



DETAILED COMMENTS ON HB 127

Submitted by the Alaska Railroad Corporation (ARRC)

Loss of Flexibility Needed to React to Business Changes

- **Changes in railroad business require the ability to respond quickly with capital investment and/or operating increases.**

Unlike other public corporations such as AHFC and AIDEA, which are not primarily operating entities, ARRC operates a multifaceted freight and passenger transportation and real estate business that require it to be responsive to the needs of Alaska citizens and businesses in order to be successful. The railroad industry in America is engaged in a capital intensive business that has experienced significant changes in customers' requirements, and therefore significant changes in its infrastructure, equipment and technology. Quick action is often required to respond to customers' needs and to seize business opportunities. For ARRC, this translates into the need for the flexibility to make business decisions unencumbered by rigid yearly appropriation schedules. For example, a decision to acquire new high capacity hopper cars was made during negotiations regarding export coal, in order to make ARRC's coal customer more competitive in the world markets, as well as improve service to other customers. Because this occurred during the middle of a fiscal year, it would have been difficult if not impossible to respond in a timely manner had it been necessary to seek administrative and legislative approval.

Effect on Borrowing and Contracts

- **The proposed bill may impair ARRC's ability to perform its legal obligations under long term contracts and loan agreements.**

The proposed bill does not address several legal problems that may arise if ARRC is subjected to the EBA. First, ARRC has been operating as a business for the past 24 years and has incurred legal obligations under existing long term contracts to provide a wide variety of transportation services to customers under constantly changing market conditions. ARRC also has several long term loan agreements that require ARRC to make periodic interest and principal payments. None of these agreements contains language conditioning ARRC's duty to perform on its receipt of sufficient appropriations from the legislature, as is the case in a typical state contract. Even if ARRC retains all its revenues, if it cannot expend them except in strict accordance with a legislatively approved annual budget, our existing customers/lenders may have valid concerns about its continuing ability to perform as their contracts require and may assert that their contract rights have been impaired in violation of Article I, Section 15 of the Alaska Constitution.

Second, putting ARRC under the EBA may create a risk that ARRC's existing long term commercial debt could be called. All of ARRC's loan agreements contain provisions

that allow the lender to declare a default and/or accelerate the loan if, as a result of changed circumstances, the lender deems itself insecure. Our lenders may have a legitimate reason to be concerned about ARRC's ability to repay their loans if the corporation is subjected to the EBA because there is little ARRC can do to assure them that the Legislature will appropriate enough money to ARRC to make the payments required on their loans.

Putting ARRC under the EBA will also seriously impact the \$165,000,000 in outstanding FTA Formula Funds backed bonds that ARRC issued in 2006 and 2007. ARRC's outside bond counsel has advised that if HB 127 is enacted, (1) it will be viewed by the bondholders as an impairment of their rights in violation of AS 42.40.675, (2) will likely result in a down grade in the ratings of the bonds and (3) may violate the ARTA mandate that revenues generated by ARRC "be retained and managed by the stated-owned railroad for railroad and related purposes."

Third, ARRC must sometimes borrow funds to enable it to fulfill its contract obligations. While this bill leaves intact several provisions regarding borrowing by ARRC, placing the corporation under the EBA may jeopardize the borrowing ability of the corporation. It may be difficult for ARRC to assure its creditors that the legislature will appropriate sufficient money, or approve line entries in its budget, to pay the debt service on their loans.

Fourth, even if ARRC can overcome the non-appropriation risk, borrowing will likely be more costly. ARRC is able to borrow money at a lower interest rate than other tax exempt entities such as the State because ARRC currently meets the definition of a "small debt issuer" under Section 235 of the Internal Revenue Code. This provision allows banks to deduct approximately 80% of their carrying costs on loans to ARRC, which has in the past resulted in an interest rate that is 80-100 basis points lower than the usual tax exempt rate. If ARRC is subjected to the EBA, its finances would no longer be considered separate from the State's and it will no longer qualify for this important benefit. As a result, ARRC's cost of borrowing could increase markedly.

In short, subjecting ARRC to the EBA will limit ARRC's ability to enter into future long term contracts with its customers and lenders because every agreement it negotiates will have to have the caveat at the end "SUBJECT TO LEGISLATIVE APPROPRIATION." If we cannot assure our customers that we will have the funds and the authority to spend them to perform the services they require, they are likely to go elsewhere.

Effect of State Fiscal Year

- **ARRC's business is highly seasonal, and moving to the state fiscal year would split the business season.**

Business activity in Alaska is highly seasonal. Subjecting ARRC to the EBA will require it to change from its current calendar year as fiscal year, to the state fiscal year that ends on June 30. While there does not appear to be a specific mandate to this effect, the requirement to participate in the governor's budgeting process and seek legislative approvals will necessitate such a change. Prudent businesses close their fiscal year at the end of a business cycle, not during its busiest time. The railroad's "busy season" ends

around November 1, and the calendar year is therefore the most appropriate fiscal year for ARRC. Not only would the state fiscal year artificially bifurcate the business year, but it would require the corporation to spend considerable time participating in the budgeting process at the same time it is gearing up to expand operations in May. This is not an efficient use of resources.

Effect on Liability

- **By assuming substantial actual control over the financial and legal obligations of ARRC, the State will likely subject itself to full liability for ARRC's operations.**

A major purpose of setting up an "enterprise fund" such as ARRC is to shield the State from liability in the event the enterprise goes under or incurs a catastrophic liability. ARRC has been a defendant in numerous lawsuits since its creation, and the State of Alaska has never been made a party as a result of ARRC's actions, nor called upon to answer in damages in any of these cases. Obviously, the language of AS 42.40.500 and the arm's length nature of the corporation's past relationship with the State have had the intended effect and spared the State these liabilities. This is not likely to continue once the State injects itself so substantially into the railroad's business decision-making process. Simply put, the more control you exercise over an entity, the more likely you are to become liable for the entity's obligations.

Violation of Alaska Railroad Transfer Act, 45 USC 1201 et seq. (ARTA)

- **The Transfer Act specifically requires that ARRC retain control of its funds and budget. The federal government could raise this violation of ARTA as a breach in its contract with the State of Alaska transferring the railroad.**

Section 1207 of ARTA mandates that the revenues generated by ARRC be "retained and managed by the State-owned railroad for railroad and related purposes". This provision was inserted in ARTA to prevent the state from repeating the mistakes that caused the federally owned railroad to lose money in almost every year of its 60 year history. A major reason that the federal railroad lost money was that all of its funds had to be appropriated under the federal budget process which deprived the railroad of the flexibility needed to respond quickly to business opportunities and prevented it from obtaining needed capital to maintain or improve service.

This bill could infringe on that "management" right in several respects. For example, inclusion of ARRC under the EBA could have the effect of prohibiting the corporation from hiring additional employees or expending any money or incurring other obligations unless these items were included in an operations plan approved by OMB, which must in turn comport with a budget approved by the legislature. See AS 37.07.080(d). If ARRC receives excess funds from its operations (beyond what is expected and accounted for in its approved budget), it must convince the administration to propose a revision to the Legislative Budget & Audit Committee and possibly wait 45 days before expending the money. See AS 37.07.080(h). Not only does this run afoul of "management" rights provided in ARTA, but it also provides another example of the potential loss of business if ARRC is

brought under the EBA. One can foresee a multitude of business opportunities or potential employees that will not wait the time required to obtain such approvals and, accordingly, be lost to the corporation.

As noted below, there does not appear to be any requirement that all of the money generated by ARRC be paid into the state treasury. However, in light of the "appropriation" language used in the bill, the bill's intent is not entirely clear. If the design is for ARRC revenues either (1) to be "state funds" which are then appropriated back to the corporation or (2) to be held by the corporation but only expended pursuant to an approved budget, then the corporation no longer has the "management" rights required by Section 1207 of ARTA. In addition, if all of ARRC's revenues are not either appropriated back to the corporation or approved to be used in the corporation's budget, part of ARRC's revenue could be used to fund a program or project that is totally unrelated to the railroad. This too would violate the mandate of ARTA Section 1207.

EBA Process Adds Time and Cost Without Adding Value

- **Participating in the budgeting process as proposed will substantially increase the costs of doing business. It is unreasonable to expect the customers to bear this additional cost.**

Subjecting ARRC to the EBA will add an unnecessary layer of expense and time consuming government bureaucracy to what is currently a profitable and self-sustaining asset. Numerous provisions throughout the EBA impose procedures with considerably different focus and detail than ARRC currently develops, such as the "agency program," "financial plan" and "operations plan." In addition, involvement of additional layers of governmental agencies (OMB, LB&A, etc.) to business sector decision-making will delay the process and therefore result in less flexibility to react to business climate changes. All of these add significant costs to ARRC's operations without adding any value. These costs will ultimately be paid by railroad customers or, worse still, by the corporation in the form of lost opportunity.

Inconsistency of Approach

- **The inconsistencies found in the bill illustrate the difficulty in separating the financial management of the corporation from the operational management left to ARRC.**

The bill expressly subjects ARRC's revenues to legislative control by making the corporation subject to the EBA. Yet, it does not change the primary legislative purposes embedded throughout the Alaska Railroad Corporation Act that require the corporation (1) to be exclusively responsible for management of the financial and legal obligations of the Alaska Railroad, (2) to carry out its responsibilities on a "self-sustaining basis," and (3) to provide for the "prudent operation of the railroad according to sound business management practices." The bill requires ARRC to "request, in accordance with AS 37.07, appropriations from the legislature to carry out the provisions of this chapter". Under this bill, ARRC will have to seek an annual appropriation for all expenditures of the corporation, with all the

accompanying budget, operations plan and other documents that are generated in the governor's budgeting process. However, the EBA itself does not require ARRC revenues to be paid into the general governmental treasury¹⁷ and it is unclear whether the bill contemplates this result. If ARRC is to retain its receipts, it is inconsistent to require the corporation to seek appropriations for operating and other expenditures.

Conclusion: HB 127 Seeks to Fix Something That is Not Broken

The most perplexing issue about HB 127 is that the impetus for the bill isn't coming from the citizens or businesses served by the railroad, or from the communities being served. Nor is it supported by any research or studies such as those provided by the Harvard Business School and University of Alaska Institute for Social and Economic Research that led the 13th Legislature to adopt the current business model that exempts ARRC from the EBA. The railroad as it exists today has provided Alaska with the best of all possible worlds-- the State owns the asset but has none of the liability associated with its operations, the railroad pays its own way as well as making a profit, and it operates an essential transportation service without any burden on the taxpayers. In short, the Alaska Railroad is working just fine as it is currently structured. It makes no sense to make so sweeping a change without any demonstrable reason.

¹⁷ Another section of the Public Finance title, AS 37.05.146, provides that ARRC receipts are not general fund receipts. Without any other section of that title being made applicable to ARRC, there is apparently no requirement that corporation funds be paid over to the state treasury.