



UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

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COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

B-206097

FEBRUARY 3, 1982

RELEASED

The Honorable Mark O. Hatfield
United States Senate

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Subject: Impact on the Federal Government if
the Combined Continental Airlines and
Texas International Airlines Fail to
Meet Their Financial Obligations
(CED-82-33)

This report responds to your letter of October 7, 1981, requesting certain information on the potential financial loss to the Federal Government if the combined Continental Airlines and Texas International Airlines fail to meet their financial obligations. The report addresses the subjects raised in your letter--essential air service to the Pacific; aircraft loan guarantees; potential revenue loss to the Treasury; and the Airline Employee Protection Program.

We reviewed Civil Aeronautics Board (CAB) documents concerning essential air service to the Pacific and the airline employee protection program; Federal Aviation Administration (FAA) documents concerning the aircraft loan guarantee program; and Department of Labor documents concerning the airline employee protection program. We interviewed CAB, FAA, and Labor officials in Washington, D.C., concerning these programs and had telephone conversations with Continental Airlines and its Washington counsel, Hydeman, Mason, Burzio, and Lloyd, concerning taxes paid or collected by Continental and concerning Pacific air service. We were not requested to make any judgments on the financial viability of the merged airline. Our review was made in accordance with GAO's current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

ESSENTIAL AIR SERVICE TO THE PACIFIC

The Airline Deregulation Act of 1978 (Public Law 95-504) guarantees essential air transportation for any point in the United States to which any carrier (1) is providing service pursuant to a certificate issued under section 401 of the

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Federal Aviation Act (Public Law 85-726) or (2) is authorized by that certificate to provide service but the service was suspended on the Airline Deregulation Act's date of enactment--October 24, 1978. Under the act, airlines are permitted to terminate air service at certificated communities. To protect small communities that receive or are eligible to receive air service as of October 24, 1978, against deterioration or loss of service from terminations, certificated communities are guaranteed essential air transportation for a period of 10 years from October 24, 1978, and airlines must notify CAB of intended service terminations. Where terminations would affect essential air transportation, as determined by CAB under the act, CAB must arrange for another airline to supply the necessary transportation and may require an existing airline to continue service until a replacement is found. Airlines may be paid subsidies where necessary to provide essential air transportation.

Continental Airlines provides service to American Samoa. Air Micronesia, which is partially owned and wholly operated by Continental, provides service to Guam, Saipan, Koror, Yap, Truk, Ponape, Kwajalein, and Majuro. These islands fall into several political jurisdictions. American Samoa and Guam are United States territories. Saipan is part of the Commonwealth of the Northern Marianas. Koror is also known as the Republic of Belau. Yap, Truk, and Ponape constitute the Federated States of Micronesia. Kwajalein and Majuro are part of the Marshall Islands.

Points eligible for essential air transportation must be within the United States, which the act defines as including "the several Territories and possessions of the United States." CAB stated in its discussion on the merger of Continental Airlines and Texas International Airlines that "there is no question as to the eligibility of Guam and American Samoa, as both are clearly 'territories'." CAB has treated the trust territory islands, which consist of the Northern Marianas, the Republic of Belau, the Marshall Islands, and the Federated States of Micronesia, as part of the United States for purposes of the act for a number of years and has recently included them as eligible points for essential air service purposes. However, CAB is aware that FAA has adopted a different interpretation on whether the act applies to areas of the trust territory. Consequently, CAB required as a condition of approving the merger that Texas International not reduce service to the trust territory below the levels already set without prior approval of CAB or its successor. This condition will make it possible for CAB to order continued service even if the trust territories should be determined to involve foreign air transportation.

Potential subsidy liability

American Samoa is served by Continental and South Pacific Island Airlines. On December 28, 1981, Continental filed notice to suspend service, requesting an exemption to suspend the service on January 8, 1982. Unless CAB grants Continental an exemption, it cannot suspend service until 90 days after the filing date. South Pacific Island Airways, on December 29, 1981, filed with CAB in support of Continental's request, offering to guarantee that it would provide American Samoa's essential air service without subsidy upon Continental's withdrawal. CAB has not acted on the exemption request as of January 19, 1982.

Guam is served by Pan American World Airways, Northwest Orient Airlines, and Air Micronesia. Therefore, Bureau of Domestic Aviation officials told us that even if Air Micronesia withdrew service other carriers would provide Guam's essential service without subsidy. Saipan is served by Air Micronesia, a commuter air carrier called Island Aviation, and Japan Airlines. Air Micronesia's service to Saipan is profitable. Consequently, a Bureau of Domestic Aviation official said that the Bureau does not expect to have to pay subsidy there. If Air Micronesia withdrew, some U.S. carrier could serve it profitably.

The remaining islands--Koror, Yap, Truk, Ponape, Kwajalein, and Majuro--are the islands for which subsidy is considered more likely. According to CAB, service to two of these points--Yap and Koror--is profitable, but service to the other four is not. No subsidy was being paid to or had been requested by Air Micronesia as of December 1981. CAB provided subsidy estimates on Micronesia service in a May 22, 1980, letter to the Office of Micronesia Status Negotiations, Department of the Interior. The following table shows estimated subsidies needed to provide essential service at the 1977 level.

CAB Estimates of Micronesia Air Service Subsidy Outlays
Under 2 Scenarios, Fiscal Years 1982-85

"Best case" scenario in which CAB calculates the subsidy need by offsetting the revenue from the profitable service to two points against losses at four points.

<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
----- (000 omitted) -----			
\$4,162	4,699	5,237	5,771

"Worst case" scenario in which subsidy would be required to maintain essential service at the four loss points only, thus losing the benefit of the profit offset.

<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
----- (000 omitted) -----			
\$5,715	6,356	7,018	7,697

CAB's current fiscal year 1982 budget authority for the essential air service program is \$28.3 million, so the Pacific subsidy scenarios shown in the table would increase program costs considerably if subsidies have to be paid.

AIRCRAFT LOAN GUARANTEES

FAA operates a statutory aircraft and equipment loan guarantee program (49 U.S.C. 1324 note). The act authorizes the Federal Government to guarantee loans for the purchase of aircraft and spare parts. A guarantee may be made only if the Administrator, FAA, finds that (1) the air carrier otherwise would not be able to obtain funds for the purchase of aircraft upon reasonable terms, (2) the aircraft to be purchased are needed to improve the air carrier's service and efficiency, (3) there is reasonable assurance of the carrier's ability to repay the loan, and (4) the value of the security pledged provides reasonable protection to the United States.

New York Airlines, Inc., the major share of which is owned by Texas Air Corporation, the parent company of Texas International Airlines, filed an application for an aircraft loan guarantee on April 22, 1981. FAA guaranteed, on September 30, 1981, 90 percent of a loan of \$24,795,000 for a term of 10 years for the purchase of four DC-9-30 aircraft and modifications.

A guarantee under the program may not exceed 90 percent of the loan, which in New York Airlines' case would amount to 90 percent of the \$24,795,000, or \$22,315,500, and 100 percent of unpaid interest. The loan itself may not exceed 90 percent of the purchase price of the aircraft, spare parts, and engines. According to FAA's Assistant Chief Counsel, Procurement Legal Division, Office of Chief Counsel, in the event of default the Government's financial exposure is the amount of the guaranteed principal outstanding at the time of default plus approximately 20 percent for interest and expenses, less whatever the Government receives from the sale of the aircraft and less any amounts it recovers from the defaulting airline.

FAA had previously guaranteed six Texas International Airlines loans made between 1975 and 1977 for the purchase of eight DC-9-10 aircraft and two DC-9-30 aircraft. The Federal guarantee was originally for \$24,462,000 and as of September 30, 1981, the guaranteed amount outstanding was \$18,429,700. As of January 1982 all loan payments were current.

POTENTIAL TAX REVENUE LOSSES TO THE TREASURY

Should Continental Airlines go out of business, the tax revenue loss to the Federal Government, in our opinion, will be less than the tax revenue generated by the services Continental provided. Much of this revenue would likely be provided by other airlines who picked up the foregone services. Even if no other airlines stepped in, the labor, capital, and other resources currently employed by Continental would transfer eventually to other occupations and provide tax revenue to the Treasury.

Continental Airlines provided us, through its Washington counsel, Hydeman, Mason, Burzio and Lloyd, nonproprietary data pertaining to Federal taxes it paid or collected in calendar year 1980. The following data provides an indication of Treasury revenues, from Federal taxes only, generated by the company and its employees.

<u>Source of Federal revenue</u>	<u>Amount</u>
	(000 omitted)
Corporate income taxes	\$ 824
Company share of social security taxes	\$14,800
Unemployment insurance	\$ 590
Taxes withheld from employee earnings	\$60,900
Ticket taxes collected	\$53,150

THE AIRLINE EMPLOYEE PROTECTION PROGRAM

Section 43 of the Airline Deregulation Act of 1978 provides a protection program for airline employees who either lose their jobs or have their pay reduced as a result of deregulation, with the exception of certain classes of employees. The Congress enacted the Airline Employee Protection Program because it believed cessation of 40 years of airline economic regulation might result in temporary adjustments in the labor requirements of some air carriers.

To qualify for monetary benefits under the program, an employee must have been affected by a qualifying dislocation, defined as a bankruptcy or a major contraction of at least 7-1/2 percent of an air carrier's total full-time work force within a 12-month period, which has occurred as a result of the changes in airline regulation. CAB must determine that a qualifying dislocation has occurred. CAB has issued a proposed rule and will consider individual applications on a case-by-case basis using the proposed rule until a final rule is issued.

The Department of Labor is responsible for determining eligible benefits, calculating the level of payments, and making the payments. Secretary of Labor Marshall signed off on regulations to implement the program on January 19, 1981, subject to a 60-day legislative review period required by the act. The current administration froze these regulations among others issued in the closing days of the previous administration. Subsequently, the Secretary of Labor, in an April 10, 1981, memorandum, stopped all regulatory activity implementing the program's provisions and announced support for legislation to repeal the provisions of the law providing for monetary compensation.

Neither the present nor the previous administration has requested appropriations to fund the program, and the Congress has not appropriated funds.

CAB included labor protective provisions in its acquisition decision

CAB's decision on the acquisition of Continental Airlines by Texas International was made subject to, among other things, Texas International's agreement to accept labor protective provisions. The provisions provide for compensatory allowances to employees affected by the acquisition. The provisions are restricted to changes in employment due to and resulting from the acquisition. Any compensation required under the provisions would be paid by Texas International.

The Unemployment Insurance Program also provides benefits

Airline employees who lose their jobs may also be eligible for the Unemployment Insurance Program, which pays a weekly benefit to unemployed persons. The basic benefits are funded by a tax paid by employers on the employees' previously earned weekly wages. Benefits vary by State because of different State eligibility criteria. For example, in California, where Continental is headquartered, weekly benefits are a minimum of \$30 and a maximum of \$130. The benefits can be paid for a maximum of 26 weeks.

We have discussed the material in this report with CAB, FAA, and Department of Labor officials. As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 14 days from the date of the report. At that time we will send copies to the Secretaries of Transportation and Labor and the Chairman, Civil Aeronautics Board. Copies will also be available to other interested parties upon request.



Henry Eschwege
Director