Convair-240 the rate is set in Western Airlines, Inc., Serial Order No. 2795, Docket No. 1374, May 6, 1949; and for the Martin-202 the CAB's dissatisfaction with the carrier's 5-year rate is expressed in Northwest Airlines, Inc., Serial Order No. 2290, Docket No. 3211, December 15, 1948, p. 5. Depreciation rates used by individual carriers are shown in their quarterly Form 41 reports to CAB on acquisitions of new flight equipment.

33. American Overseas Airlines' Sleeper Lounge service to Scandinavia is advertised as follows: "Designed for 43 passengers, American's Constellations are luxuriously fitted out for only 23!" (*The Washington Post*, November 25, 1949, p. 10.) A domestic carrier advertises, "National Airlines proudly presents the STAR-DC-6 *Luxury PLUS*. . . . The STAR is the hallmark of travel perfection . . . provides even *more superb* service than you've always enjoyed on National Airlines. ONLY NATIONAL GIVES YOU THE STAR." (*The Washington Post*, January 10, 1950, p. 19. Emphasis is National's.)

seem justified except possibly for special cases.³⁴ Again we would prefer to see the funds channelled into support of coach service (which, however, gives every evidence thus far of being self-sustaining).

34. For a detailed analysis of Feeder economics, see the writer's testimony in Air-Line Industry Investigation, *supra*, pp. 967-974.