

**MARINE HIGHWAY TRANSPORTATION
IMPROVEMENT STUDY – PART I**

**SUSTAINABILITY OF THE
ALASKA MARINE HIGHWAY SYSTEM**

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PRELIMINARY CONCLUSIONS AND RECOMMENDATIONS

Southeast Conference has contracted with the McDowell Group to assess the potential benefits of commissioning a comprehensive, independent study of the future of the Alaska Marine Highway System. The task of identifying the key components of such a study is not yet complete. However, the need for it, as the AMHS approaches its 40th anniversary next year, is compelling.

Alaska's Marine Highway System (AMHS) is entering a period of profound change. With its financial reserves exhausted, vessels in need of major refits or replacement, an intractable cost structure and waning political support, cuts in service seem imminent. Yet the communities it serves are heavily dependent on reliable marine transportation. The next five years will see the system navigate one of three courses:

- **Steady decline in service.** The gap between operating costs and state funding has widened each year since 1995. If the system and its users are unable to muster the political support to alter this trend, service levels cannot be maintained. Further, it is not clear that the additional financial resources needed to modernize the system will be available.
- **Abrupt restructuring.** Radical new management models proposed in this and prior legislative sessions might be imposed, though without any real understanding of whether these models will be able to solve the problems facing the system.
- **Transition to a new, well-conceived management and operations model.** With interim financial support and careful planning, operations and service levels may be aligned with available, secure funding sources *over the long-term*.

Why is "fixing" the system so difficult? The Alaska Marine Highway operates in an environment with market, political and operational challenges unlike those anywhere else in the world. Its service mandate is broad, its markets small and diverse, and its political support increasingly fragmented. Typically, annual appropriations fall approximately \$10 million short of what is needed to sustain operations. The balance has come from a now-depleted reserve fund. Success over the long-term will require a carefully crafted combination of management, operations and funding strategies (and execution).

Yet the value of the system is clear. In addition to providing transportation to communities with no other options and infrastructure for several regional economies, Alaska's Marine Highway System has an annual economic impact estimated at \$171 million in 1995.

Conclusions

This preliminary study identified the following key issues concerning the sustainability of ferry service in Alaska:

- The Marine Highway continues to serve critical infrastructure needs in coastal Alaska.
- The system is in financial crisis.
- The issue of how to make the Marine Highway system financially sustainable has not been resolved.
- The current operating model is outmoded and no longer adequately meets the needs of users.
- The Southeast Alaska Transportation Plan holds promise, but leaves many important questions unanswered.
- The existing management structure may not be sufficient for the future, and other management models exist that are worthy of consideration.
- Proposed legislation leaves some key issues unaddressed.

The Marine Highway serves critical infrastructure needs. Even more now than when it was conceived half a century ago, the system is a socio-economic lifeline for its communities. A number of smaller communities are extremely dependent on the AMHS for the movement of basic goods. In addition, it provides the basis for regional trade and may be key to addressing new seafood markets. The system is also a critical element in the visitor industry statewide.

The system is in financial crisis. A reserve fund that peaked in 1995 at \$46 million, is now fully depleted. While earned income has been relatively steady at 54 percent of operating expenditures, general fund appropriations to the Marine Highway Fund have declined from 49 percent of expenditures during the late 1970s and 1980s to 37 percent of expenditures during the past five years. Confronted with proposed FY03 funding that is \$6.6 million below the AMHS request, managers have outlined a program of service cuts and vessel lay-ups. Even if next year's funding is restored, the gap between earned income and operating expenses is expected to remain at roughly \$40 million per year until the SATP is substantially implemented (currently projected in 2008). Even with planned improvements, however, expenses are projected to outstrip earned income by \$32.7 million in 2010 according to AMHS planning documents. This is \$4.5 million more than the average annual general fund appropriation over the past decade.

The issue of how to make the Marine Highway system financially sustainable has not been resolved. A formal evaluation of alternative financial models and their implications for Alaska has never been performed. Some long-term, acceptable balance of public funds and earned income must be achieved, yet none has yet been proposed.

The current operating model is outmoded. The operating model on which the AMHS has been based since its inception clearly is no longer acceptable. Both vessels and cost structure are inflexible. The system is unable to meet users' highest priority need: regular and convenient schedules.

The Southeast Alaska Transportation Plan holds promise, but leaves many questions unanswered. A new Alaska ferry operations model is articulated in the Southeast Alaska Transportation Plan (SATP): faster ships, shorter runs, smaller crews. In fact, regional self-sufficiency is an explicit goal of the SATP. However, the Plan does not specify how self-sufficiency is to be achieved, and critical elements remain either

unknown or undefined. While fast catamaran vehicle ferries are increasingly used worldwide, they have not been tested in Alaska service. Further, critical elements of the SATP are either in limbo or have been added or dropped in ad hoc fashion in the years since the plan was first developed. These include key road links, location of terminals, the structure of individual routes, and whole vessels, for example to provide mainline service not envisioned by the original SATP, but subsequently determined to be desirable.

SATP financial projections are not sufficiently detailed to generate confidence in the financial performance of the system in actual operation. The potential response of AMHS's largest market segment, the visitor market, to SATP-type service is unknown and largely untested. Given what has been learned from the *Alaska Marine Highway Marketing and Pricing Study (2000)* and other recent analyses, do the load factors projected in the SATP still seem reasonable? If not, what is likely to be the impact on fares and service? Finally, with the legislature reluctant to authorize GARVEE bonds for construction of new vessels, how will the SATP be implemented and over what period of time?

The existing management structure may not be sufficient for the future, and other models exist that are worthy of consideration. Community testimony about ferry service and the role of the Department of Transportation and Public Facilities in providing it continually echoes themes of confusion and frustration about how decisions are made and enacted. For its part, the department is caught between demands for better service at lower prices, growing pressure to cut costs, and equipment and labor contracts that largely preclude either. With no clear agreement or direction about how to resolve this dilemma, is it any wonder that AMHS decisions often appear to emerge from an inscrutable "black box?" Yet the question of whether there are better ways to manage the system in the future has not been systematically addressed.

Ferries and many other types of mass transit in the US are commonly organized as "authorities." While Alaska's needs are unique, aspects of this model may help address the seemingly inherent conflict in designing a system that is responsive to user needs and also autonomous enough to operate efficiently. Preliminary research into this type of structure indicates that it holds promise. For example, the Inter-Island Ferry Authority recently inaugurated independent ferry service between Ketchikan and Prince of Wales Island. However, significant questions remain. There is neither another ferry system nor a transportation authority in the US that approaches the geographic scope of Alaska's Marine Highway. Further, authorities are typically based on a predictable revenue stream that makes them relatively independent of annual appropriations. The mechanism by which this would occur system-wide in Alaska has not yet been identified. Other public/private hybrids that may be relevant include selective privatization and public/private partnerships.

Proposed legislation leaves some key issues unaddressed. Two bills introduced this legislative session – SB 130 and SB 271 – proposed sweeping changes to the structure of AMHS. However, neither addressed fundamental questions about how service levels should be determined or on what basis they should be funded. Two characteristics of the Alaska Railroad – relative insulation from the political process and a portfolio of revenue-producing real estate and other assets — hold promise for ferries as well. However, merging the two systems, as SB 271 proposed, does not seem a good solution. Neither is it clear that the type of board structure envisioned in both bills will work well for a system the size and complexity of AMHS.

Recommendations

The Alaska Marine Highway System is at a critical juncture. It cannot continue with business as usual because the funding is not available. It may be able to buy time to implement a new operating model. However, the Marine Highway Fund has been used to buy time since 1995 to the tune of \$46 million. The new system (as described in the SATP) is still several years away and to some extent undefined. As time erodes so do options and the chance to act in a deliberate and thoughtful way. With Alaska's coastal infrastructure needs heavily warged on the SATP model, the stakes are high.

McDowell Group therefore recommends that the following broad questions be examined in order to better identify the Marine Highway that will best meet the future needs of Alaska:

- What entity or combination of entities is most likely to operate the Marine Highway System in a way that achieves the best possible mix of cost control, service provision (passengers and freight), and revenue generation? Possibilities include:
 - A government department (current method)
 - One or more public corporations or "authorities," for example, similar to the Alaska Railroad or the Inter-Island Ferry Authority
 - One or more private corporations
 - Some combination of the above
- What is the financial performance of the SATP as currently conceived likely to be? What capital and operating decisions are most critical to that performance? On what basis and by whom should those decisions be made?
- What mix of public (federal, state, and local) funding and earned income will provide the most stable basis for Alaska's marine transportation infrastructure and how can it be achieved? This is the most pressing issue for the system, since none of the other improvements can be implemented unless this problem is solved.

Related issues include how to balance statewide, regional and local needs and interests, and the how ferry service will be integrated with other transportation infrastructure.

This White Paper presents limited, preliminary research into alternative approaches to marine highway service in Alaska. It is not intended to provide answers to these difficult questions. Rather, it suggests avenues for further investigation and analysis.

The paper discusses why this is a critical opportunity for the Marine Highway and outlines steps to help ensure that the opportunity is not lost. Attachments include a preliminary framework for evaluating management models and descriptions of a few of the relevant management and operational structures to be found in and outside Alaska.

Situation Overview

Role of the Marine Highway

Of the 32 Alaska communities currently served by state ferries, only a handful are connected to the road system, and just a dozen have jet service. For the others, small planes, private boats and an occasional barge are the only outside links. Regionally, the Marine Highway System provides the only reliable transport between most of these communities. Airplanes – both small and large – are expensive, weather dependent, and capacity constrained. The Alaska Marine Highway provides a surrogate road system and a foundation for regional trade.

For the state as a whole, the Marine Highway System is both a key visitor access point and one of the state's best known and most popular destinations. The system carries approximately 50,000 non-resident visitors per year either into or out of the state. These visitors stay in Alaska an average of more than two weeks. All told, approximately 140,000 visitors travel each year on the Marine Highway at some point during their visit. They travel widely, with nearly half (47 percent) visiting Anchorage.

As a recreational attraction, the Marine Highway has few parallels. Ninety-three percent of summer travelers – visitors and locals alike – rate their overall experience on the Alaska ferries good or very good. Nearly all summer passengers use the ferries primarily for pleasure and to experience the Inside Passage, Prince William Sound and other coastal waterways in a special way. Two thirds of summer passengers do not consider another alternative when making their trip plans, and only 7 percent consider traveling by cruise ship.¹

Mission of the AMHS

The formal mission of the AMHS is not entirely clear, a condition that has contributed to the volume, if not the quality, of debate on the system. According to Legislative Research Report 02.016 (December 14, 2001), the published mission of the Alaska Marine Highway System is “to provide safe, reliable, and efficient transportation of people, goods and vehicles among Alaska communities, Canada and the ‘Lower 48,’ while providing opportunities to develop and maintain a reasonable standard of living and high quality of life, including social, education and health needs.”

The *AMHS 2000 Traffic Volume Report* articulates a mission “to serve Alaskan communities by providing passenger, freight (van) and vehicle transportation service between communities without land highway connections. This service helps meet the social, educational, health and economic needs of Alaskans.” The Southeast Alaska Transportation Plan (SATP) reinforces a view of the Marine Highway as necessary infrastructure. The Plan, which largely concerns itself with ferry service, offers as one of its six formal goals to “support local economic development and strength through the provision of adequate and affordable transportation....”

¹ *Alaska Marine Highway System Marketing and Pricing Study*. McDowell Group, 1999-2000.

Residents of AMHS-served communities often cite the system's designation as part of the national highway system as evidence that it is intended to meet the same essential needs as a land road, and with the same expectation of public subsidy normally associated with highways. However, according to the Legislative Research Agency, "the phrase "essential service" was not mentioned in the AMHS enabling legislation." The agency suggests that "... legislators may have acted under the assumption that the AMHS would eventually become self-supporting, as one pre-statehood report predicted."²

Historical Performance

In AMHS's early years, the new services and vessels were warmly welcomed and became, by default, the benchmark against which expectations were measured. Prior to 1975, the whole system ran on \$20 million per year, about two-thirds of which was earned income. By 1985, operating costs had nearly tripled, to approximately \$62 million per year. They have continued to rise at about half the rate of inflation³, to the current level of \$80 million.

Ridership has trended somewhat differently. After rising more or less steadily into the early 1990s to a high of 420,000 annual passengers, ridership declined. In 2000 351,000 people rode the Marine Highway, about 20,000 fewer than in 1985.

The most often cited reasons for the increase in operating costs are labor contracts and new Coast Guard regulations. Law makers have also accused the AMHS of being "top heavy" in management. However, the *Marketing and Pricing Study* of 2000 noted that certain management capacity considered critical to private sector marine operations -- namely marketing, customer relations and reservations -- was woefully inadequate at AMHS and, further, that this was a significant cause of the system's declining ridership.

If there is "excess" management at AMHS, it seems more likely to lie in the cumbersome contracting and oversight mechanisms that may be inherent in public services. For example, a 2001 *Ferry Operations and Service Study* of northern Southeast Alaska routes added an 11 percent premium to its estimates for new vessel construction to account for the difference between historical state contracting costs and those typical of the private sector. The state's lengthy dispute with the builders of the Kennicott, which cost nearly \$80 million, seems to bear out that approach.

Current Financial Situation

Declining state support together with failure to raise fares and market effectively during a decade of rising costs have left Alaska's Marine Highway System (AMHS) on a precipice and without a net. Although the system typically earns more than half the amount of its operating expenses, this leaves a significant gap. For reference, the Washington State Department of Transportation ferry system, with much simpler routes and a much larger market, earns only about 60 percent of its operating costs.

The AMHS has been demonstrably in financial crisis since 1995. At that time its operating reserve in the Alaska Marine Highway Fund reached a peak of \$46.3 million and began to decline. Ostensibly established (July 1, 1991) to see the system through short-term and emergency expenditures, the fund's reserve balance has not functioned for that purpose. Rather, it has been used to fill an ever-widening gap between the sum

² Legislative Research Report 02.016

³ Based on the national Consumer Price Index

of AMHS earned income plus annual legislative appropriations and the system's actual operating expenditures.

Since FY 1996 operating revenues have increased slightly from around \$39 million to \$42 million. Legislative appropriations have held between \$27 and \$29 million. However operating costs have trended steadily upward since 1998. The gap between revenues and expenses is now in the neighborhood of \$10 million per year.⁴

Reserve funds were exhausted during FY 2002. As a result, a recent proposal by the legislature to fund AMHS at \$6.6 million less than its requested level for FY 2003 is projected by DOT/PF to result in service reductions for three vessels and the accelerated retirement of two others, also resulting in less service. Unless the system is drastically reconfigured or receives substantially more public funding, it seems clear that routes must be permanently cancelled and vessels idled.

The Alaska Marine Highway Vessel Replacement Fund was also designed as a "savings account" for the system, this one to provide for repair and replacement of aging vessels. Most of these capital expenses have been covered by federal highway and transit funds. The balance of the Vessel Replacement Fund is currently zero.

**Summary of AMHS Operating Budget (in \$millions)
1991 to 2000 with 2001 and 2002 Projected**

Fiscal Year	AMHS Fund Beginning Balance	AMHS Revenue to AMHS Fund	General Fund Subsidy to AMHS Fund	AMHS Operating Expenditures	AMHS Fund Ending Balance
1991	0.0	40.5	70.5	70.5	40.5
1992	40.5 ⁵	44.1	30.7	69.7	45.6
1993	45.6	42.2	30.0	71.6	46.1
1994	46.1	41.7	28.7	71.1	45.4
1995	45.4	43.6	28.4	71.1	46.3
1996	46.3	39.0	28.3	69.5	44.0
1997	44.0	38.6	28.6	69.9	41.4
1998	41.4	37.4	26.9	68.0	37.7
1999	37.7	38.8	27.3	74.0	29.8
2000	29.8	40.3	27.1	75.2	22.0
2001	22.0	42.7	27.9	80.1	12.5
2002	12.5	42.6	28.8	80.5	3.5

Source: Legislative Research Report, December 14, 2001, Report #02.016

⁴ Amounts are approximate and based on analysis and projections prepared during FY 2001 by Legislative Finance Division.

⁵ The AMHS Fund became effective July 1, 1991. It was capitalized with \$40.5 million from prior year AMHS revenue.

Source of the Gap between Revenues and Costs

In fiscal year 2000, ferry system revenues covered 54 percent of operating expenditures, and no capital costs.⁶ While it is the norm for public transportation to cost more than it brings in, AMHS operating costs of approximately \$1.25 per passenger mile are high.⁷ Excess capacity, inefficient vessels, unprofitable routes or schedules, inflexible labor costs, and inadequate peak prices and off-peak price differentials are the main drags on operating margins. Historically, labor costs have represented approximately 70 percent of the AMHS operating budget.

Revenues

Market studies have identified lack of consistent, convenient scheduling and a responsive reservations system as the biggest barriers to increasing local ridership. A combination of 24 hour crewing, tidal restrictions and long, complex routes makes it difficult to spread service evenly over the week or month and impossible to schedule arrivals and departures at convenient times of day. Telephone hold times on the reservations system have improved recently, but historically have exceeded industry standards by a factor of five or more.

Simple follow-up target marketing has been identified as the most effective way to increase business, but, until recently, the system has lacked the capacity to execute it. Years of administrative downsizing together with a general lack of private-sector visitor industry experience and orientation have resulted in steadily declining visitor sales during a period of rapid expansion in the cruise industry. Alaska arrivals via AMHS declined 37 percent overall from 1989 to 1999. During the same period cruise ship arrivals increased by 200 percent.⁸

This suggests that management structures designed to respond to a market model could make a major contribution to the sustainability of the ferry system. A more market-oriented system could employ the profit incentive and shed political constraints to reach more optimal capacity, vessel and service configurations, routes, service schedules, labor schedules and costs, and pricing.

Costs

The same factors that hamper the system's ability to respond to market needs combine to leave current ferry management with few options for cost control beyond large cuts in service. Labor and fuel cost are the two significant variables in vessel operations efficiency. Both are largely pre-determined by existing vessels and routes. When vessels operate for more than 12 hours in succession, as AMHS vessels do, the Coast Guard requires that they carry a fresh crew aboard to assume operations at or before the 12-hour deadline. The Coast Guard also sets requirements for the number and type of crew that must be aboard depending on the type of vessel and service.

⁶ Table 2, *A Summary of the Legislative and Fiscal History of the Alaska Marine Highway System*, Legislative Research Report No. 02.016, December 14, 2001.

⁷ For comparison, operating costs for BC Ferries in 2001 were approximately \$0.95 per passenger mile.

⁸ McDowell Group, *Alaska Marine Highway System Marketing and Pricing Study*, 2000. Vol I, page 49.

To the extent that there has been room within Coast Guard regulations to institute labor savings, the AMHS has had little success in the past obtaining labor contracts that accomplish this. In 1997, an attempt to take a hard negotiating stance with the three AMHS unions – the Marine Engineers Beneficial Association, the Masters, Mates and Pilots union, and the Inland Boatman’s Union – ended with little change in the system’s cost structure, according to Legislative Research Report 02.016. The current three-year contracts end in 2003.

This leaves the AMHS with only one real cost-control option, cutting voyages and laying-up vessels. The option is not attractive since layup produces no revenue and labor inflexibilities limit cost savings. The fundamental problem is that the units of adjustment consist of large vessels and long routes. This means that capacity cannot be matched to demand using reasonable incremental adjustments. Any cost-saving measure big enough to be effective has a draconian impact on service.

Challenges to Continued Operation

The Alaska Marine Highway System is confronted with a funding crisis so severe that its ability to meet basic needs is in doubt. Service cuts are already being planned for this summer. Although a new operating model – faster ships with smaller crews on shorter routes – has been designed (the SATP), it is not clear that there is the political will to implement that system. Neither is it clear that the current management structure – resource-thin and battered from years of political wrangling – is the best choice to operate it. Finally, it has not been demonstrated publicly that the new system will, in fact, be financially sustainable.

Limits of Past Planning

Unknowns in the SATP

The Southeast Alaska Transportation Plan (SATP), developed over the past decade, recognizes many of the shortcomings of today’s AMHS. It identifies a new service paradigm consisting largely of faster ships, smaller crews and more direct routes. However, to implement these recommendations without also looking hard at the operating entity charged with making them work and the financing mechanisms that will keep them solvent is to set the stage for failure. The SATP, itself, was developed within the system that produced the current malaise and may be expected to reflect that system’s limitations. These include limited understanding of markets and marketing, susceptibility to political pressure and a general lack of private sector experience in setting and achieving financial performance goals.

Most critical, the SATP was not designed to be financially sustainable. It calls for vessels and routes that should, in theory, be more economical. However, it does not identify either a funding mechanism or an operating rationale to ensure stable, sustainable service. In fact, the plan represents something of a “Cadillac,” with its combination of fast point-to-point service and continued mainline routes supplemented by occasional Inter-Island Ferry Authority (IFA)-type vessels.

Shortcomings of Other Planning

Ferry system planning to date has, to the study team's knowledge, been conducted in sound, workmanlike fashion. However, it suffers from a systemic shortcoming: the agenda and scope of work in nearly all cases have been determined by DOT/PF. *The Socio-Economic Impacts of the Southeast Alaska Transportation Plan on Petersburg* (2000) is something of an exception. However, it, too, was funded by the Department.

A result of DOT/PF's approach to planning is that, by and large, the objective has been to identify the most cost-effective alternative, including the "status quo" or "do nothing" alternative. Not generally included, however, are attempts to identify the most financially sustainable alternative, or to re-think the fundamental rationales behind service provision.

Further, the world of ferries, especially fast ferries, is changing rapidly. This evolution is being tracked on many fronts. The US Transportation Research Board currently catalogues more than 50 recent studies pertaining to ferries, ranging from new ways to project ridership to environmental impacts, to analysis of how public decisions are made. The Board is undertaking its own National Ferry Study on the evolution and current status of US ferry systems.

Ferry transportation in many other countries is more advanced than in the US. However, little is known about the financial structure of these operations because most of them are private companies. An attempt by independent consultants to learn more in this regard was largely unsuccessful, according to AMHS management.

Limits of Proposed Solutions – SB 130 and SB 271

Bills to alter the structure of the Marine Highway and, specifically, to create a ferry system "authority," have been introduced in the legislature since the mid-1990s. The current legislative session is considering two proposals. SB 130, sponsored by Senator Robin Taylor of Wrangell and co-sponsored by Senators Austerman and Cowdery, proposes to create a separate authority to manage the system. It's seven-member board would consist of the commissioner of DOT/PF and six citizens appointed by the governor, two of whom represent ferry system unions. Two board members must have private sector experience and others must represent the public in various specified ways.

A second bill, SB 271, sponsored by Senator Jerry Ward of Kenai and co-sponsored by Senators Austerman, Cowdery and Taylor, is similar in many regards. In its first draft, it called for state ferry service to be combined with the Alaska Railroad under a single authority charged with operation of both. A committee substitute was offered, eliminating the combination with the Railroad. The new entity would reflect the current Alaska Railroad Corporation model in that real estate holdings would be managed in such a way as to subsidize operations, at least to some extent. The new authority would be authorized to select 500,000 acres of land conveyed to the state under the Alaska Statehood Act. The bill does not address the type or location of the land, why this particular amount was chosen, or what revenues the authority would be expected to generate with it.

The bills are similar in that:

- Both amend AMHS enabling legislation with language that indicates increased state commitment to the system's financial and service stability. SB 130 goes farther, noting that the system is an "essential part of the state transportation system and that it warrants continued and predictable state support."
- Neither provides a mechanism for ensuring certain relevant expertise in the governance body. For example, no board members are required to have experience operating a profitable marine transportation system.
- The bills require the legislature to fund the system in "an amount that is consistent from year to year and is the amount necessary, after consideration of gross revenue, to provide stable services to the public consistent with the provisions of AS 19.65.050 (b) (4)" i.e., predictable and stable service. However, they do not describe a means by which to establish service or revenue expectations.
- Similarly, the bills call for vessel schedules to "optimize" the frequency of service to all ports, but do not describe how the number and choice of ports is to be determined nor on what basis frequency is to be optimized.
- Both bills also authorize management to conduct independent labor negotiations, and both provide for labor to be represented on the governing board.

Unanswered Questions

Before we risk condemning any future ferry system to the same funding, operational, and management demons that afflict this one, it makes sense to ask some basic questions.

- Will the construction and working capital to implement the Southeast Alaska Transportation Plan (SATP) be forthcoming?
- If implementation of the plan is delayed, what will happen to day-to-day ferry operations now that the Marine Highway Fund is exhausted?
- Is there a package of fair and sustainable financial support that can meet the long-term operating and capital needs of Alaska's ferries, and make the system less vulnerable to annual budget trade-offs?
- What set of routes, vessels and services would maximize the potential of the system to earn income?
- Can the system be designed so that basic operating decisions about who gets service and how often avoid becoming mired in political turmoil? What can we learn from other systems in this regard?
- What management and governance structure is most likely to succeed at meeting the system's dual mandates of basic transportation infrastructure and income generation while demonstrating a standard of efficiency that makes it financially justifiable. Again, what models might provide guidance?

In simplest terms:

What mix of service, management and funding will make for a ferry system that is stable, sustainable and that best meets state and regional needs?

A Vision of Sustainability

In the words of the Alaska Legislature's Legislative Research Services, AMHS's ... "self-imposed mandate – to provide basic transportation services to Alaskan communities – has been the source of much controversy and debate in the legislative and public arenas."⁹ No one has ever defined "basic transportation" nor identified a mechanism by which to determine appropriate funding. This is not uniformly the case for other Alaska public "enterprises," however.

Other Alaska Models

The State has used its resources to subsidize other activities that are normally viewed as a less essential government activity than provision of transportation. The Alaska Housing Finance Corporation ("AHFC") has received more than a billion dollars to subsidize interest rates to homebuyers. The Alaska Industrial Development & Export Authority ("AIDEA") at one time had \$388 million in capital contributed by the State to subsidize business loans. Hundreds of millions were spent by the State to subsidize power production and distribution by building the Bradley Lake and Four Dam Pool hydroelectric facilities and the Railbelt Intertie.

Approximately \$190 million (\$100 million from the Constitutional Budget Reserve and about \$90 million from sale of the Four Dam Pool hydroelectric facilities) has been used to endow the Power Cost Equalization program, which subsidizes rural electric rates. \$100 million was appropriated to the Alaska Science & Technology Foundation to promote scientific and technology development.

The Future of AMHS

The programs just mentioned differ from the Alaska Marine Highway System in one important respect. Each was designed, after a start-up period, to reach a level of financial sustainability after which continued large infusions of cash would not be required. While this may have been an intention on the part of legislators who authorized the start-up and evolution of the AMHS, it has not been an explicit operating goal.

Yet it is within the realm of possibility, indeed necessity, for the Marine Highway System to provide "basic transportation" while requiring no more than a generally acceptable level of operating subsidy. "Necessity" because infrastructure that is annually at risk of curtailment due to lack of funding cannot be the basis for a healthy regional or statewide economy.

The critical elements of sustainable service are discussed in the following section.

⁹ *A Summary of the Legislative and Fiscal History of the Alaska Marine Highway System*, page 4.

Three Elements of Sustainability

Each of three critical elements of the system must be in place and coordinated with the other two:

- Management
- Operations
- Finances

Past ferry studies, including the Southeast Alaska Transportation Plan, have focused on operations. At best, this is enough to build a one-legged stool, and even that leg is not clearly drawn.

Management and Governance Planning

The attachment "Evaluation of Potential Management Models" discusses three broad management approaches: public, private and some combination. Each type has strengths and weaknesses with respect to the Alaska Marine Highway System. Purely public entities tend to be more subject to political pressures and less skilled at business tactics. Private sector firms may not be responsive to public needs and may not have access to certain types of funding. Public/private hybrids are possible, but require careful structuring and monitoring.

Preliminary analysis suggests that the "authority" model, variously used for ports, transit systems, bridges, tunnels, ferries and airports, offers some advantages for Alaska's ferry system. Authorities are overseen by a board of directors charged with meeting both service and financial goals. They typically are able to act more independently than government line agencies (departments).

Placing the ferry system in the hands of an authority is not a panacea, however. The degree to which it is publicly responsive depends on the makeup of its board and the nature of its mission. Extending this line of reasoning to its logical extreme suggests that responsiveness might be maximized under multiple sub-regional authorities similar to the IFA. The mechanism by which those bodies might work together to provide an efficient whole is by no means clear, however.

Further, an authority's independence relies heavily on its ability to cover its own costs. Authorities are generally designed so that the sum of their operations makes them self-supporting. Within a port or transit authority, for example, bridge tolls may be used to subsidize ferry service.

Further analysis of a range of potential management entities is warranted. Entities should be evaluated on the extent to which they are able to:

- Control operating costs
- Generate revenues
- Access appropriate public funds
- Engage in effective contracting negotiations

- Make timely, well informed business decisions
- Understand and respond to local, statewide and visitor market needs
- Meet the requirements of vessel and port operations
- Manage effectively all the assets of the system

Operations and Service Planning

There is no need to replicate the planning process undertaken for the SATP. It is generally accepted as having been reasonably thorough and most of its fundamental findings are not at issue. However, is the SATP a financially sustainable operations plan? The answer is that no one knows. Sustainability was not a goal of the SATP process. Rather, the plan sought the “best balance of cost and service,” a quality that clearly depends on one’s perspective. Financial projections for the SATP demonstrate that it compares well with other operating options *at a particular level of service*. However, the projections do not provide guidance with respect to how service can best be modified, should financial considerations demand.

The Inter-Island Ferry Authority (IFA), on the other hand, is predicated on sustainability, that is, on fares covering operating costs. Whether this will prove achievable is not yet known. Although its scope of operations is tiny compared to AMHS, IFA may be an instructive case study.

The IFA-type vessel is another variable. The SATP identifies a number of advantages to small passenger vessels built under Subchapters T and K of Coast Guard regulations. However, it leaves their potential deployment in Southeast Alaska unspecified. Further analysis is needed to understand the financial implications of using these vessels for day and, possibly, 24-hour service, or day service with the vessels overnighing in outports, depending on scheduling demands.

Other unresolved SATP issues include decisions about certain key road links and terminal locations and about the nature and cost of ground transportation needed between proposed terminal sites.

To address these issues, the SATP must be translated into a business plan. It must specify the degree to which each of its services is expected to contribute to net revenues. It must define the best *sustainable* balance of cost and service system-wide. This means that, if an unprofitable service is to be pursued, the source of its subsidy must be identified, whether that source is earned or unearned income. It also means that effort and expertise must be invested in maximizing profits, or at least contribution margin, throughout the system.

This type of analysis was performed for a recent BC Ferries study – *Review of BC Ferry Corporation and Alternative Uses for the Fast Ferries* (2001). The author concluded that the BC system could not realistically expect to implement its own operating plan. The report recommended a thorough re-examination of BC Ferries’ management with the goal of “de-politicizing” decision making. While Alaska’s Marine Highway is not faced with the Canadian dilemma of what to do with expensive new vessels that have been deemed unusable for their intended purpose, politically motivated decisions have taken their toll here as well.

Financial Planning

Identifying the composition of a fair and sustainable financial plan is the single most important step needed to secure the Alaska Marine Highway's role in the future. This is precisely because operating all runs on a break-even basis is unrealistic. Like any public infrastructure, coastal marine transportation must have a package of funding that is generally accepted at the federal, state, regional and local levels as practical, fair and reasonable. Here, again, we must address a continuum. Stability will likely result from a combination of operating and capital revenue sources that includes earned income, and federal, state, regional and local funds.

Earned Income

Based on past market studies, it is clear that the system could increase its level of earned income significantly. This, in turn would reduce public subsidy and pass more costs along to users, ideally in return for value delivered. There are at least five general sources of earned income:

- Regular/Local tariffs – Management should understand how – and have the authority -- to set regular tariffs in a way that maximizes net revenue per route. If some other rationale is used to set tariffs – such as “everyone pays the same” – then some subsidy must be identified to make up the difference.
- Seasonal/Visitor tariffs and tours – As studies have pointed out, it is critical in the travel business to be able to charge according to what the product is worth to individual market segments. This means seasonal pricing, package pricing and pricing based on reservation and trip timing. The airline model of price discrimination and load management may not be desirable, but many of its fundamental characteristics are.
- Concessions and licensing – Lack of management capacity, entrepreneurial incentives, and seed money, together with restrictions imposed by labor agreements, have prevented the system from exploring concession and licensing opportunities. While not likely to be big business, these can contribute to a sustainable system.
- Freight tariffs – Freight service has long been a kind of homeless child of the AMHS. Not wanting to compete with private firms, the system has underplayed its freight services to the point where many potential customers do not take them seriously. A sustainable ferry system will need a business strategy that takes advantage of its capacity to serve the niche that lies between barge and air freight services.
- Asset management – Income from managing, leasing, trading, etc. of system assets is a relatively unexplored avenue for AMHS. Assets may be land, financial instruments, vessels, even expertise and information.

Federal Funds

In addition to funds specifically designated for ferry systems, AMHS has been eligible in the past for federal highway and safety funds and, to a lesser extent, public transit funds. Another federal funding rationale that might be applied to ferry service is the Essential Air Service program, which currently subsidizes air service for approximately 100 smaller rural communities, one quarter of which are in Alaska.

State Funds

In addition to annual appropriations, state mechanisms used to fund ferry operations elsewhere include gasoline excise taxes and highway taxes. Funding for particular functions, such as marketing for private ferry service that serves public and visitor needs, has also been provided by some states.

Regional and Local Funds

Local funding mechanisms used elsewhere to subsidize ferry service have included sales taxes, bridge and tunnel tolls, airport revenues,¹⁰ and real estate taxes. Bed/head taxes on visitors is another potential source of local funding.

Summary of Options

Management and Governance

Key Question: What management structures and skills will be most successful at operating in a way that meets consumer needs, minimizes costs, maximizes earned income and acts as a vehicle for other funding as appropriate?

Structures	Line agency, public corporation/authority, public/private partnership
Skills	Vessel operations, sales and marketing, customer service, political skills, financial management, yield management, partnering

Operations and Service

Key Question: What combination of routes, vessels and other services will meet regional and statewide needs most efficiently?

Routes	Long-distance, shuttle, hub & spoke, road links
Vessels	Size, speed, capacity, operating cost
Schedules	Timing and incidence of service
Other services	Freight, tourism, reservations, retail sales,

¹⁰ Tunnel tolls and airport revenues are generally part of a mix of revenue typically available to larger metropolitan authorities.

Finances

Key Question: What combination of earned and unearned income will sustain the Alaska Marine Highway System in a manner commensurate with the services it provides to its local, statewide and visitor constituencies?

Earned Income	Local fares Visitor fares and tours Concessions and licensing Freight tariffs Asset management (real estate, investments, vessels)
Federal Funding	Highway and transit funds Essential service funds Other federal programs
State Funding	Taxes for local / regional infrastructure Visitor industry support Other state programs
Regional/Local Funding	Bed tax / Head tax / Sales tax Other local programs

A Preferred Ferry Management Model

At this preliminary stage, it is not clear that any particular management structure is an obvious choice for the Alaska Marine Highway. The attributes, advantages and disadvantages of various structures are discussed in the attachment "Evaluation of Potential Management Models."

A sustainable model must combine responsiveness to community needs with responsiveness to market demands. In many cases, these may be at odds. For this reason, a desirable model must also offer access to public funding mechanisms. Four basic choices exist:

- **A line agency of government** (current system)
- **A statewide public corporation** (for example, Alaska Housing Finance Corporation)
- **A regional quasi-public corporation** (such as the Inter-Island Ferry Authority)
- **A public/private partnership** (wherein some management functions are performed by public employees and some contracted to the private sector. Note that this arrangement may be a subset of either a statewide or regional public corporation. The barriers to incorporating private contracts into line agency management are more significant.)

A purely private operating model is unlikely to be satisfactory unless service expectations by users are substantially adjusted. Many routes do not have enough ridership potential in the foreseeable future to be profitable at current service levels or in all seasons. Vehicle and freight van service, in particular, are difficult to provide to smaller communities on the basis of positive marginal revenues.

EVALUATION OF POTENTIAL MANAGEMENT MODELS

The ability of a management structure to move AMHS towards sustainability can be evaluated in terms of the scope of management authority, operational efficiency, external controls on management, and access to capital.

1. Does it have the authority to make the necessary decisions?
2. Does it have the incentive to operate efficiently?
3. Is it responsive to local and statewide needs?
4. Does it have access to necessary funding?

Structures that offer the greatest latitude to management to determine the services provided and the prices charged, and control costs will have the best hope of reaching sustainability. With respect to services provided, what ability will management have to determine capacity, vessel configurations, routes, and service schedules? In the near-term, flexibility in regard to service is limited by the fleet configuration. Access to capital, as well as market economics, will constrain the long-run.

Possible management structures for AMHS range from pure public sector to pure private sector, to some mix in between. Decentralization of management is another dimension to be considered. Decentralized operations could involve a mix of public and private structures. Statutory guidance and standards for the process of decentralization would be needed.

Decentralizing ferry management can be a force for sustainability. For one thing, the limited geographic scope of management limits the opportunity for cross-subsidization of routes. It also limits access to general tax and financial resources of the State or other communities that might be used for subsidies. It helps ensure that services are tailored to market demand.

Key Management Measures

Operating Authority

An *Alaska Marine Highway System Marketing and Pricing Study* documents the failure of AMHS to raise fares, even to keep up with inflation, for a period of ten years from 1991 to 2000.¹¹ This is a strong signal that management's current scope is unduly confined by political and bureaucratic pressures.

Labor is currently the largest cost of AMHS operations. In fiscal year 2001, it represented 65 percent of AMHS operating budget. Services provided and the fleet make-up build in a lower threshold for labor costs. But, beyond the effects of service decisions, to what extent can management control manning and staffing, work hours and rules, or compensation? A study of the British Columbia ferry system¹² identified the following as collective bargaining issues that significantly affect efficient operations:

- Inflexibility in work rules, hours, and contracting out

¹¹ *Alaska Marine Highway System Marketing and Pricing Study, Volume 1*, McDowell Group, , September 2000, page 34.

¹² *Review of BC Ferry Corporation and Alternative Uses for the Fast Ferries*, page 14.

- Promotions based on seniority, rather than merit
- Above-market compensation
- Overtime policy as a disincentive to on-time performance
- Ability to set crew levels and pay on new vessels

Will management have a free hand in pricing and the resources to effectively market ferry services? The *Alaska Marine Highway System Marketing and Pricing Study*¹³ demonstrates how reservation and marketing resources and market pricing could go a long ways towards getting AMHS on its own two feet.

AMHS currently operates under a number of administrative procedures to provide accountability and public control and protect the public interest. These include:

- Executive Budget Act
- Administrative Procedures Act
- State Personnel Act
- State Procurement Act

These procedures should be compared to those under alternative management structures to shed light on management's relative ability to determine services and prices and control costs.

Does the management entity have the power to issue debt, at least in the case where it is supported solely by system revenues? Would it have the power of eminent domain?

Operating Efficiency

Balancing customer expectations with cost-effective operation is the fundamental challenge in any business. It is a much greater challenge when the business involves a public service such as transportation. The private sector can use a simple, easily quantified measure of efficiency: profits. However, public service is measured by an almost infinite spectrum of often vague, even mutually exclusive expectations.

To be useful, then, management measures of operating efficiency must combine financial and public service goals. Past ferry system planning documents have not directly addressed what a desirable balance in this area might be, nor even how to go about finding one.

A more complex question is "does the current system operate as efficiently as it can." To this, one must assume that the answer is "yes." Public employees cannot profit personally from inefficient operations, for example, by making "deals" that are in their own financial interest. Therefore, they must do the best they can within the constraints and incentives imposed by the system in which they work. It is these constraints and incentives that warrant further study.

The internal dynamics that cause AMHS or DOT/PF to operate the way they do also have not been formally analyzed. The issue was addressed in a limited way by the *Marketing and Pricing Study*, which noted that improving the *financial* performance of AMHS sales and reservations staff would be much easier if standard industry pay incentives could be employed. Private sector firms often take this principle farther, for example by offering cash rewards to employees who identify cost-saving measures. The

¹³ *Alaska Marine Highway System Marketing and Pricing Study*.

most efficient management structure for the Marine Highway will be one that understands how, *and has the authority*, to align individual staff incentives with this goal.

Responsiveness to Local and Statewide Needs

Where statewide or local management is governed by a public corporate form, careful attention would need to be given to the make-up of the board and the approvals required, if any, from local municipalities or electorates, as under the Alaska Port Authority Act.

Responsiveness to statewide needs suggests the continued need for an overall statewide management entity. The Alaska Mental Health Trust Authority has potentially useful elements of a management structure for determining services in coordination with available statewide funding, even though it does not operate services itself. A similar ferry entity could operate services and also be responsible for devolution of services to be operated by subsidiary entities, either public or private, on a decentralized basis.

Access to Funding

Where an essential public service is provided to communities and that service is known to require a financial subsidy, does management have access to a reasonable and secure level of public funding? The management structure must be eligible to participate in a program of public funding mechanisms that is capable of supporting the desired level of public service.

Ferry transportation also requires large capital investments. Access to capital markets or government aid for capital improvements will be critical in the long run. If operations are not sustainable, a ferry will also need an outside source of funding for operating subsidies.

A management structure could need access to federal, state, or municipal support. Given the predominance of federal highway aid (both formula programs and Discretionary Ferry Boat funding¹⁴) and mass transit aid for capital improvements, legal, institutional, and political barriers, or competition for these funds need close examination.

Access to the public debt and private equity markets may also be important for capital funding. The ability to use tax-exempt borrowing would be important if there is any possibility of debt financing supported by ferry revenues. Revenue debt can require net cash flows that are 25 percent or more greater than debt service. This would be a far greater challenge than sustainability of operating costs, given that cash flows currently barely covering half of operating costs.

If a ferry operation can use tax-exempt financing, State or municipalities might provide additional credit support. This could include general obligation bonds ("GOB's"), limited-GOB's, moral obligation bonds, lease-financings, and GARVEE or other bonds supported by a particular government revenue stream.

¹⁴ Section 1207, TEA-21.

Public Sector

Line Agencies

Ferry systems can be operated as a **line agency** of a government. This is the current structure of AMHS. It is a division of the Alaska Department of Transportation and Public Facilities ("DOT&PF"). It is governed by the appointed officials in the chain of command from the Governor, to the DOT&PF Commissioner, and on down, subject to various State laws and administrative procedures, labor agreements, and Federal regulations.

Enterprise Funds

While still a line agency, ferry systems can be structured as an **enterprise fund** within the government's accounting system. An example of this is the International Airports System within DOT&PF.

Generally accepted accounting principles¹⁵ define the purpose of enterprise funds as:

"...to account for operations (a) that are financed and operated in a manner similar to private business enterprises—where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through users charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes."

Enterprise funds are often used to meet the disclosure and accountability necessary to issue revenue bonds. This is the case with the International Airports System.

AMHS statutes have created two funds—the Alaska Marine Highway System Fund and the Alaska Marine Highway System Vessel Replacement Fund—that provide something similar to enterprise fund accounting. But, they are accounted on the State's books as part of the general fund, a governmental fund.

One of the principal differences between enterprise and governmental funds is that only enterprise funds report long-term assets and liabilities on their balance sheets. Also, full accrual accounting is required only of enterprise funds. These differences would require an accounting of AMHS capital assets and annual charges for depreciation.

The Governmental Accounting Standards Board is phasing in requirements that will move even governmental funds closer to an enterprise model. The Board's Statement 34 will require accounting for infrastructure asset values and annual depreciation or maintenance charges.

¹⁵ National Council on Governmental Accounting Statement No. 1, Governmental Accounting and Financial Reporting Principles.

Public Authorities

Public authorities are another type of governmental structure. They have a legal existence independent of the state or municipal government—usually, they are created by law as public corporations. They may still be administratively lodged in departments of government—for example, AHFC is part of the Alaska Department of Revenue—to facilitate oversight, budget coordination, or other administrative functions.

They also typically have a different governance structure, usually a board of directors, either appointed, *ex officio*, elected, or some mix. They may be created with statewide, regional, or municipal scope, for any purpose. They typically have administrative procedures similar to government, but often with greater flexibility.

Authorities may be given the power to tax or issue debt. Authority debt may receive various forms of credit support or guarantees from the parent government.

Authorities can provide a degree of independence from electoral politics. But, they also run the risk of becoming captives or advocates of users or suppliers of the services they administer. A degree of financial independence in terms of budgetary approval or retention of earnings may shift authorities closer to market-driven incentives. Endowment with financial resources can encourage an orientation to bottom-line results, but can also encourage assaults by interest groups that lead to the ruination of the commons.

Private Sector

Private sector management assumes that the State would exit the ferry business altogether, or on selected routes during selected times of the year. It denotes leaving the decision to the market as to what, if any, ferry service will be provided. Private ferry operations are common, particularly in Europe. In the US, public entities often eschew potential profits in favor of private operations. For example, when a study projected that a fast ferry operating between Gloucester, Massachusetts and Shelburne, Nova Scotia could be profitable, the City of Gloucester actively courted private sector interest in the route.

Private sector management structures would most likely take the form of **for-profit corporations**. Unlike public corporations, they can issue stock to raise capital, finance acquisitions, or reward employees. Significant capital investment would normally weed out other structures such as non-profit corporations that do not provide a return on risk capital. Business and other risks would rule out proprietorships or partnerships that do not provide limited liability. Small business structures that do provide limited liability such as limited partnerships, limited liability corporations, or subchapter S corporations can be cumbersome for obtaining outside capital or providing equity participation incentives to employees.

System Divestiture

The geographic scope of private sector ferry operations could be system-wide or confined to selected routes. The current deficit in AMHS operations suggests that **system-wide privatization** would severely truncate routes and service. If a private sector operator had to recover capital costs, it would create great uncertainty about what, if any, routes or services could sustain themselves. This would be true whether a private operator acquired existing AMHS assets or purchased new vessels or terminals.

Even if AMHS donated its existing assets to a private sector operator, the continuation of many routes and services would be in doubt. In addition, federal regulations may restrict the terms of transfer of assets funded from federal aid, or require repayment to the federal government of the proceeds of any such asset sales.¹⁶

No AMHS assets have been financed with tax-exempt bonds. If they had been, IRS regulations governing private-activity bonds could create problems with transferring assets to a private entity. Looking forward, private owners could face higher capital costs because of lack of access to tax-exempt financing for future capital improvements.

Service Shedding

Rather than abandoning the system to the vagaries of the private sector, AMHS could indulge in selective **service shedding**. AMHS could solicit proposals for providing service for selected routes, seasons, etc. that cover, or could reasonably be expected to cover, their costs.

Divesting any service that made money for AMHS would deepen the System's operating deficit. In theory, bids should represent the capitalized value of the routes' future earnings stream. If earnings were potentially greater under private operation, bids would more than compensate for aggravated future deficits.

Regulation of Competition

Where AMHS relinquishes service, some encouragement could be given to private ferry operations by limiting competition. AMHS could award **franchises** for particular areas as part of the bidding process. Alternatively, public utilities-style regulation could be established, requiring **certificates of convenience and necessity**.

¹⁶ Executive Order 12803 from 1992, Executive Order 12893 from 1994, and the current federal highway aid statutes, as amended by TEA-21 would need to be examined.

Public/Private Partnerships

Where both the public and private sectors are involved in providing a good or service, the operation is frequently referred to as a “**public/private partnership**”. In actuality, this seldom takes the legal form of a partnership or joint venture. More often, “public/private partnership” is a term used to garner popular support for either public financial support to private sector operations or contracting out public sector services to the private sector.

For example, Wisconsin’s ferry service across Lake Michigan is essentially a private operation. However, the state has shown a willingness to provide such things as start-up support for new routes, marketing support and assistance for capital projects.

Partnerships

Partnerships, in the true sense of the word, denotes **legal partnerships, joint ventures, or corporations**, in which there are both public and private equity investment and joint governance, if not management and operation. Conflict could be expected between profit incentives and government mandates to provide ferry services. The joint operating agreement or articles of incorporation would have to spell out strictly the scope of services and equitably allocate costs, profits, and risks.

Public Financial Support

Public financial support for private or subsidiary public ferry operations can take many forms. But, the most critical element is what control or assurances of service the government obtains in return. A **laissez-faire approach** leaves determination of what services will be provided to the private sector or subsidiary entity. Financial support could include:

- subsidies or prizes, awarded for example on a passenger-mile basis
- dedicated or shared revenues, also based on some performance measure
- tax incentives or exemptions with respect to income, property, sales, or fuel taxes
- credit support or financing guarantees for assets used in Alaska ferry operations; or
- lending for ferry assets

With a **public services approach**, government would retain control over the services provided. But, ownership of assets and operation of service would lie with the private sector. Financial support would be provided in the context of a contractual relationship that sets out routes, schedules, or capacity of services provided. The types of support mentioned above could be provided, but there would be more flexibility to negotiate fixed payments or obligations, as well as performance-based ones. In addition, support could include:

- capital contributions in the form of equity or grants
- endowment of ferry operations

A study of the British Columbia ferry system¹⁷ suggests that if a process for privatizing routes were established,

“Even for operations where there is little present appetite in the private sector, the very conduct of the process and the accompanying pre-commercialization activities will ultimately result in further commercialization opportunities.”

Private Sector Contracts

In addition to privatizing ferry operations on specific routes, “public/private partnership” could include **contracting out** specific functions in running a ferry operation. For example, the cabin housekeeping or ship operations of vessels might be contracted to a private firm. Restaurant or bar operations might be provided on a concession basis.

Administrative or shoreside operations that might be contracted out include:

- management/administration
- marketing
- reservations
- dock operations
- layup

AMHS already depends to a great extent on private firms for planning, design, and construction of capital improvements. But, in addition to acquisition of capital assets, AMHS might be able to lease vessels or terminals or pay usage or port fees for the use of terminals. Of course, AMHS could contract with municipalities, public authorities or agencies, or non-profits as well as the private sector.

¹⁷ *Review of BC Ferry Corporation and Alternative Uses for the Fast Ferries*, Fred R. Wright, December 2001, page 25.

EXAMPLES OF ALASKA MANAGEMENT MODELS

Current AMHS Model

AMHS operates nine vessels on routes that cover 3,500 miles of Alaska and British Columbia coastline between Bellingham, Washington and Dutch Harbor. It serves 32 Alaska communities plus Bellingham and Prince Rupert, British Columbia. The system has always been operated as an agency of state government. In 1997, the legislature ordered that AMHS be reorganized and merged with the Department of Transportation and Public Facilities.

The primary management units at AMHS are general administration, financial administration, reservations, vessel operations and port operations. Recently, authorization was obtained for a single marketing position. General planning and contracting are handled by other DOT/PF units. The director of Southeast Region for DOT/PF is also active in ferry system issues and sits on the ferry committee of the national Transportation Research Board.

Decision-making is handled as with any State department. There is no special mechanism or body to provide representation for the communities served by the system. Funding is prioritized through the same Statewide Transportation Improvement Program (STIP) that determines other DOT/PF project funding. An often-discussed issue is whether the STIP is an effective way of addressing the ferry system's strategic needs. For example, the first two fast vehicle ferries are slated for service between Sitka and Juneau and in Prince William Sound. However, it is not clear from existing planning documents that these are the routes that present the greatest opportunity for revenue enhancement or system-wide service improvements as a result of the new vessels.

Since 1990, ferry system finances have been funded through the Alaska Marine Highway Fund and the Alaska Marine Highway Vessel Replacement Fund. Both are sub-funds of the state's general fund. The Alaska Marine Highway Fund receives revenue from operations and annual appropriations by the legislature. Appropriations do not lapse at year-end. However, the fund meets Alaska's constitutional prohibition against dedicated funds because it is at all times subject to legislative appropriation for any purpose. The fund provides AMHS an increase in financial autonomy over the pre-1990 arrangement whereby the system was operated directly from the general fund by annual appropriation.

The Vessel Replacement Fund was to act as a "savings account" to meet vessel-related needs. To date \$19.5 million have been appropriated to the fund, all of which has been spent or committed. Since 1995, the vast majority of vessel refurbishment and replacement projects have been funded through the National Highway System Designation Act and the Transportation Equity Act for the 21st Century. This includes \$31 million for the first fast vehicle ferry, authorized in 2000.

Alaska Railroad Corporation

The Alaska Railroad Corporation is a public corporation, legally independent from the State. It cannot issue stock (AS 42.40.300). Organizationally, it is a political subdivision of the State Department of Community and Economic Development.

Notably, operation of the Railroad is declared to be an essential government function (AS 42.40.010). At the same time, it is mandated to generally operate on a self-sustaining basis (AS 42.40.100 (3)). Statutory provisions exist for requesting and receiving State subsidies for particular services. But, no subsidies have ever been requested. The statutes would require subsidies to be calculated in a specific manner, as prescribed by the United States Interstate Commerce Commission, now the Surface Transportation Board. Revenue and profits, if any, are retained by the Railroad for railroad purposes (AS 42.40.530).

The Railroad has been endowed with substantial amounts of land, both along railroad rights-of-way and elsewhere. In part, this is to assure unobstructed, efficient rail operations. But, revenues from non-rail uses of land also provide financial independence from State politics. They can cover variations in operating earnings that might otherwise require the Railroad to go hat in hand to the Legislature to maintain essential services.

Historically, the Railroad's rail operations have shown a profit, sufficient to recover depreciation. In 2001, they only covered operating expense. About half of the Railroad's \$306 million in assets have been funded from Federal grants and earmarked appropriations. \$79 million in retained earnings have funded another quarter of the assets.

Eighty-three percent of total rail revenues of \$96.2 million in 2001 came from freight; fourteen percent came from passengers. Net income of \$6.6 million from real estate accounted for all of the Railroad's net earnings in 2001. The Railroad actively manages its real estate. It has had a real estate department since the mid-1990's. Still, of some 18,000 leasable acres, only about 2,500 are under lease or permits.

Privatization is a possible goal for the Railroad. A number of rail services do not pay their own way and would most likely be jettisoned under private operation. AS 42.40.260 requires an annual report that analyzes the potential for sale of the corporation to private owners. Annual costs and income by category of service are included in the annual report. The Governor may also lease the Railroad under certain conditions (AS 42.40.940). The Railroad has privatized some passenger services via "pull" contracts for railcars owned by Princess and Holland America and relies on private contractors for the bulk of its capital improvements.

A seven-member board of directors governs the Railroad. The board includes two State commissioners and five public members. The majority of public members enhances the board's political independence. The public members must be appointed by the Governor and confirmed by the Legislature. Two members must have railroad expertise and one member is a Railroad employee bargaining unit member. Terms are staggered, but members serve at the pleasure of the Governor, potentially undermining continuity and independence.

The scope of the board's management authority is broad. It includes service levels and routes, rates, labor agreements, and budgets. Its budget is not subject to approval by the Governor or Legislature. With approval of the Governor, the Railroad may exercise the power of eminent domain.

There are a number of external limits on management's authority in these matters. The Railroad is deemed a common carrier subject to the jurisdiction of the Interstate Commerce Commission (AS 42.40 060 (b)(2) , now the Surface Transportation Board. Rates must conform to the requirements of the Alaska Railroad Transfer Act of 1982 (AS 42.40.250 (14)). Legislative approval is required for the Railroad to issue bonds. There are no provisions for the State to make its credit available for Railroad debt obligations.

The Railroad is generally exempt from the State's Administrative Procedures Act, State personnel and collective bargaining statutes, and the State procurement code. But, there are Railroad statutory provisions relating to adopting rules, collective bargaining, and procurement. About 80 percent of Railroad's 670 employees belong to one of five unions. The Railroad and interest on its debt are exempt from State and municipal taxes (AS 42.40.910), as well as Federal taxes.

As a corporation, the Railroad's liability is limited to its own assets or revenues. Railroad obligations create no rights against the State (AS 42.40.500). The Railroad's land is exempt from taking by adverse possession (AS 42.40.450).

Alaska Industrial Development & Export Authority

The Alaska Industrial Development & Export Authority ("AIDEA") is a public corporation, legally independent from the State. It also is a political subdivision of the Department of Community and Economic Development.

The main purpose of AIDEA is to provide financial assistance to business enterprises. AIDEA does so by purchasing loan participations, issuing loan guarantees, and owning and operating economic development projects. Economic development projects are often transportation infrastructure facilities.

These activities have been funded through State capital contributions of cash and existing State business loans; proceeds of AIDEA taxable and tax-exempt bond issues; and earnings on loans, investment securities, and development projects. Earnings on loans include loan commitment and guarantee fees charged to borrowers, as well as interest earnings.

AIDEA is essentially mandated to cover its costs. Interest rates on loans are statutorily set at AIDEA's cost of funds, including overhead. Bond-funded economic development projects must be able to meet debt service. AIDEA is authorized to charge fees for the projects it owns to provide a return on investment. This mandate, combined with a contribution of almost \$300 million from the State, now produces substantial earnings—over \$40 million in fiscal year 2001. This helped prompt a statutory provision that AIDEA pay an annual dividend to the State.

The oil price crash of the mid-1980's caused large loan losses for AIDEA, and limited demand for new loans into the 1990's. As a result, AIDEA's net worth grew little during this time. But in the last ten years, AIDEA's equity has grown from \$643 million in 1991 to \$878 million in 2001. And, this is after paying a cumulative total of \$91 million in dividends to the State from 1996 to date.

A five-member board of directors governs AIDEA. The board includes three State commissioners and two public members. The Governor appoints the public members. There are no expertise or experience requirements for any members. Except for two ex-officio State commissioners, members serve two-year terms.

Even with a majority of State executive branch cabinet members on its board and short terms for public members, AIDEA has remained profitable. Business-like management has played a role. But in large part, AIDEA's profitability is due to statutory privatization of the underwriting decision.

Private lenders determine what loans will be made to business enterprises. AIDEA by statute (AS 44.88.155) may only purchase participations (up to 80 percent) in loans that are originated by private lenders. Further protections are contained in statutory underwriting criteria for these loans, such as loan-to-value ratios.

For economic development projects, AIDEA statutes limit bond financing to projects that are economically and financially feasible (AS 44.88.095 (d)). The statutes allow projects to be subsidized by the State (AS 44.88.173 (b)). But, primary reliance on bond market financing enforces profit-oriented decision-making.

The scope of the board's management authority is rather limited. Statutory and financial market underwriting criteria ensure funding only for viable enterprises and projects. Of course, there is still a lot of judgment and discretion that must be exercised by the board with respect to individual projects. Interest rates and fees on loans are limited by statute.

AIDEA's operating budget is subject to the Executive Budget Act. AIDEA is generally not subject to the State's Administrative Procedures Act or personnel statutes. Legislative approval is required for AIDEA to issue bonds in excess of \$10 million for economic development projects. Until 1989, AIDEA could issue moral obligation bonds of the State. Authority to issue any bonds other than refunding or conduit bonds sunsets July 1, 2003.

AIDEA is exempt from Federal, State, and municipal taxes, though it often negotiates payments in-lieu of taxes on economic development projects. Interest on its debt is exempt from State and municipal taxes (AS 44.88.140), but some private activity bonds are subject to Federal taxation.

As a corporation, the AIDEA has limited liability and cannot obligate the State.

Inter-island Ferry Authority

The Inter-island Ferry Authority ("IFA") is a public, legally independent, corporation organized under the Municipal Port Authority Act (AS 29.35.600-730). It is a political subdivision of the municipalities that created it.

Petersburg, Wrangell, and Prince of Wales ("POW") out-port communities—those not on designated National Highway System ("NHS") ferry routes—created the IFA to improve AMHS ferry service between their communities and with Ketchikan. Parallel ordinances adopted by each participating municipality, and approved by their voters, created the IFA. A Memorandum of Understanding was executed between the AMHS and IFA to transfer responsibility for POW ferry service to IFA.

Under the Municipal Port Authority Act, each participating municipality had to approve an IFA development plan for the specific project that it would operate. Under the plan, IFA has financed the construction of two ferries and terminal improvements from the proceeds of IFA revenue bonds, guaranteed by the Ketchikan Gateway Borough and issued through the Alaska Municipal Bond Bank, earmarked Federal appropriations passed through the Federal Transit Administration, Federal and State aid to highways, and other sources.

Unlike some port, bridge or other types of authorities elsewhere in the U.S., authorities under the Alaska Municipal Port Authority Act do not have the power to levy any taxes. Nor are they entitled to receive any dedicated government revenues. Alaska port authorities are designed for self-sustaining operations.

In addition, formation of port authorities requires local initiative. This requires that there be a perceived need for improved or lower cost services. It reinforces realistic assessment of market demands, or the value of any services that might be subsidized.

A seven-member board of directors governs IFA. Each participating municipality appoints one director and the board ordinarily then appoints an at-large director from nominations made by participating municipalities. Terms are staggered.

IFA expects to cover all operating cost from the farebox and concessions. No provisions have been made for any subsidized operations. It expects a profitable operation, even though fares and employee wage and benefit levels¹⁸ are comparable to AMHS.

IFA's ability to provide improved services on a profitable basis stems from four operating characteristics:

- dayboat operations cuts work hours from 24 to 12;
- smaller vessels¹⁹ reduce excess capacity and crew requirements;
- eliminating cabin services reduces crew requirements and increases fuel efficiency; and,
- food and beverage operations are privatized.

IFA has substantial political and budgetary independence. As long as it does not require subsidies, approved IFA projects do not need budgetary approval by participating municipalities or other outside parties. Unlike AMHS, it is not subject to the State's Executive Budget Act and the associated statewide budgetary politics of legislative and gubernatorial approval.

IFA is not subject to the State Administrative Procedures Act or Procurement Act. It had the option to exercise the power of eminent domain within its designated boundaries, but chose to renounce it. Authorities under the Municipal Port Authority Act can issue bonds payable from authority income and receipts, or payable by another party if secured by lease or agreement.

In October, 2001, IFA opted out of the State's collective bargaining statutes²⁰ and IFA employees are not unionized. As a result, it is subject to the National Labor Relations Act. It can designate masters and mates as management supervisors under the Wage and Hour laws, thereby exempting them from collective bargaining. This ability of IFA (and other Title 29 authorities) to operate unencumbered by existing bargaining units is key to keeping its cost structure manageable. Shuttle operations have benefited local employment and employee morale, because crew return home each night.

As a non-profit, municipal corporation, IFA remains eligible to receive Federal highway and transit funds. It has limited liability and is tax-exempt, though it may negotiate payments in-lieu of taxes.

¹⁸ IFA employees participate in the State's Public Employees' Retirement System ("PERS"), have Blue Cross/Blue Shield health insurance, and are covered under Social Security, rather than the State's Supplemental Benefits System ("SBS").

¹⁹ IFA vessels are regulated under U.S. Coast Guard Subchapter K. Subchapter K applies to vessels under 100 gross tons. Coast Guard manning requirements increase dramatically for vessels over 100 tons. Subchapter K vessels can have more than 150 passengers, subject to safety and stability requirements.

²⁰ Public Employment Relations Act (AS 23.40.070-260).

Alaska Mental Health Trust Authority

The Alaska Mental Health Trust Authority ("Authority") is a public corporation of the State. It manages the Alaska Mental Health Trust ("Trust"), spends income from the Trust, and plays the lead role in planning and budgeting all State mental health services.

The Authority occupies a unique niche in state government. Unlike other State authorities, the assets the Authority manages are an endowment. Plus, the Authority annually plans and recommends the State's spending on mental health not just from the Trust's income, but from all sources, including State general funds. Thus, it has complete control over its own assets and substantial influence over all other resources that the State devotes to mental health.

The Trust assets and income are dedicated to mental health services. The State cannot appropriate or use Trust assets or income for other purposes. By contrast, equity contributions made by the State to AIDEA or Alaska Housing Finance Corporation (AHFC) could be reappropriated for other uses. And, a portion of the income from these corporations is paid into the State's general fund as dividends each year.

The State Constitutional prohibition of dedicated revenues²¹ barred creation of endowments or trusts after statehood, absent a Constitutional amendment (e.g., the Alaska Permanent Fund) or except as required for participation in federal programs. The Trust exists because it was created by federal law prior to statehood.

Prior to statehood, there were no mental health services available in Alaska. The Federal government sent mentally ill persons to an institution in Portland, Oregon. As part of the transition to statehood, Congress passed the Alaska Mental Health Enabling Act of 1956. This act transferred the responsibility for mental health services from the Federal government to the Territory of Alaska and created the Trust. The state selected and received one million acres of federal land to endow the Trust.

Rather than manage these lands to fund mental health services, the state transferred the most valuable parcels to private ownership and other State and municipal government uses, such as parks. By 1982, only about 35% of the land trust remained unencumbered and in State ownership.

Litigation by mental health beneficiaries, begun in 1982, resulted in a Supreme Court order that the original trust be restored. In 1994 a final settlement reconstructed the Trust with 500,000 acres of original Trust land, 500,000 acres of replacement land, and \$200 million. The Legislature also created the Authority pursuant to the settlement.

The Alaska Permanent Fund Corporation invests the Trust's financial assets. The Trust Land Office in the Department of Natural Resources manages the land. The Authority spends the income from the investments and land for mental health services. Under the settlement, the Authority may spend Trust income without a legislative appropriation.

By statute, the Authority each year develops a Comprehensive Integrated Mental Health Program and forwards a mental health services operating and capital budget to the Governor and Legislature. The statute requires a separate appropriation bill for the program. If the Governor or Legislature changes the budget, they must explain the difference in writing.

²¹ Section 7, Article IX, *Alaska State Constitution*.

In shaping the Comprehensive Integrated Mental Health Program, the Authority reviews the recommendations of three other boards:

- Alaska Mental Health Board
- Governor's Council on Disabilities and Special Education
- Governor's Advisory Board on Alcoholism and Drug Abuse
- Alaska Commission on Aging

Trustees usually choose to have existing state agencies administer Trust funds. These state agencies must have legislative approval to receive and spend Trust funds. Three times each year the Authority awards small project grants to non-government organizations providing grass roots mental health services. These projects are administered solely by the Authority and are funded with Trust income. The Authority is subject to the State Administrative Procedures Act.

A seven-member Board of Trustees governs the Authority. The Governor appoints the Trustees, after considering recommendations of a panel composed of mental health beneficiaries or their representatives. Trustees are subject to legislative confirmation and serve staggered five-year terms. The Governor is to appoint Trustees based on their expertise in financial, investment, or land management or mental health services. The Governor may remove a Trustee only for cause.

The statutes prohibit officers or employees of the State, or an organization that receives Trust money under grant or contract, from serving as Trustees. This unusual provision may be due to the more sensitive fiduciary nature of trustees' duties. But, it recognizes a conflict that exists for corporate directors as well, even though they are held to less stringent legal standards of conduct.

EXAMPLES OF NON-ALASKA MANAGEMENT MODELS

Public Ferry Operations

Washington State Ferries

Washington state ferries are operated by the Washington State Department of Transportation. Ferry operations are funded through a combination of fare box receipts and state taxes. Approximately 4.7 percent of state motor-fuel tax receipts are dedicated to ferries, half to operations and half to capital construction. Fare box earnings are required to pay for at least 60 percent of the operating program. The Washington State Transportation Commission, a 7-member board appointed by the governor, oversees operational plans for the ferry system. The commission develops long-range plans through six-year investment programs, capital project lists and biennial budgets. The commission works with federal, state and local officials to develop partnerships and remove barriers to achieving the state's transportation goals.

BC Ferries

The British Columbia Ferry Corporation operates as a Crown corporation of the British Columbia government. The corporation is governed by a Board of Directors, and regional citizen committees advise BC Ferries regarding customer service and tariff reviews. In 2000, the BC government implemented a new fiscal framework for the ferry system. The government removed over 1 billion dollars of the corporation's debt, enacted legislation to dedicate 1.25 cents of the motor fuel tax, and put three fast ferries up for sale. Complex tariff structures were rationalized, information systems were upgraded to improve financial performance and accountability, and partnerships with travel industry organizations were developed and expanded to promote increased ridership and promote British Columbia as a tourist destination. After a long period of deficits and insolvency, the corporation recorded an operating surplus in 2001.

Nationalized Ferries

Caledonian MacBrayne (CalMac) is a nationalized ferry company operated by the Scottish government that plays a "crucial social, economic and tourism role" in serving remote, rural communities in the Scottish Isles. Tariff levels and operational efficiency levels are set by the parliament. Although CalMac carries 80 percent of the market's 6 million annual passengers, three private firms are also active. The system is currently under review for compliance with the European Community law, which requires that government subsidies be paid only to fulfill a Public Service Obligation, and the services so covered must be open to competition.

CalMac provides a network of 24 approved services. In return, the company, which is wholly owned by Scottish Ministers, a public body, receives grant support for the operating losses it incurs. In 1998, the subsidy amounted to roughly \$10 per passenger. CalMac also receives capital grant funds.

Port and Transit Authorities

Massachusetts Bay Ferries

The Woods Hole, Martha's Vineyard and Nantucket Steamship Authority was created by the Massachusetts legislature to operate ferries between Cape Cod and the nearby islands. Series A and B bonds have been issued over the years for capital improvements to vessels and facilities. The Authority derives revenues from its operations (fare box, vehicle fare, parking and freight) to meet the cost of service in most years. Surplus funds are deposited into a reserve fund, which is used to make up operating costs in deficit years. In recent years, towns on the shore of Cape Cod have sued the Steamship Authority to try to restrict its autonomous control of shore-side facilities and operations. The state supreme court has ruled that the Authority's mission to act as an "essential" supply line to the islands supercedes local zoning and other ordinances and that the Authority need not take into account the interests of shore communities. A bill before the 2001 Massachusetts Legislature proposed altering the make-up of the Authority for broader regional representation.

New York / New Jersey Ferries

The Port Authority of New York and New Jersey is a financially self-supporting agency that relies almost entirely on revenues generated by facility users in the form of tolls, fees and rents. The governors of the two states each appoint six board members. The Authority has a broad range of assets including bridges, tunnels, real estate, and vessels. It is responsible for public transportation, including ferry service, in the greater New York City area.

Much of the ferry service in the New York area is privately provided and has evolved in response to residential development in areas of New Jersey and Long Island. In at least one instance, "vertical integration" has made ferry service a more attractive venture for the private sector. When much of the New Jersey waterfront lost its value as a shipping center, a developer purchased the land, built condominiums and established private ferry service so that tenants could commute directly to Manhattan from their homes. NY Waterways is now the largest private ferry operation in New York City and recently purchased additional vessels from Allen Marine in Sitka.

Kitsap, Washington Ferries

Kitsap Transit is a Public Transportation Benefit Area Authority (PTBAA), established by the voters in the late fall of 1982 and owned by Kitsap County, Washington. It provides public transportation services in the greater Bremerton and Port Orchard portions of Kitsap County, including contracting for a passenger ferry. Kitsap Transit is funded by local sales tax, fares, and miscellaneous revenue.

Delaware / New Jersey Ferry

The Delaware River and Bay Authority operates the Lewes, Delaware to Cape May, New Jersey ferry, 5 airports, a toll bridge, a business park, and a passenger-only ferry to an historic island. The DRBA is self-sufficient in that it receives all of its revenues for operation from tolls, tariffs and concessions. An official there said that the ferry itself was not self-sufficient. Out of the 1.3 million annual passengers, about 900,000 traveled from May-Sept., but the DRBA is required to operate the ferry 365 days a year.

San Francisco Ferries

From a customer service standpoint, ferries, particularly fast ferries, have been a success on San Francisco Bay. It is estimated that ferry trips could increase from the current level of 100 trips per day to nearly 700 trips per day in the next decade. In 1999, the California Legislature created the San Francisco Bay Area Water Transit Authority, a new regional agency. The legislation authorized the WTA to develop and adopt a long-range plan for operating a comprehensive water transit system in San Francisco Bay. The bill also specified the organizational structure for the WTA and the technical studies that need to be conducted.

In 2000, the California Legislature appropriated \$12 million to fund the environmental impact reports and design functions specified in the legislation. The objective of the WTA is to relieve the Bay Area's traffic congestion by delivering a cost-effective, convenient and environmentally responsive ferry transit alternative. The WTA is to provide the California Legislature with assessment of the costs and benefits of ferry service expansion and to compare the environmental and economic effectiveness of ferry service investment with other potential transportation investments.

Minnesota Public Transit

Southwest Metro Transit (SWT) is the public transit agency for Chanhassen, Chaska, and Eden Prairie, Minnesota - suburbs of Minneapolis. The Southwest Metro Transit Commission is a seven-person board responsible for oversight of the agency. The Commission is composed of one elected official and one appointed citizen from each city, and a rider representative. The agency is a public agency with private sector drivers. The agency owns the buses and all infrastructure, but contracts for driver services. The agency was at first funded by property taxes, according to John Kragness, an SWT official. This was a stable funding source that grew in relation to property values. Recently, funding for the SWT was tied to the motor vehicle excise tax, which is more volatile from year to year in response to variable vehicle sales.

The Airline Deregulation Act of 1978 was passed to make the airline industry more an agent of market forces and less directly subject to government regulation. In passing the law, Congress recognized that smaller communities would require continuing government support, if they were to retain air service. The Essential Air Service program (EAS) was scheduled to expire after 10 years. It was reauthorized for another 10 years and, in 1996, was made permanent. The amount of required minimum service is defined as two flights per day, five days per week. Required service and the amount of federal subsidy have all varied over the years. Outside Alaska, service is provided with 19-seat aircraft. The use of jets in several Alaska communities reflects the most practical approach given other routes and schedules.

Currently, a maximum of \$50 million per year is set aside to guarantee service to approximately 100 communities. As of January, 2002, 31 of these were in Alaska, including 9 in Southeast Alaska. The amount of subsidy ranged from \$5,000 in Chatham and Funter Bay to more than \$1 million in Adak. EAS subsidies for Alaska are summarized in the table.

Community	Annual Subsidy
Kodiak (9 bush communities)	\$125,774
Akutan	343,246
Cordova	273,000
Gustavus	273,000
Adak	1,312,435
Cape Yakataga	30,870
Central	17,975
Chatham	5,129
Circle	17,976
Cordova	273,097
Funter Bay	5,129
Gulkana	93,131
Gustavus	273,097
Healy Lake	38,605
Hydaburg	55,443
Icy Bay	30,870
May Creek	29,594
McCarthy	29,594
Nikolski	45,033
Petersburg	273,097
Port Alexander	24,583
Seward	82,878
Wrangell	273,097
Yakutat	273,897
Total Alaska EAS Subsidy	4,200,550

²² Information about Essential Air Service was drawn primarily from General Accounting Office documents prepared for a 2000 Congressional Subcommittee on Aviation meeting to discuss the future of the program and available at <http://www.airportnet.org/depts/federal/eryn99/easbackground.pdf>

The program affects approximately 500,000 passengers per year nationwide, with the average subsidy per passenger approximately \$80. The average load factor in 1999 on EAS flights was 19 percent, compared with 70 percent overall for most major airlines. As fuel and airport costs rise and the size of aircraft used to provide EAS flights increases, the program grows more and more expensive. Another significant contributor to increased costs has been the Commuter Safety Initiative, which mandates "one standard of safety" for both major and commuter airlines.

The subsidy is calculated to cover an airline's cost plus a reasonable profit, less any revenue collected on the route. This means that any cost increases are charged entirely to the program. In spite of this, fewer and fewer airlines have shown an interest in EAS routes, in part because airline consolidation has reduced the effects of competition in the industry.

No estimate has been identified of the impact, if any, of the campaign against terrorism on the cost of essential air service. However, the events of September 11 have reportedly caused the US Department of Transportation, which was already considering cutting EAS to some communities, to review the program. According to the US DOT web site, the FY 2003 Office of the Secretary budget requests \$117 million for EAS. The request is accompanied by proposed language that would allow the program to be "targeted to the communities with the greatest need."