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# REPORT TO THE CONGRESS



BY THE COMPTROLLER GENERAL  
OF THE UNITED STATES



## Why The Federal Airline Subsidy Program Needs Revision

Civil Aeronautics Board

The Civil Aeronautics Board's subsidy program, which annually pays airlines about \$60 million to serve small communities, needs complete revision.

The Congress should authorize the Civil Aeronautics Board to restructure the current airline subsidy program to provide necessary air services to small communities at the least cost to the Federal Government.

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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

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To the President of the Senate and the  
Speaker of the House of Representatives

This report discusses the need for the Congress to provide the Civil Aeronautics Board with a legislative mandate to restructure the airline subsidy program to insure necessary air services to small communities at the least cost to the Federal Government and identifies ways program effectiveness can be improved.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Director, Office of Management and Budget; the Chairman, Civil Aeronautics Board; the Secretary of Transportation; interested congressional committees; and other interested parties.

A handwritten signature in black ink, appearing to read "Thomas B. Athol".

Comptroller General  
of the United States

D I G E S T

The Civil Aeronautics Board has concluded that its subsidy program, which annually pays airlines about \$60 million to serve small communities, needs complete revision. GAO agrees.

The program is directed at sustaining local service airlines (those serving specific geographic areas) rather than necessary air service to small communities which cannot support air service without Federal subsidy.

Essentially, the program finances losses that airlines incur in serving small communities without regard to the appropriateness of routes, flight frequencies, or type of aircraft used. This is brought about primarily because the Board has not defined specific services which should be subsidized.

The Board's proposal opens the door for a more rational Federal approach to maintaining and expanding service to small communities. The Board's proposal would base subsidies on a given level of service on a route with a specified aircraft type. While the Board can change the program, it believes new legislation would enable it to be more effective. GAO agrees. (See pp. 16 and 17.)

The Board needs to (1) establish criteria that spell out who is eligible for subsidy, (2) define "adequate service," and (3) periodically reevaluate the continued need to provide a city with subsidized air service, considering the service it receives from unsubsidized airlines and its proximity to larger airports. Furthermore, the Board needs authority to subsidize commuter and intrastate airlines because they often can serve small communities at lower costs than other airlines. (See pp. 6 to 17.)

The Congress should provide the Board with a legislative mandate to restructure the current subsidy program and direct it to

- establish standards to measure when a community's air service is inherently unprofitable and warrants Federal subsidy,
- establish a standard of what is adequate service to a community and base subsidy on the actual cost of providing the service,
- subsidize uncertificated airlines when they can provide necessary small community air service at lower costs,
- periodically reevaluate air service at all subsidized communities to determine if they continue to merit Federal subsidy support, and
- consider scheduled air service provided by unsubsidized airlines in evaluating the need for and adequacy of air service at small communities.

Both the Civil Aeronautics Board and the Department of Transportation agreed that the current subsidy program needs reform. The Board stated it is moving in the direction suggested by the report. (See pp. 18 to 21.)

The airlines agreed with GAO's overall conclusions, but expressed concern that the eligibility criteria and adequacy of service standards to be developed may be inappropriate if they and the communities are not involved in their formation. (See p. 21.)

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### ABBREVIATIONS

CAB	Civil Aeronautics Board
GAO	General Accounting Office

## CHAPTER 1

### INTRODUCTION

In March 1977 the Civil Aeronautics Board (CAB) proposed a new airline subsidy program designed to reduce Federal costs and improve air service to the Nation's smaller communities. We have reviewed the evolution of airline subsidies to the current subsidy program and agree with CAB. Reform is needed. This report discusses the current subsidy program, identifies its problems, and suggests ways to correct them.

### CURRENT SUBSIDY PROGRAM

Over 200 small communities throughout the Nation receive federally subsidized air service to further commerce, postal service, and national defense. Ordinarily, because of too little demand, these communities would have no air service.

According to CAB, the subsidy program is also intended to promote adequate, economical, efficient, and convenient air service to feed traffic from small- and medium-sized communities into a network of service between major traffic airports. CAB administers this program under the Federal Aviation Act of 1958, as amended (49 U.S.C. 1301 et. seq.).

From the program's beginning in the early 1940s, CAB has paid airlines about \$2 billion in Federal subsidies, of which \$1.2 billion have been made to local service airlines--those carriers which generally operate in specific geographic regions of the Nation. The remaining subsidy payments were made to the national and international trunk airlines, Alaskan and Hawaiian airlines, and some helicopter services. CAB can subsidize all these carriers, but in recent years only local service and Alaskan airlines have been subsidized.

Subsidies in fiscal year 1976 amounted to \$72 million--\$68 million to local service airlines serving the 48 contiguous States and \$4 million to airlines serving Alaska. This report deals exclusively with subsidized local service airlines in the 48 contiguous States, except New England. At the time of our review CAB was reviewing the need for Alaskan subsidy support. New England's subsidized air service was not reviewed because it is a unique, experimental program.

## DOMESTIC AIR SERVICE

Most domestic passenger service in the United States is provided by four categories of airlines--trunk, local service, commuter and air taxi, and intrastate.

### Trunk airlines

The trunk airlines, which include the largest carriers, carried about 160 million passengers in 1976, accounting for most domestic air service. These carriers are:

American Airlines	Northwest Airlines
Braniff Airways	Pan American World Airways
Continental Air Lines	Trans World Airlines
Delta Air Lines	United Air Lines
Eastern Air Lines	Western Air Lines
National Airlines	

CAB specifies the cities each airline can serve and the fares they can charge. CAB does not specify the number of flights they must provide, except that they maintain a minimum level of service.

### Local service airlines

In 1976, these local service airlines carried about 38 million passengers. CAB regulation of local service carriers is similar to its regulation of trunk airlines. However, all local service airlines, except Allegheny Airlines, are subsidized to serve some locations.

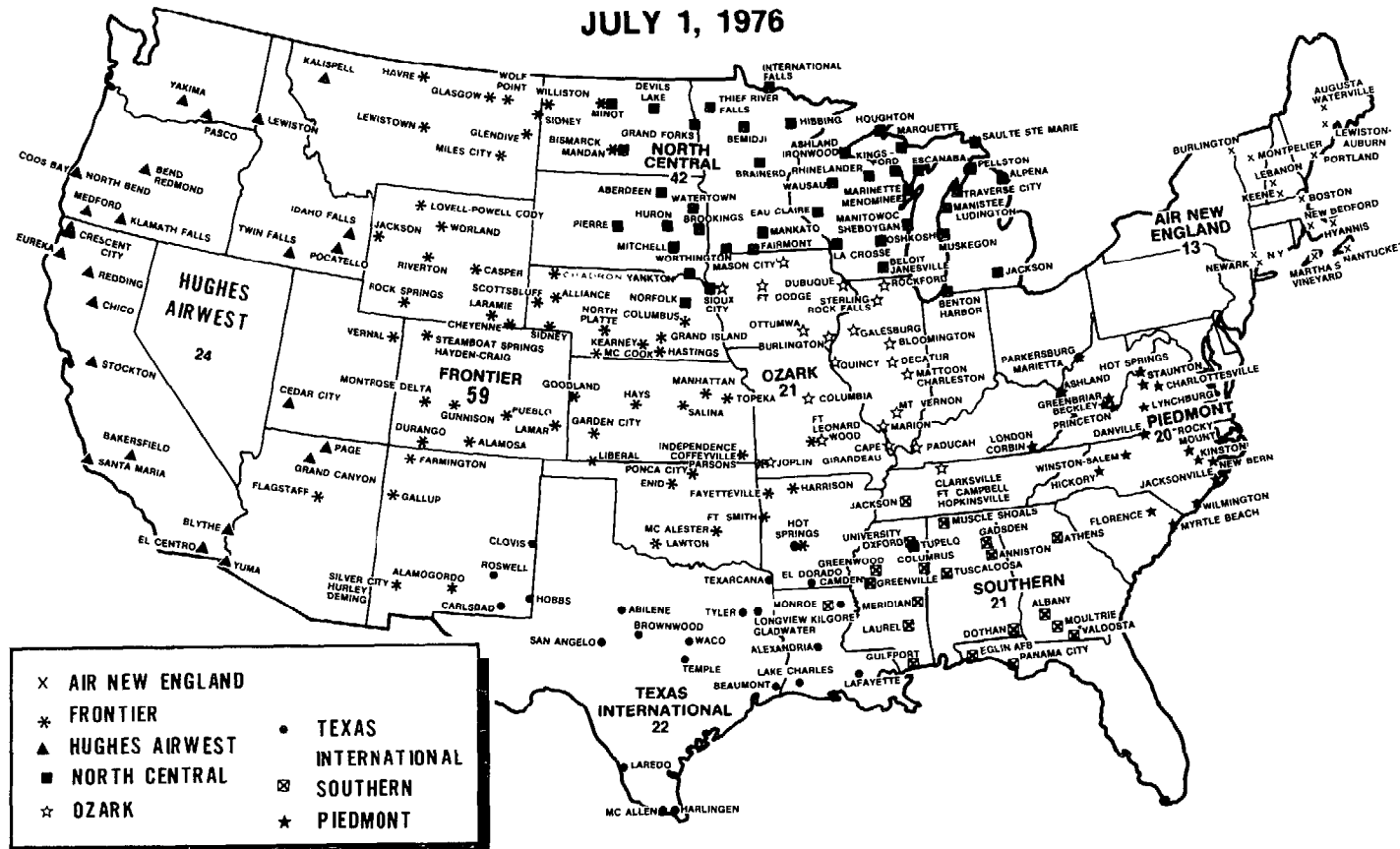
### Commuter and air taxi airlines

CAB defines commuter airlines as those which (1) make at least five round trips per week between two or more points according to a published schedule or (2) transport mail under contract with the U.S. Postal Service. Air taxi airlines differ from commuters in that they do not have fixed flight schedules.

CAB requires these airlines to use aircraft which have a payload of less than 7,500 pounds and seat no more than 30 passengers. Apart from the weight and size limitations, CAB imposes almost no economic regulatory restrictions on their operations. These airlines can begin or end service to any city, provide any level of service, and charge any fare. They are, however, required to register with CAB, report some traffic statistics, and carry liability

# LOCAL SERVICE AIRLINES AND SUBSIDY ELIGIBLE CITIES SERVED

JULY 1, 1976





insurance. In the year ended June 1976, commuter airlines carried about 7 million passengers.

### Intrastate airlines

Intrastate airlines operate entirely within the boundaries of a single State and are not regulated by CAB. Unless restricted by the State, the airlines can serve any city within the State, use any type of aircraft, and charge any fare.

In March 1977, there were seven intrastate airlines:

--One in Alaska.

--Three in California.

--One in Florida.

--One in Illinois.

--One in Texas.

The intrastate airline operations, in many respects, are comparable to the local service airline operations.

### HISTORY OF SMALL COMMUNITY AIR SERVICE

To connect small communities with air transportation to most larger cities, local service airlines initially were certified to make relatively short flights between these communities and cities served by trunk airlines. CAB recognized that these small communities had limited traffic potential and would require subsidization.

Most cities now served by local service carriers and many previously served by truck carriers were certificated to receive subsidized service in the 1940s and 1950s. Originally, some stops were required by the shorter range of aircraft at the time; others were served because of airmail requirements in the 1930s.

New cities, frequently small with unknown or marginal traffic potential, were added to the local system during the 1940s through the mid-1960s. During this period CAB adopted a liberal policy of approving new service on the premise that if traffic did not develop, the service would be terminated. To guarantee this, CAB adopted a use-it-or-lose-it policy which had two facets:

--Each city receiving service had to average five or more passengers daily.

--New flights between two cities had to average at least five passengers.

Because of the use-it-or-lose-it policy and airline requests to terminate or suspend flight service, many cities with little traffic have been removed gradually from the system.

#### SCOPE OF REVIEW

In reviewing the evolution and effectiveness of subsidized airline service to small communities, we examined CAB policies and procedures and pertinent legislation, regulations, and judicial decisions. We also interviewed agency personnel.

We worked primarily at CAB headquarters in Washington, D.C. We also visited two local service airlines--Hughes Airwest and Frontier Airlines--to obtain information on their subsidized air service. To ascertain the type of service provided and the consequences of losing certificated service, we obtained information from several communities served or formerly served by these airlines.

We met with officials of two State airline regulatory agencies and several commuter and intrastate airlines to obtain their views on small community air service.

## CHAPTER 2

### SUBSIDIES ARE DIRECTED AT SUSTAINING AIRLINES, NOT SMALL COMMUNITY AIR SERVICE

The Civil Aeronautics Board's subsidy program does not guarantee only necessary air service to small communities at the least possible cost. The program is directed at sustaining local service airlines rather than service to small communities.

Federal subsidies to airlines are based on their need for revenues to earn a fair return on the investment used to serve designated subsidy-eligible communities. Although the program provides incentives for airlines' efficiency, it essentially finances airlines' losses incurred in serving small communities.

CAB does not limit subsidy only to necessary air service which is inherently unprofitable under efficient management. Instead, CAB subsidizes airlines for any number of flights they choose to provide to an eligible community with any type of aircraft. It also provides airlines with great freedom in determining the city-pair routes to be flown from the subsidized city.

Most subsidized air service to small communities originated before 1965; since then, changing circumstances have caused CAB to end subsidized service to some cities. Other cities, however, with similar characteristics, continue to receive subsidized service.

### CAB SUBSIDY PROCEDURES

Section 406(a) of the Federal Aviation Act authorizes CAB to provide the method or methods to pay a subsidy. Before January 1961 CAB usually established a subsidy rate for each airline by reviewing its financial reports; however, this was time consuming and cumbersome and led to long delays in processing subsidy claims.

In 1961, CAB began computing subsidy rates using a single formula based on average local service airline costs and revenues, rather than on individual airlines' financial results. CAB refers to the formula as a "class rate" because it applies to all airlines in the local service airline class.

The current class rate became effective July 1, 1976, and, like previous class rates, attempts to give each

subsidized airline the opportunity to earn a fair return on its investment. The class rate creates incentives for managerial efficiency by attempting to induce airlines to

--operate a maximum of two round trips each day (124 departures a month) in each city pair eligible for subsidy and

--use aircraft seating less than 50 passengers.

Although the class rate provides incentives for efficiency, it essentially finances an airline's losses in providing service to subsidy-eligible communities in 1976, regardless of the daily flights flown or type of aircraft used by the airline.

For example, two local service airlines--Ozark Airlines and North Central Airlines--received subsidy payments for providing service between Sioux City, Iowa, and Sioux Falls, South Dakota, for the year ended March 31, 1976. This is one of five instances where two local service airlines were both subsidized to serve the same city-pair market. As the following table shows, they provided different flight service and used different types of equipment, resulting in different subsidy requirements.

	<u>Ozark Airlines</u>	<u>North Central Airlines</u>
Departures a month (March 1976)	185	274
Aircraft most often used	DC-9 (75-to 95-seat jet)	CV-580 (48-seat turboprop)
Subsidy needed to earn a fair re- turn on invest- ment	\$738,000	\$409,000
Average subsidy per passenger (note a)	\$ 25	\$ 21

a/Based on the passengers originating or terminating at Sioux City on flights going through Sioux Falls.

CAB has stated, and we agree, that Federal funds could be more effectively used if subsidies were based on the cost of providing a given level of service between a city pair with a specified aircraft type, rather than upon the airline's need for subsidy.

DEFINITION OF SUBSIDY ELIGIBILITY  
IS INADEQUATE

CAB knows that some subsidized operations included services between large cities which could have been operated profitably with appropriate equipment and schedules, but often were not. To correct this, in July 1976 CAB established new criteria, limiting subsidies to cities where certificated airlines enplane <sup>1/</sup> less than .05 percent of all domestic passengers (fewer than 96,537 annual or 264 daily passengers). CAB said this was merely a step toward a more exacting definition of the small community services which require subsidy support. CAB's revised definition does not consider scheduled airline enplanements by uncertificated airlines, and does not assure that only inherently unprofitable services are subsidized.

Not all scheduled enplanements considered

Eligible communities are automatically eliminated from the subsidy program if CAB certificated airlines enplane more than 96,537 passengers annually. This ignores the scheduled air services often provided to the same communities by uncertificated airlines--intrastate and commuter airlines. Thus, the traffic and profit-generating ability of some communities seems underestimated.

If CAB considered all scheduled air services, i.e., trunk, local service, intrastate, and commuter airlines, some subsidized communities would become ineligible. For example, Bakersfield, California, applying CAB's criteria, is eligible for a subsidy because CAB certificated airlines enplaned 94,761 passengers in 1975. Adding the enplanements of a commuter airline serving Bakersfield, its 1975 enplanements were 97,460 passengers, exceeding CAB's definition of a subsidy-eligible community. Because not all data on intrastate and commuter enplanements was readily available, we did not assess the effect these airlines had at other subsidized cities.

Subsidy may not be limited to inherently unprofitable operations

Because of CAB's current criteria, the subsidy program has not been directed to inherently unprofitable services. In a 1972 report, CAB's Bureau of Operating Rights estimated

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<sup>1/</sup>According to CAB definition this refers to the number of passengers boarding airlines at a specific community.

that most cities where airlines enplane at least 40 passengers daily have profit potential. According to CAB, this standard approximates the threshold at which unsubsidized service can be provided with large turboprop aircraft.

At some eligible cities, the subsidized airline enplanes many passengers because it is either the only or the dominant airline serving the city. As the following table shows, local service airlines enplaned over 40 passengers daily at many eligible cities.

<u>Subsidized airline</u>	<u>Cities which enplaned more than 40 passengers a day for the year ending June 30, 1975</u>  (percent)
Frontier	31
Hughes Airwest	63
North Central	43
Ozark	43
Piedmont	60
Southern	67
Texas International	50

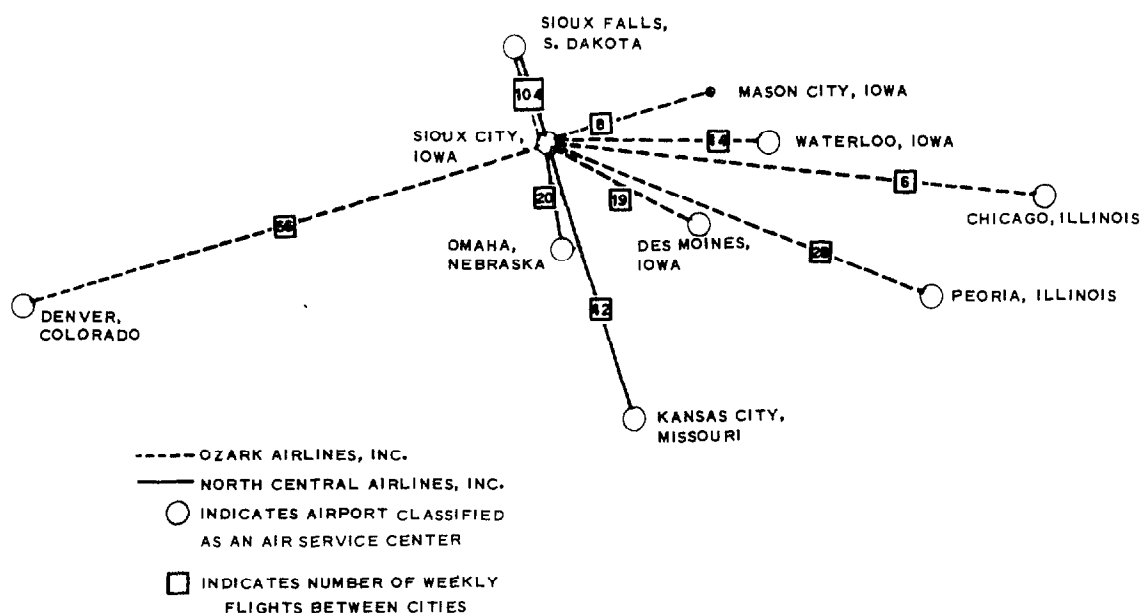
Using the 40-a-day criteria, the 1976 subsidy payments to airlines could be reduced by about 57 percent according to CAB.

Further, the Department of Transportation, in a March 1976 report, "Air Service to Small Communities," stated that most cities with 80 passengers a day could support service by the jet aircraft likely to be operated by local service airlines.

CAB HAS NO DEFINITION OF ADEQUATE  
SUBSIDIZED SERVICE

The local service airline system was designed to link small communities with air-service centers (larger airports) where connecting service is available to distant places. CAB has not, however, defined how much linking service a subsidized community should receive. The subsidized airline has great freedom in determining the routes to be flown between the subsidized city and other cities included in its route authority, and can independently determine the number of daily flights to be flown. For example, Sioux City, Iowa, a subsidy-eligible community, was connected with nonstop air service to nine other cities, eight of which were air-service centers.

ROUTES AND WEEKLY FLIGHTS SERVING  
SIOUX CITY, IOWA MARCH 1, 1976



Both Ozark and North Central served these city-pair markets on a subsidy-eligible basis, except for North Central's Sioux City-Kansas City route and Ozark's Sioux City-Denver route, which CAB excluded from subsidy eligibility. In 1976 both airlines generated a \$1.4 million subsidy need for serving Sioux City, of which \$1.1 million was for service on the Sioux City-Sioux Falls route which they both served.

Apparently Sioux City receives substantial subsidized and unsubsidized service connecting it to the national air transportation system. The need for subsidized service, particularly when two airlines serve one route, seems questionable.

To assess the extent that cities receiving subsidized air service are connected to the national air transportation system, we analyzed all air service to the 22 cities eligible for subsidy which Ozark Airlines served on March 1, 1976. These cities were connected to the national air transportation system to varying degrees. Two cities received one-stop service to an air-service center while another city received nonstop service to eight such centers. The remaining 19 cities received nonstop service to air centers as follows:

7 cities to 1 center.  
2 cities to 2 centers.  
7 cities to 3 centers.  
2 cities to 4 centers.  
1 city to 5 centers.

Until CAB determines how much service a small community needs for reasonable access to the national air transportation system, CAB will not know whether

--each community is receiving the linking service it needs or

--Federal funds are supporting only necessary service.

#### NEED TO PERIODICALLY REASSESS SUBSIDY SUPPORT

CAB certificated most subsidized air service to small communities before 1965; since then circumstances which justified certification at many communities have changed. In some cases, airlines have requested and CAB has approved the deletion or suspension of subsidized air service. However, many cities still receiving subsidized service have similar characteristics:

--The city is within reasonable driving time to another city which has adequate air service.

--The city is served by either unsubsidized local, trunk, intrastate, or commuter airlines.

CAB has not periodically reviewed air service to all subsidized communities to identify those which may no longer merit subsidy support.

#### Proximity to larger airports

The benefit of air service to any community cannot be determined without considering the community's access to nearby airports served by the national air transportation system. Location plays an important role in determining whether a community will develop more than marginal traffic. Even a large city often will not develop its full air transportation potential if a larger airport in a nearby city provides better service in terms of flight frequencies and places served.

The Bureau of Operating Rights developed a standard defining a community's isolation so that CAB can measure the individual characteristics of each community.



Basically, the standard relates a community's isolation to the time it takes to travel by automobile to the nearest air-service center. It provides that:

--No community is isolated if it is less than 90 minutes driving time from an air-service center, while all communities 136 or more minutes driving time away are isolated.

--Communities requiring between 90 and 136 minutes driving time are isolated or not isolated depending on the number of flights available at the adjacent air-service center. Essentially, the larger the airport in terms of available flights, the greater the permissible driving time before a community is considered isolated.

In December 1974 the Bureau evaluated the isolation of 140 communities served by local service airlines enplaning 40 or less passengers--which the Bureau considered as having poor profit potential. The Bureau found that 72 of these communities (52 percent) were not isolated according to its standard.

CAB did not reevaluate the need for continued subsidized air service at most of these communities. Of the 26 communities it reevaluated, 23 were at the airline's request and 3 others were transferred to Air New England as part of an experiment.

Because changing conditions can alter a community's need for subsidy, CAB needs to periodically reassess its subsidy support to communities. The Bureau's isolation standard is an objective way to highlight communities that CAB may need to investigate to ascertain if continued subsidy support is justified.

#### Presence of unsubsidized air service

Some communities, in addition to receiving subsidized air service from local service airlines, receive service from unsubsidized trunk, intrastate, and commuter airlines. CAB has not periodically reviewed the extent that alternative unsubsidized air service is available. How then is it to identify those communities which may no longer merit subsidy support?

Our analysis shows that extensive unsubsidized air service is often available. For example, an unsubsidized trunk airline and a commuter airline provided 75 weekly flights

between Bakersfield, California, and five other communities. Hughes Airwest, a subsidized airline, also provided 14 flights weekly between Bakersfield and two other communities.

In addition, Hughes Airwest provided subsidized service to 18 communities receiving service from unsubsidized local, trunk, commuter, and intrastate airlines. At 14 of these cities the unsubsidized airlines provided more weekly service than Hughes Airwest.

	<u>Unsubsidized air service</u>			<u>Hughes Airwest service</u>
	<u>Trunk and local service airlines</u>	<u>Commuter</u>	<u>Intrastate</u>	
Cedar City, Utah	-	53	-	13
Chico, Calif.	-	126	-	28
El Centro, Calif.	-	58	-	42
Eureka, Calif.	-	55	-	68
Grand Canyon, Ariz.	-	118	-	14
Idaho Falls, Idaho	51	-	-	28
Kalispell, Mont.	14	-	-	28
Lewiston, Idaho	-	40	-	21
Medford, Oreg.	35	-	-	14
Page, Ariz.	-	19	-	10
Pasco, Wash.	-	70	-	63
Pocatello, Idaho	42	-	-	28
Redmond, Oreg.	-	36	-	14
Redding, Calif.	-	114	-	28
Santa Maria, Calif.	-	79	-	14
Stockton, Calif.	28	-	42	25
Yakima, Wash.	-	56	-	63
Yuma, Ariz.	-	21	-	56

The need to provide subsidized service to communities receiving substantial unsubsidized service from other airlines is questionable.

CAB relies on airlines to identify unnecessary subsidies

At the specific request of the airlines, CAB has terminated or suspended subsidized air service to 80 communities during 1971-76. By relying on airline requests, not all unnecessary subsidies may have been discontinued. Airlines are influenced by factors other than the need for air service to a community, such as subsidy paid to maintain air service. The air service to Stockton, California, illustrates the need for CAB to periodically review subsidized service and initiate an investigation when such service no longer appears justified.

In 1955, CAB granted Southwest Airways--a predecessor of Hughes Airwest--authority to serve Stockton along with Sacramento, San Jose, and San Francisco. Noting that Stockton had very poor access to the three cities, CAB stated:

"The highway between Sacramento and Stockton has only two lanes and has been described as 'one of the worst bottlenecks in the State of California'  
\* \* \*

"Stockton and San Jose are separated by hazardous terrain which must be crossed on 20 foot pavements."

While road conditions may have justified subsidized service to Stockton in 1955, the highway system has since improved greatly. Stockton is now within 90 minutes driving time to three air-service centers--Sacramento, San Jose, and Oakland.

In addition, Stockton received a lot of unsubsidized air service as of March 1, 1975.

<u>City served with Stockton</u>	<u>Weekly flights</u>	
	<u>Subsidized service by Hughes Airwest</u>	<u>Unsubsidized service by other airlines</u>
San Francisco	14	70
Fresno	-	42
Modesto	-	28
Santa Maria	14	-

In May 1974 Hughes Airwest applied to CAB to temporarily suspend its subsidized Stockton service. The application stated:

"Hughes Airwest's certificate to serve Stockton requires the provision of capacity that is excessive in the market. This excess capacity diverts traffic from the non-subsidized carriers serving Stockton and requires Hughes Airwest to apply its resources in a market which has no present prospect for improvement, contrary to the original intent of the subsidy program. Stockton is not isolated from the National Transportation Network, having adequate access to five air service centers. Continuance of service by Hughes Airwest would be wasteful of subsidy funds, fuel, flight equipment and manpower, and is not justified by the minimal utility of the service."

In June 1974 Stockton officials objected to the suspension request. CAB later denied Hughes Airwest's request for suspension and instituted a study of the subsidized Stockton air service. In April 1975 CAB dismissed its study because Hughes Airwest withdrew its request for service suspension.

Although the Hughes Airwest request to suspend service indicated that

--the community was not isolated from the air transportation network,

--few people used the service,

--the service was costly in terms of subsidy-need generated,

and the Administrative Law Judge reviewing the case stated,

"\* \* \* it is doubtful whether there is any real justification for continuation of the subsidy-eligible Stockton-San Francisco shuttle service

that the parties appear to agree serves little or no purpose."

CAB did not pursue the matter further.

The Stockton case illustrates the need for CAB to independently initiate investigations to determine if communities still need to be subsidized. CAB should not rely on either the airline or the community to request termination or suspension, because both can be motivated by other factors. Airlines are compensated for the losses incurred while serving the community, and the community receives air service at no direct cost.

#### CAB ACTIONS TO IMPROVE SMALL COMMUNITY AIR SERVICE

In March 1977 CAB proposed a major overhaul of the current subsidy program and requested that the Congress authorize it to implement the new program. CAB believes its proposal would reduce subsidy costs while dramatically improving flight frequencies, timing, and reliability of small community air service.

#### CAB's proposal

CAB concluded that the best method for obtaining better small community service at lower subsidy is to use uncertificated commuter airlines more because their costs are far lower. The new program proposed by CAB would allow it to subsidize any airline, including uncertificated airlines. CAB would establish the level of service and the cities to be served and would base the subsidy on representative commuter airline costs.

According to CAB, the program's principal features are:

1. Eligible communities would, at the outset, be all those which enplane 80 or fewer passengers daily and which are currently included in the certificate of carriers, even if service has been suspended. After a 3-year phase-in period, other cities could be added to the program. However, CAB believes many communities would actually be served by commuter or certificated carriers without subsidy.
2. CAB would determine the routes, flight frequencies, and types of aircraft for which subsidies would be paid. Each community's help in this process would be actively solicited. According to CAB, each

community would at least receive two daily, well-timed round trips to an appropriate larger city. In most cases, the standard aircraft used would have at least 15 to 20 seats, turbine engines, and other minimum characteristics.

3. The methods of determining cost would be based on costs representative of commuter airlines for the above aircraft. Subsidy initially would be based on these costs. Later, CAB would be guided by actual traffic experience.
4. Carefully defined carrier qualifications would be adopted to make sure that the airlines are experienced, safe, and financially responsible.

To carry out this proposed program, CAB believes it needs new legislative authority to

- pay subsidies when needed to uncertificated airlines and
- establish routes, flight frequencies, and type of aircraft for which subsidies would be paid.

## CHAPTER 3

### CONCLUSIONS, AGENCY AND AIRLINE COMMENTS, AND

#### OUR EVALUATION AND RECOMMENDATIONS

##### CONCLUSIONS

The Civil Aeronautics Board's subsidy program is directed at sustaining local service airlines rather than necessary small community air service.

Although the current subsidy program provides incentives for airlines to be more efficient, it essentially finances airline losses incurred in serving small communities, without regard to the appropriateness of routes and flight frequencies or type of aircraft used.

We believe that the program needs standards for determining when a community is eligible for subsidized air service and for measuring adequacy of service. Also, subsidized service to communities needs to be periodically reevaluated to determine if the communities continue to merit subsidy, considering air service provided by unsubsidized airlines, and the cities' access to larger airports within reasonable driving distances.

CAB's proposed overhaul of the subsidy program would provide a framework for a more rational Federal approach to maintaining and expanding service to small communities by establishing routes, flight frequencies, flight times, and aircraft type and by basing subsidy on representative commuter airline costs.

##### CAB'S COMMENTS

CAB stated (see app. I) it agrees the current subsidy program needs reform, and it has moved and will continue to move to correct the defects of the current system.

##### Legislative authority

In a draft of this report, we proposed that CAB establish subsidy eligibility and adequacy of service standards and periodically reevaluate the continued need to provide a city with subsidized air service.

CAB stated that although

--the Federal Aviation Act of 1958 may be sufficiently flexible to permit many of the suggested changes and

--our proposals generally appear to be consistent with sound policy objectives,

it believes the operational and economic complexity of airline operations make such an undertaking impractical, if not impossible, without a change in the basic statute.

CAB said that the intent of subsidy was to aid the development of a national air transportation system by providing assistance to airlines until they achieve self-sufficiency. Thus, CAB believes the act dictates that the financial need of each airline's entire system must be taken into account in establishing subsidy rates. CAB also stated that because it is expressly prevented by the act from restricting an airline's right to adjust its equipment or schedules, it lacks authority necessary to assure that subsidized service to small communities is economical and tailored to the community's needs.

We believe CAB offered several persuasive arguments for the need of new legislative authority to correct the current program defects.

#### Need to periodically review subsidized services

CAB does not agree that it should periodically review each community receiving subsidized air service to assure it continues to merit Federal support. CAB believes the airlines have identified most such communities and an affirmative program on CAB's part would be costly and result in eliminating few additional subsidized services.

We continue to believe CAB must periodically review subsidized communities in order to prudently manage its program. CAB's policy, which relies on the recipients of Federal funds to determine when subsidy should terminate, clearly is unacceptable; in effect, the Board is abdicating its management responsibilities.

#### Duplicate subsidized service

CAB stated we used the service between Sioux City-Sioux Falls as an example to demonstrate excess service, and that



it is an isolated case. Only one of five subsidy-eligible city pairs are served by two local service airlines.

The Sioux City-Sioux Falls service was used primarily to demonstrate that CAB essentially finances an airline's losses in providing service to small communities regardless of the number of flights flown or type of aircraft used. In this case, each airline serving the city pair provided different flight frequencies and used different types of aircraft, resulting in different subsidy requirements. We do, however, question the need to subsidize two airlines on this route, particularly when they generated a \$1.1 million subsidy need for this service.

CAB stated that there are only 20 city pairs among the approximately 450 city pairs eligible for subsidy where local service airlines compete with other airlines, including commuter and intrastate carriers.

Duplicate city-pair service should not be the only consideration in evaluating the adequacy of subsidized air service to a small community. Air service to other airports on the national air transportation network also should be considered. For example, Hughes Airwest provided subsidized service to 19 communities that also received service from unsubsidized local, trunk, commuter, and intrastate airlines. At 15 of these cities, the unsubsidized airlines provided more weekly service than Hughes Airwest.

#### Eligibility criteria

CAB does not agree that it should consider uncertificated airlines' enplanements in determining whether service to a community should be subsidy eligible. Our report showed that Bakersfield, California--which generated \$235,000 in subsidy need for the year ended March 1976--would become subsidy ineligible under current criteria if uncertificated enplanements were considered. CAB considered this to be one of very few such cases and said, further, that information on enplanements of uncertificated airlines is not readily available.

We believe if CAB continues to regard enplanements as the sole subsidy-eligibility measure it should consider all enplanements at a subsidized community--including those of uncertificated airlines. Furthermore, CAB can draw on data which is available at various Federal and State agencies.

## DEPARTMENT OF TRANSPORTATION'S COMMENTS

The Department's position (see app. II) is that the Federal subsidy program for air service to small communities should be revised. The Department stated it had no substantive additions to our evaluation of the present subsidy program.

## AIRLINES' COMMENTS

We contacted the following local service airlines to obtain their views and comments concerning our report:

Frontier	Piedmont
Hughes Airwest	Southern
North Central	Texas International
Ozark	

They generally agreed with our overall conclusion, but expressed concern about some matters.

Although they agree CAB should establish standards for subsidy eligibility and adequacy of service, they stated that CAB needs to develop such standards in cooperation with the airlines and communities being served. Specifically, they said that CAB should not establish an arbitrary standard to be universally applied without considering how an airline actually serves each community. Most of the airlines said that any new program should provide for a transition period during which they would have the right to suspend or terminate service that could not be operated profitably.

The airlines said that they can efficiently utilize modern jet aircraft, such as the B-737 and DC-9, in serving small communities. According to the airlines, these aircraft are operated on linear routes which consolidate traffic at a number of small communities, thereby developing good load factors and low seat-mile costs. The airlines believe this type of operation is efficient and provides the communities with good service. We believe that if this type of service can be provided at the least cost to the Government, it should not be precluded from subsidy. The airlines also said the subsidy payment to an airline should be based on its costs to serve a subsidy-eligible city and not be reduced for profits earned on nonsubsidized routes. We agree.

## RECOMMENDATIONS TO THE CONGRESS

We recommend that the Congress provide CAB with a legislative mandate to restructure the current airline

subsidy program to provide necessary air services to small communities at the least cost to the Federal Government. Specifically, we recommend that the Congress direct CAB to:

- Establish standards to measure when a community's air service is inherently unprofitable and warrants Federal subsidy.
- Establish a standard of what is adequate service to a community and base subsidy on the actual cost of providing that service.
- Subsidize uncertificated airlines when they can provide necessary small community air service at lower costs.
- Periodically reevaluate air service at all subsidized communities to determine if they continue to merit Federal subsidy support.
- Consider scheduled air service provided by unsubsidized airlines in evaluating the need for and adequacy of air service to small communities.



CIVIL AERONAUTICS BOARD  
WASHINGTON, D.C. 20428



JUN 24 1977

Mr. Henry Eschwege  
Director, Community and  
Economic Development Division  
United States General Accounting Office  
Washington, D. C. 20548

IN REPLY REFER TO  
B-1-66

Dear Mr. Eschwege:

This is in response to your letter of May 3, requesting Board review and comment on the draft GAO report to Congress, "Why the Federal Airlines Subsidy Program Needs Overhaul." We welcome and appreciate the opportunity.

The enclosed comments were prepared by the Board's staff. I hope they will be helpful to you.

Sincerely,

A handwritten signature in black ink, appearing to read "Alfred E. Kahn".

Alfred E. Kahn  
Chairman

Enclosure

STAFF COMMENTS ON THE GENERAL ACCOUNTING OFFICE (GAO)  
DRAFT REPORT TO CONGRESS ENTITLED  
"WHY THE FEDERAL AIRLINE SUBSIDY PROGRAM  
NEEDS OVERHAUL"

The draft report to the Congress on the overhaul of the Federal airline subsidy program concludes that (a) the program should be substantially modified, and (b) the Board can and should undertake such modification under its existing statutory authority. The staff is in general agreement with the analyses presented in the draft report which address the problem of the need for reform of the current subsidy program. As the report recognizes, the Board has for some time been moving in the direction suggested by the GAO. However, we cannot agree that it would be either useful or permissible for the Board to undertake the suggested modifications in subsidy policy without a change in the basic statute.

The subsidy provisions of the current Act (Section 406), which are essentially the same as the provisions of the Civil Aeronautics Act of 1938, emphasize the maintenance and continued development of air transportation by underwriting the financial needs of the air carriers in order to support required air services. The Act was passed at a time when, by and large, airline service was unprofitable and had to be underwritten by Federal funds. As a result, the Act focuses on the system needs of the carriers. While the developmental focus of Section 406

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has undoubtedly accelerated the transition of the trunkline carriers and Allegheny to self-sufficiency, it has not proved effective in directing subsidy toward maintenance of small community service.

The Board is prevented by statute from paying subsidy for needed services to non-certificated carriers, although such carriers are uniquely suited to the provision of small-community service. The prohibition in the statute against interference with scheduling and equipment decisions by certificated carriers, and the constraints placed on the Board's ability to effectively insure good service in light of the judicially imposed "security of route" concept, 1/ make it difficult, if not impossible, to achieve a maximally effective subsidy program under current law.

It may be, as GAO concludes, that the present Act is sufficiently flexible to permit many of the suggested modifications aimed at channeling subsidy only to operations that the Board finds necessary to insure appropriate continued service to deserving small communities. Furthermore, the GAO recommendations generally appear to be consistent with sound policy objectives. We are, however, convinced that it would be impossible to practically administer a subsidy program structured along the lines implied by the GAO suggestions.

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1/ The Supreme Court has effectively prevented the termination of a carrier's license, or modifications in that license, in the absence of hearings.

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The GAO report recommends that the current subsidy program be modified by (1) establishing criteria to measure when a community's air service is inherently unprofitable and warrants Federal subsidy and (2) establishing a standard of what is adequate service to a community and basing subsidy on the actual cost of providing these services.

In order to establish these criteria, standards, and subsidy levels, it would be necessary for the Board to construct hypothetical airline operations. The operational and economic complexity of airline operations of the size of the local service carriers make such an undertaking impractical, if not impossible. Furthermore, under Section 406, which the Supreme Court has stated reads like a typical public utility ratemaking authority, any attempt to develop theoretical service patterns, service levels, equipment choices, etc., which differ substantially from actual operations would raise innumerable and (probably) insolvable issues of fact. As a legal matter, ratemaking under Section 406 cannot be divorced from reality, and as a practical matter carrier experience ultimately must form the basis for rate determinations. On the other hand, new legislation along the lines of the Board's proposed small community program would remove these legal and practical impediments.

The Board has moved and will continue to move to correct the defects of the current system to the extent they can be corrected. In Class Rate VIII, which became effective July 1, 1976, the definition of services eligible for subsidy support was significantly altered and the carriers were put on notice

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that a more stringent definition of subsidy-eligible operations would be applied in future class rates. Class Rate VIII removed all operations between hub airports from the calculation of subsidy need. The Board clearly indicated that this action constituted a first step in focusing subsidy more directly toward services which truly require underwriting with public funds. For the year ended March 31, 1976, the removal of hub-to-hub services resulted in a \$10-million reduction in subsidy need recognized under the class rate. Research currently underway is directed toward more precisely determining the minimum level of traffic necessary to support profitable operations by the class-rate carriers, given the carriers' equipment mix and service patterns. The results of this research will be used to establish the kinds of services which will be recognized as eligible for subsidy under the next class rate. It should be noted that the level of traffic necessary to support profitable operations by the locals is undoubtedly higher than the level needed by carriers operating small equipment.

Similarly, in a recent proceeding involving a new small-community certificated carrier, Air Midwest, the Board imposed a condition which would prohibit subsidy for service provided with larger equipment not specifically suited to small-community service. This condition and, indeed, the entire award to Air Midwest, is currently the subject of litigation.



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The staff recognizes that the current system has, in some cases, resulted in excessive service levels, as the examples in the CAO report point out. In many other cases, particularly at the smallest points, the service levels are minimal. It is, however, doubtful whether these problems can be satisfactorily corrected as long as the current statute remains in effect. The Board's Small Community Service Program would give the Board the tools necessary to assure appropriate service levels at small points. Furthermore, by gradually removing subsidy support from the more mature local service carriers over a seven-year period, the program should induce more efficient service at the points which these carriers will continue to serve.

We would emphasize that any program to better direct the payment of subsidy for small-community services should be gradual. The Board's proposed Small Community Service Program, which we have asked Congress for authority to implement, contemplates that the local service carriers will be removed from Section 406 subsidy over a seven-year period. During the period when Section 406 subsidy is being phased out, the carriers' route authority will be reviewed and modified as necessary to fit the changed circumstances. Likewise, the Board's ongoing program to improve the administration of Section 406 subsidy must take a gradual approach. The present local service industry evolved under Board route actions under Section 401 and subsidy support under Section 406. Precipitous changes in subsidy policy without concurrent changes in route authority could have adverse

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effects on the financial stability of the industry. For example, the GAO report suggests that subsidy payments to the local service carriers could be reduced by 57 percent if only the need associated with subsidy-eligible services involving at least one point enplaning fewer than 40 passengers per day were recognized. This would represent a subsidy level of roughly \$31 million—a reduction of approximately \$40 million in subsidy payments to the class-rate carriers. In the year ended September 30, 1976, a subsidy reduction of \$40 million would have resulted in a 61-percent reduction of operating profit for the class-rate carriers; net cash income for the carriers would have been cut by 44 percent; and net income would have been reduced by 61 percent from a level of \$35.3 million to \$13.7 million. Furthermore, the impact on the financially weaker carriers would have been more severe than the industry-wide reductions indicate.

The GAO report is critical of the Board for not actively pursuing a program to eliminate subsidized air service at points which, due to changing circumstances, may no longer require such service. As the report points out, the Board has relied on the initiatives of the carriers to eliminate the most uneconomical points. In the opinion of the staff, an affirmative program on the part of the Board would have required enormous staff resources and would not have resulted in an appreciably greater reduction of subsidized services. We recognize that the decision of the carriers to maintain service at a point can be motivated by factors different from those which might be considered by a

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regulatory agency. Nevertheless, the points which were eliminated by responding to the requests of the carriers most likely represent the majority of the points which would have been eliminated had the Board embarked on an affirmative program to purge the weakest points from the locals' certificates.

As indicated earlier, we are in general agreement with the overall emphasis of the GAO analysis. We do, however, question the appropriateness of some of the examples presented in the report. Specifically, much of GAO's discussion of excess service is based on an analysis of service between Sioux City and Sioux Falls, an unrepresentative city pair. The situation is an isolated case. Under the present class rate, Sioux City - Sioux Falls is one of only five subsidy-eligible city pairs where two locals compete against each other. Furthermore, this city pair may well become ineligible for subsidy under the more restrictive definitions contemplated for the next class rate. Sioux Falls is now a hub airport, and Sioux City is near the upper limit of non-hubs as currently defined. A review of schedules published in the Official Airline Guide indicates there are only about 20 city pairs among the approximately 450 city pairs defined as subsidy eligible under Class Rate VIII where locals compete with other carriers including commuter and intrastate carriers.

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Based on an analysis of passenger enplanements at Bakersfield, California, GAO suggests that a definition of subsidy eligibility in terms of enplanements should include the enplanements of commuter and intrastate carriers as well as those of certificated carriers. While this could be done, we do not believe it would constitute a significant improvement over the present system. In our judgment, the addition of commuter and intrastate enplanements would change the status of few, if any, points other than Bakersfield. Furthermore, the suggestion might be impractical because information is not readily available. As the GAO report acknowledges, Bakersfield was the only point for which GAO could obtain all of the needed information.

Finally, GAO's discussion of the Board's small community service proposal is based on the Board's original testimony before the Senate Committee which envisioned guaranteed service at points enplaning fewer than 40 passengers a day. In later testimony presented to the House Committee, the Board revised its proposal to assure that service would be maintained at points which enplane fewer than 80 passengers a day. [See GAO note.]

GAO note: The report has been revised to reflect this change.



OFFICE OF THE SECRETARY OF TRANSPORTATION  
WASHINGTON, D.C. 20590

ASSISTANT SECRETARY  
FOR ADMINISTRATION

June 20, 1977

Mr. Henry Eschwege  
Director  
Community and Economic Development Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Eschwege:

We have enclosed two copies of our reply to the General Accounting Office draft report "Why the Federal Airline Subsidy Program Needs Overhaul." Please let us know if we can assist you further.

Sincerely,

*for* *William B. Davis*  
Edward W. Scott, Jr.

Enclosures (2)

DEPARTMENT OF TRANSPORTATION REPLYTOGAO DRAFT REPORTONWHY THE FEDERAL AIRLINE SUBSIDY PROGRAM NEEDS OVERHAULSUMMARY OF GAO FINDINGS AND RECOMMENDATIONS

GAO reviewed the CAB proposal to establish a new small community air service program. Comparisons were made between the current air service program which relies solely on certificated local service carriers and the proposed program which would rely in large part on uncertificated commuter air carriers. The GAO found that the present system, which allows subsidy payments only to certificated local service carriers, results in payments to a class of air carriers based on their system need, therefore tending to sustain air carriers, not necessarily service to small communities. The GAO found that while the local service carriers have been sustained as carriers, service to small communities has decreased. Furthermore, the GAO found that the present system has no controls over either the type of equipment or the adequacy, routing or timing of schedules to small communities.

GAO recommended that the current subsidy program be overhauled. Specifically the GAO recommended that the overhaul involve a redefinition of the specific services which should be subsidized based on the following:


1. establishment of criteria to measure when a community's air service is inherently unprofitable and warrants Federal subsidy;
2. establishment of a standard of what is adequate service to a community and basing subsidy on the actual cost of providing those services;
3. periodic reevaluation of air service at all subsidized communities to determine if they continue to merit Federal subsidy support; and
4. consideration of scheduled air service provided by unsubsidized airlines and the city's proximity to larger airports in evaluating the need for and adequacy of air service.

Furthermore, the GAO recommended changes in the Federal Aviation Act which would allow subsidy to be paid to commuter and intrastate airlines.

DEPARTMENT OF TRANSPORTATION POSITION

It is the position of the Department of Transportation that the Federal subsidy program for air service to small communities should be revised. DOT has no substantive additions to the evaluation of the present subsidy program made by the GAO. The CAB proposal to establish a new small community air service program raises a number of issues pertinent to review of the present system and to rationalization of the Federal approach to small community air service. Revision of the Federal subsidy program for air service to small communities should recognize the following:

1. No presently certificated point should be in jeopardy of losing air service on account of a revised program.
2. Subsidy should be calculated on the basis of market and community needs rather than on the basis of carrier needs.
3. The type of equipment, routing, frequency and timing of schedules provided in service to subsidy eligible points should be adequate and appropriate to the needs and demands of the market and community.
4. Both local service carriers and commuter air carriers should be eligible for subsidy payments for provision of small community air service.
5. Appropriate regulations should be established to ensure that carriers providing subsidized air service meet high standards of financial fitness and operational safety.

  
Chester Wavenport, Assistant Secretary  
for Policy, Plans, and International  
Affairs

PRINCIPAL OFFICIALS RESPONSIBLE FOR ADMINISTERING  
ACTIVITIES DISCUSSED IN THIS REPORT

Tenure of office  
From                      To

CIVIL AERONAUTICS BOARD

CHAIRMAN:

Alfred E. Kahn	June 1977	Present
Lee R. West (acting)	May 1977	June 1977
John E. Robson	Apr. 1975	Apr. 1977
Richard L. O'Melia (acting)	Jan. 1975	Apr. 1975
Robert D. Timm	Mar. 1973	Dec. 1974
Secor D. Browne	Oct. 1969	Mar. 1973





