DEPARTMENT OF TRANSPORTATION

U.S. Department of Transportation Notice of Policy, Incentives to Improve Subsidized Essential Air Service

AGENCY: **Office of Aviation and International Affairs, U.S. Department of Transportation (DOT)**.

ACTION: **Notice of Policy: Incentives to Improve Subsidized Essential Air Service**

SUMMARY: This notice explains the U.S. Department of Transportation's (the Department or DOT) policy related to incentives to improve subsidized essential air service.

SUPPLEMENTARY INFORMATION:

I. Background:

Section 427 of the Federal Aviation Administration Modernization and Reform Act (the Act), Public Law 112-95, states that the Secretary may encourage air carriers to improve subsidized Essential Air Service (EAS) by incorporating financial incentives in the EAS contracts based on specified performance goals, including improving on-time performance, reducing flight cancellations, establishing reasonable fares (including joint fares beyond the hub airport), establishing convenient connections to flights providing service beyond hub airports, and increasing marketing efforts. The Act directed the Department to publish guidelines for these financial incentives.

This Notice describes DOT's policy for subsidizing EAS to include financial incentives for improved service.

II. Financial Incentives to Improved Subsidized Essential Air Service

The Civil Aeronautics Board (CAB) was originally responsible for administering the EAS program after Congress established it in 1978 as part of the Airline Deregulation Act. In establishing the regulations and procedures for the EAS program, the CAB included many financials incentives designed to ensure that subsidized carriers would provide reliable service. When the CAB was "sunset" on December 31, 1984, the responsibility for administering the EAS program transferred to DOT. The Department has maintained these financial incentives established by the CAB. Some are rather technical in nature involving the mechanics of how carriers are actually paid. These incentives are described below.

First, the Department provides incentives for reliable service through the payout formulas used to compensate subsidized carriers. Carriers are paid a fixed amount of subsidy per flight, based on their overall annual subsidy request, the number of annual scheduled flights, and an assumed completion factor. DOT's general policy is "no fly, no pay" in order to maximize carriers' incentives to complete flights. Air carriers providing EAS submit claims for their services on a monthly basis in arrears, after the end of each month. The carriers generally may claim only flights that were actually operated. Occasionally, the Department (as did the CAB before it) may authorize subsidy for flights that were not completed, if they were not completed because the pilot determined that unsafe weather conditions warranted that the flight be diverted to a different airport or returned to the departure airport. Other weather-related cancellations are reviewed on a case-by-case basis and may require additional documentation and justification by the carrier. The Department maintains this flexibility to authorize subsidy payment in these situations out of a concern that safety not be jeopardized.

Second, financial incentives for reliable service also arise from the way carriers construct their proposals. When carriers submit proposals, they frequently account for some cancellations based on experience in the market or predicted controllable and non-controllable cancellations. For example, if a carrier's subsidy is $500,000 for 1,000 scheduled flights, the subsidy per flight is not necessarily $500 per flight. Rather, carriers typically use anywhere from a 95 to 98 percent completion factor estimate that accounts for cancellations based on historical data -- either system-wide completions or market specific. To further illustrate, if a carrier assumed 96 percent completion, the Department would pay $500,000 divided by 960 flights or $521 per flight, such that if the carrier completed 96 percent of the flights, it would receive the $500,000. If the carrier completed only 95 percent of its scheduled flights, it would receive 95/96ths of $500,000. Similarly, if the carrier completed 97 percent of its scheduled flights, it would receive 97/96ths of $500,000. This incentivizes an air carrier to increase completion rates above the rate estimated in a proposal.

Additionally, carriers submit pro forma profit and loss statements for an individual EAS route based on forecast expenses and revenues. The EAS subsidy is the difference between the forecast annual expenses (including a modest profit element) and the forecast annual revenues (a description of the expenses used to construct a subsidy can be found in the Department's Orders requesting proposals). For example, if a carrier forecast $3.2 million in expenses (including a profit element) and $1.3 million in revenue (passenger and cargo), the annual subsidy would be $1.9 million. However, the carrier has every incentive to generate more than the forecast revenue by providing good service because the Department does not reduce the carriers' subsidy. Similarly, if the carrier generates only $1.1 million in revenues, the Department does not increase the carrier's subsidy, and the carrier absorbs the loss. Thus, again, the carriers have an incentive to provide good service so that they exceed their forecast revenues.

Section 427 also mentions encouraging carriers to provide convenient connections to flights providing service beyond hub airports, and to increase marketing efforts. These elements are included in the statutory criteria the Department must use to select EAS carriers. (See 49 U.S.C.

41733(c) for all of the statutory carrier-selection criteria.) Section 41733 of Title 49 requires that, in selecting an EAS carrier, the Department must consider, "…the contractual and marketing arrangements the applicant has made with a larger carrier to ensure service beyond the hub airport; and the interline arrangements that the applicant has made with a larger carrier to allow passengers and cargo of the applicant at the hub airport to be transported by the larger carrier through one reservation, ticket, and baggage check-in…" Thus, carriers that can satisfy these pro-consumer criteria have a built-in advantage in the carrier-selection process, and this should provide incentives for those carriers without such marketing and interline arrangements to attain them.

Third, Section 427 asks the Department to permit longer-term contracts as further incentive for reliable service. Historically, typical EAS contracts were for two years, and, to a large extent, two years continues to be the typical term of an EAS contract today. However, the Department currently has 43 contracts that run longer than two years, most of which are four years or more. The Department has only considered longer-term contracts when a longer term is proposed by a carrier interested in serving an EAS community. In addition, because community preference is a key carrier-selection criterion (49 U.S.C. 41733(c)(1)(D)), the Department also seeks the affected community's input on the desirability of a long-term contract. Of course, only communities that are very satisfied with their EAS carrier's service would be willing to support longer-term contracts.

Finally, during most of the years since deregulation, the airline industry lost billions of dollars. In that environment, the EAS program was fairly attractive as a vehicle to make a modest profit. However, in the last five years or so, perhaps as a result of industry consolidation, lower fuel prices, and a gradually improving economy, the overall airline industry has been making record profits. In this current environment, the typical five percent profit for EAS routes may not be as attractive as it once was in certain markets, especially for the larger carriers operating extensive networks to smaller communities. However, there is no regulatory or statutory ceiling of five percent, and we have conveyed that to several EAS carriers that are code-share partners of network carriers in an attempt to attract more reliable and higher-quality service. We note, though, that the Department may consider relative subsidy requirements in its carrier selection decision. (See Consolidated Appropriations Act, 2016, Public Law No. 114-113). Thus, carriers requesting a higher profit element (and thus higher subsidy) could reduce the overall attractiveness of their proposal, and, therefore, affect the possibility of being selected.

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