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Subcommittee on Aviation
United States House of Representatives**

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**Perspectives on the
Aviation Trust Fund
and Financing the
Federal Aviation
Administration**

**Statement of
The Honorable Kenneth M. Mead
Inspector General
U.S. Department of Transportation**



Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify on the state of the Aviation Trust Fund and financing the Federal Aviation Administration (FAA). This is one of the most important transportation issues currently facing the Congress, FAA, and the aviation community. The current FAA authorization—Vision 100—and the current ticket taxes expire in 2007.

Secretary Mineta and Administrator Blakey have taken important steps to begin the dialogue about the most appropriate way to finance FAA. Just last week, FAA hosted a conference on the status of the Trust Fund that sparked a good discussion of the problems. It set the stage for many of the issues that will be discussed today, but solutions are not as obvious as the problems.

Today, our testimony is going to address the following:

- The financial shape of FAA.
- Additional steps that FAA should take to control costs and determine current and future funding requirements
- Perspectives on financing options

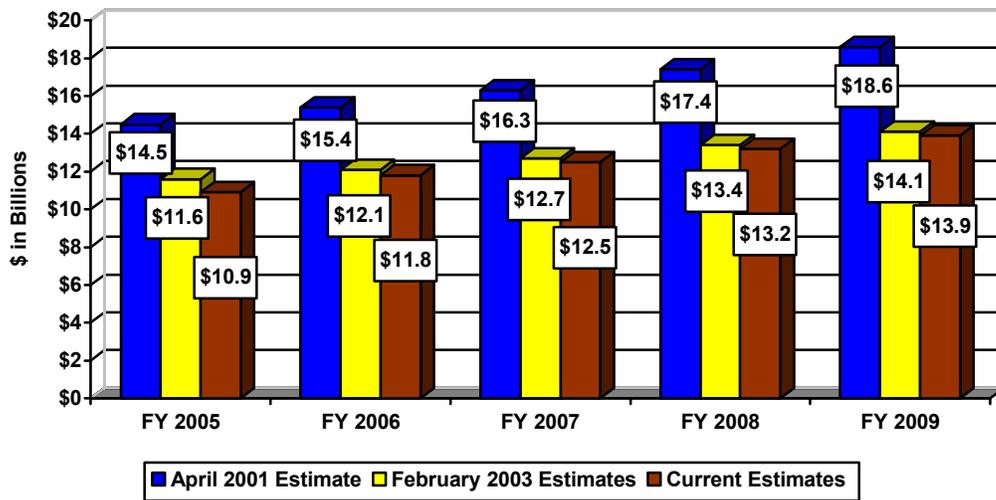
Financial Shape of FAA

In 1970, Congress authorized the creation of the Airport and Airway Trust Fund to provide a dedicated source for funding aviation programs. The Trust Fund collects a series of aviation excise taxes, which are used to fund a large portion of FAA's annual budget. Initially envisioned as the means to fund the infrastructure and modernization needs of the National Airspace System, the Trust Fund has also paid for large portions of FAA's operating budget, the Essential Air Service Program, and for one-time items such as security funding after the September 11th attacks.

The Trust Fund has provided FAA with a dedicated stream of revenue for many years; however, like the airlines, FAA is now facing a significantly changed financial landscape. In the past, increasing revenues into the Trust Fund and a large balance focused the debate on why funds were not being spent and how to "unlock" the Trust Fund. This is no longer the case.

While air traffic levels continue to show improvement from the sharp declines that began early in 2001, expected Aviation Trust Fund revenues have not materialized. In 2001, FAA estimated that Trust Fund revenues in 2005 would be about \$14.5 billion, which would have exceeded FAA's Fiscal Year (FY) 2006 budget request. That estimate has now been reduced to \$10.9 billion, a reduction of \$3.6 billion or nearly 25 percent, of the 2001 estimate.

Figure 1. Estimated Trust Fund Revenues



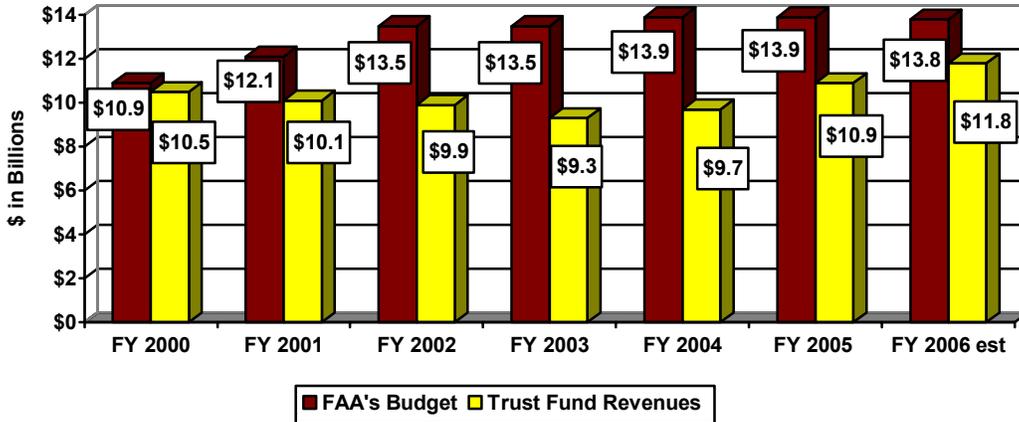
Those decreases can be attributed largely to reduced yields from the 7.5 percent ticket tax because of lower fares. The 7.5 percent ticket tax is the main revenue driver of the Trust Fund, accounting for about half of the tax revenues deposited into the Trust Fund each year. However, since 2000, the average air fare has dropped dramatically. For example, our analysis of Air Transportation Association data shows that in March 2000 the average cost of a ticket for a 1,000 mile flight was \$149. In March 2005, it was nearly \$118, a drop of over 20 percent.

Since FY 2000, revenues from the ticket tax have dropped from \$5.1 billion to a low of \$4.2 billion in FY 2003. With the enormous growth of low cost carriers and market pressure for continued low air fares, this phenomenon may reflect a long-term structural change within the industry.

A brief word about the segment tax, a potential funding source some have pointed to for bonding. It is a \$3.20 charge on each segment of a passenger's flight and does not vary with the price of a ticket. In 2001, FAA estimated that this tax would generate about \$2.5 billion in 2005, but the Agency now expects it to generate about \$2 billion. By 2007, FAA expects the segment tax to generate over \$2.3 billion.

While expected Trust Fund revenues have not materialized, FAA's budget has increased substantially. As shown in Figure 2, between FY 2000 and FY 2004 FAA's budget increased from \$10.9 billion to \$13.9 billion, an increase of nearly 28 percent. In FY 2006, FAA's budget is expected to exceed estimated Trust Fund revenues by \$2.0 billion.

Figure 2: FAA's Budget vs. Trust Fund Revenues



Historically, the General Fund has been tapped to pay for some portion of FAA's budget. There are some exceptions, including FY 2000, when the Trust Fund paid for all of FAA's budget. For the last 10 years (FY 1996 to FY 2005), the General Fund contributed on average 21 percent of FAA's total budget.

As shown in Figure 3, General Fund contributions for FAA's budget have dropped from \$3.2 billion in FY 2003 to \$1.6 billion estimated for FY 2006, or 11 percent of FAA's total budget.

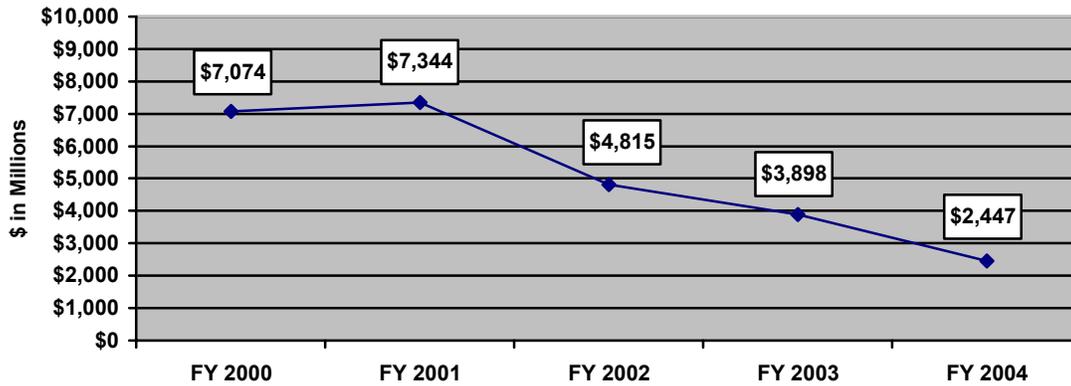
Figure 3: General Fund Contributions to FAA's Budget



Differences between FAA's budget and the contributions from the General Fund and Trust Fund have been made up by relying on the Trust Fund's uncommitted balance. For example, of FAA's \$13.9 billion budget for FY 2004, Trust Fund taxes and interest collected that year provided \$9.7 billion, the General Fund provided \$3 billion, and the remaining \$1.2 billion was provided by the

uncommitted balance. The following illustrates the decline in the Trust Fund’s uncommitted balance.

Figure 4: Aviation Trust Fund Uncommitted Balance at the End of the Fiscal Year



FAA’s budget has remained essentially flat at approximately \$13.8 billion since FY 2004. However, there are significant differences in the distribution of FAA’s budget among the Agency’s various accounts. As shown in the Table 1, FAA is requesting increases above FY 2004 and FY 2005 levels for its operating budget but significant reductions for its capital account (Facilities and Equipment, or “F&E”) and its Airport Improvement Program (AIP). With the budget staying flat, the effect is that the increased cost of FAA’s operations is “crowding out” funds available for the Agency’s capital and airport investments.

Table 1: FAA’s FY 2006 Budget Request*
(\$ in billions)

	FY 2004 (Actual)	FY 2005 (Enacted)	Difference (05 to 04)	FY 2006 (Requested)	Difference (06 to 05)
Operations	\$7.5	\$7.7	\$0.2	\$8.2	\$0.5
F&E	\$2.9	\$2.5	(\$0.4)	\$2.4	(\$0.1)
AIP	\$3.4	\$3.5	\$0.1	\$3.0	(\$0.5)
RE&D	\$0.1	\$0.1	\$0.0	\$0.1	\$0
TOTAL	\$13.9	\$13.9	(\$0.1)	\$13.8	(\$0.1)

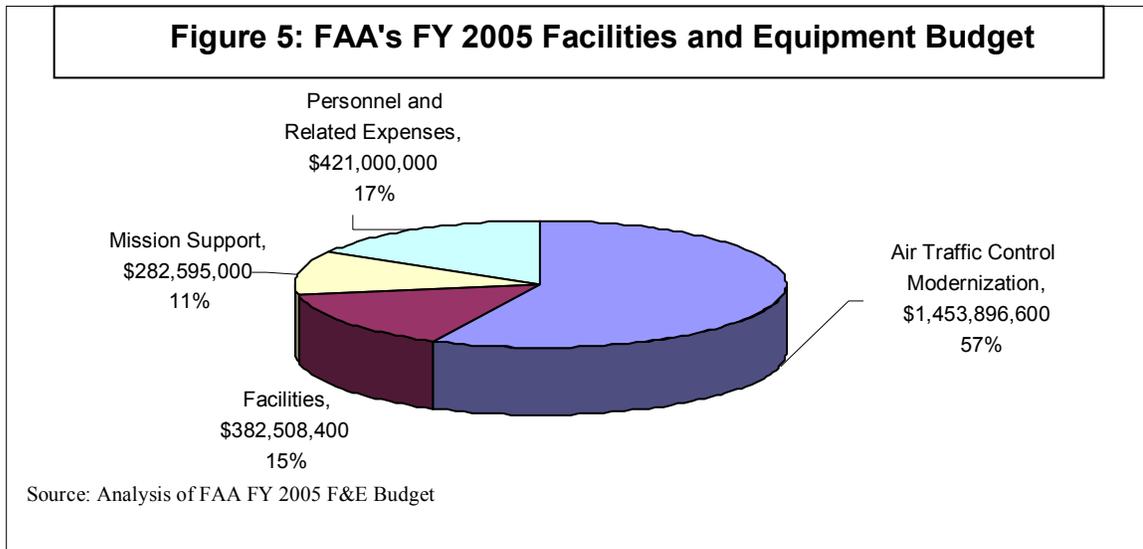
* Some figures do not add up due to rounding

FAA is requesting about \$2.4 billion for its capital account for 2006. This is about the same level as last year but significantly less than the nearly \$3 billion FAA received in FY 2004.

As we noted in a hearing before this Subcommittee last month, the current funding level of FAA’s capital account is not sustainable. This is a result of the combined effects of increased operations costs (salaries) and the fact that modernization

projects have suffered so much cost growth that there is little room for new initiatives. This explains why most of FAA’s efforts now focus on keeping things running, or “infrastructure sustainment.” And this is why there is so much discussion about how to finance new air traffic management initiatives.

Moreover, roughly 60 percent of the capital account goes specifically for acquisitions—the remaining 40 percent is for support contracts, facilities, and salaries. This is illustrated in Figure 5.



At this Subcommittee’s request, we reviewed 16 major acquisitions and found that 11 account for cost growth of \$5.6 billion—more than 2 years’ appropriations for the capital account. Additionally, 10 of these projects account for delays ranging from 2 to 12 years, and 2 projects have been deferred until at least 2008. There has been cost growth with major acquisitions since the establishment of the Air Traffic Organization (ATO), but the bulk of the cost growth represented by the \$5.6 billion occurred before the establishment of the ATO. The growth is also a reflection of the ATO’s efforts to re-baseline a number of projects, which identified costs that had been pent up for some time.

Before turning to options for financing FAA, I would like to talk about steps that FAA needs to take.

FAA Needs To Take Additional Steps To Control Costs and Determine Current and Future Requirements Before New Revenue Streams Are Explored

The Congress and the aviation community need assurances that FAA is doing all it can to control costs before decisions can be made about the adequacy of current funding levels and whether or not additional revenue is needed. There are four basic steps FAA needs to take—getting a handle on its cash flow requirements for existing projects in its capital account, controlling costs and improving the effectiveness of Agency efforts, finalizing the implementation of a cost accounting system, and determining funding requirements for future initiatives. Any business seeking an infusion of capital would take these steps. Moreover, these are preconditions for determining whether current funding sources will be sufficient or whether new revenue streams and authority are needed.

Determining FAA’s Current Cash Flow Requirements for the Capital Account and Making Decisions on Projects That Have Been Delayed for Years. As noted earlier, projects already in the pipeline have been delayed by years and are substantially over FAA’s estimates. FAA recognizes the need to obtain reliable information for its major acquisitions and is planning to update a number of program baselines. This will be important to establish the cash flow requirements on a yearly basis for the entire modernization portfolio.

Key decisions need to be made on projects like the Standard Terminal Automation Replacement System (STARS). For example, FAA revised estimates show that a “full STARS” solution (the replacement program of computers and controller workstations at terminal facilities) would cost over \$2 billion. FAA has been studying its approach to terminal modernization since 2003 and is committed to assessing alternatives. A decision needs to be made on what technology is needed to complete terminal modernization based on time, cost, and capabilities.

FAA Must Take Additional Steps To Control Costs and Improve the Cost Effectiveness of Agency Efforts. FAA is taking important steps to control costs. The recent Flight Service Station decision has the potential to make significant savings—\$1.7 billion over 10 years. We outlined a number of other things in a recent hearing before this Subcommittee that could save money. They include, but are not limited to, (1) controlling costs on support contracts valued at \$2 billion and (2) taking proactive steps with the \$2.1 billion En Route Automation Modernization (ERAM) project.

Getting a handle on support service contracts is a key area for savings. This is particularly the case for three large Indefinite Delivery contracts valued at over \$2 billion that involve over 100 contractors. We have concerns over exactly how the contractors’ work differs from work FAA employees do but at substantially higher costs to the Government. For example, one of the contractor’s employees

on one task order is a retired FAA support staff manager who earned \$109,000 just before retiring from FAA in 2003. This same person went to work for the contractor (within days of retirement) as a senior financial analyst, performing the same type of duties but at an annual rate charged by the contractor of over \$206,000. The savings from greater control over these contracts could be substantial.

Also, FAA can reduce risk and potential for cost growth with the \$2.1 billion ERAM effort. The purpose of ERAM is to replace the Host computers (the brain and central nervous system) for facilities that manage high-altitude traffic. The ERAM contract is currently a cost reimbursable agreement that places most of the risk with the Government. The early stages of this effort are within schedule and budget, but the heavy lifting of software development lies ahead.

Significant opportunities exist to control costs through the use of fixed price agreements for items not yet negotiated. FAA can also streamline software development and assess advantages of the state-of-the art computer capabilities to centralize computer processing that allows for sufficient redundancy.

At the recent Trust Fund Forum, a number of participants wanted to know what additional cost cutting measures could be taken by FAA and view cost control as an element in the debate about financing alternatives.

Implementing a Cost Accounting System and Getting a Labor Distribution System in Place. Progress is being made with developing a cost accounting system, particularly in the last 2 years. It is a critical tool for FAA because it has the potential to make significant contributions to assessing Agency cost centers and will help allocate costs among users. A cost accounting system includes a labor distribution system, which will help FAA manage its labor costs. FAA's cost accounting system has been delayed for years at significant taxpayer expense (\$51 million), but the Agency has made the deployment of an effective cost accounting system a priority and plans to have a fully operational system in place by September 2006.

However, there are several hurdles that still need to be overcome. FAA must complete changes in the system to account for its recent organizational changes involving the ATO, begin assigning actual labor costs and other unassigned service costs to facilities and activities, and link performance measures to the cost accounting system. Addressing those issues is central for FAA to achieve the potential performance efficiencies and cost savings associated with an effective cost accounting system.

A reliable system to track labor costs is also a basic requirement for an effective cost accounting system. Labor distribution is the process of associating labor cost directly with activities and services by requiring employees to record their time

worked on specific activities. A labor distribution system represents an improvement because FAA can account for time spent by controllers managing traffic (on scope) and performing other tasks. This is critical given that over 73 percent of FAA's operating budget costs are made up of personnel compensation and benefits.

FAA is deploying a labor distribution reporting system for the ATO which, when fully deployed, will be used by about 35,000 employees. The system is running at over 100 terminal facilities (out of almost 300) and expects to have all terminal sites running by the end of June. FAA has also begun testing the system at en route facilities. FAA has committed to implement the labor distribution system and link the labor distribution system to the cost accounting system by December 2005.

Determining Funding Requirements for New Initiatives, What Capabilities Will Be Pursued, and When They Can Be Brought On Line. At last month's hearing on the ATO, there was considerable attention focused on the importance of the new Joint Program Planning and Development Office at FAA and what the new office can deliver. This new office is expected to coordinate research among diverse Federal agencies, including the National Aeronautics and Space Administration and the Department of Defense, with a focus on the 2025 timeframe. The office has published a plan, but FAA has not provided details on what capabilities will be pursued or how much they would cost to implement—this will be critical for determining the Agency's capital needs.

While the 2025 timeframe has merit, benchmarks for what can be done in 5- and 10-year intervals are also important. The other imperatives focus on determining what level of funding is actually required, how much other agencies will contribute, what specific capabilities will be pursued, and when they can be implemented. The Department committed to the Chairman that by the year's end, they would provide specifics on how much money is needed, when they will need it, and for what purposes.

Options and Alternatives for Financing FAA

Once FAA addresses the steps we just outlined, Congress and the Administration will be in a much better position to judge what FAA's financial requirements are and explore options. There are a number of options for financing FAA—none of them are painless.

Greater Reliance on the General Fund. As noted earlier, the General Fund has provided on average of about 21 percent of FAA budget over the last 10 years. Except for FY 2000, when the General Fund did not contribute anything, the contribution from the General Fund to FAA's budget has ranged from \$1.1 billion (FY 2002) to almost \$3.8 billion (FY 1998). Past studies and commissions have

recognized a General Fund contribution for FAA’s safety oversight functions and Government use of the system, including the Department of Defense. Clearly, the role of the General Fund is an important element in the debate and was discussed at FAA’s recent Trust Fund Forum. It is difficult to expect an increase above historical levels from the General Fund, given the competition for funds from other Federal programs and the current deficit environment. The debate would be better informed if a specific level of funding from the General Fund is identified for planning purposes as various alternatives are examined.

Reliance on Taxes. The primary source of revenue into the Trust Fund is the 7.5 percent ticket tax, but there are other taxes, including the \$3.20 segment tax. The ticket and segment taxes combine for almost 70 percent of Trust Fund revenues. There is some controversy about the current system and whether the wide range of users are paying their equitable share of the services they receive. As was noted at FAA’s Trust Fund Forum, the current excise taxes bear little resemblance to services various airspace users receive. For example, airlines contend that other airspace users are utilizing many of the same services they do but do not contribute their fair share. On the other hand, the General Aviation community (piston-powered aircraft) argues that they are only marginal users of a system designed primarily for the airlines and as such pay their fair share. The following provides information on the current taxes.

Table 2: Listing of Current Airport and Airway Trust Fund Taxes

<u>Tax</u>	<u>Rate</u>	<u>Percentage of Total Tax Collections in FY 2004</u>
Ticket Tax	7.5% on Airfares	49.7%
Segment Tax	\$3.20 per Flight Segment	19.6%
Rural Airport Tax	7.5% on Airfares from Rural Airports	0.8%
Waybill Tax	6.25% on Price of Freight and Mail Transferred by Air	5.4%
GA and Jet Fuel	GA Fuel: 19.3 cents/gallon Jet Fuel: 21.8 cents/gallon	1.9%
Commercial Jet Fuel	4.3 cents/gallon	5.8%
International Departures/Arrivals	\$14.10 per international departure/arrival	14.4%
Alaska/Hawaii Tax	\$7.00 per domestic departure/arrival to Alaska or Hawaii	0.8%
Frequent Flyer Tax	7.5% on proceeds of third party sales of frequent flyer miles	1.6%
Total		100%

Source: FAA

Given that FAA still has to establish its current and future funding requirements, it is difficult to determine the level of increase in revenue that would be needed, even if this was under consideration. Also, there is the issue of elasticity of demand—the airlines contend that they cannot pass on a tax increase to the flying public.

User Fees. Under this approach—also referred to as fee-for-service—fees collected from airspace users would replace most taxes. They have long been a favorite of economists, make sense conceptually, and were a core recommendation of the National Civil Aviation Review Commission (NCARC) report in 1997. Unlike the current system where the taxes paid by users bear only a limited relationship to the cost of the services they use, the fees charged under a defensible user fee system would be directly related to the cost of providing services.

However, before a defensible and equitable user fee system can be considered, FAA needs to complete its cost accounting system. This will allow FAA to determine what its costs are and allocate those costs to the various users of the airspace system.

Efforts to adopt user fees have met with stiff opposition from some quarters in the past, including the unsuccessful proposal in 1995 to spin off air traffic operations into an independent government corporation (U.S. Air Traffic Services Corporation, or USATS). In 1999, the Clinton Administration again proposed a shift from excise taxes to cost-based user fees, but that too was unsuccessful. These proposals were unsuccessful for a variety of reasons, including an intense debate surrounding who should pay what, the potential impact on fares, and FAA's inability at the time to allocate the costs of its system.

Today, we are again faced with a similar debate. However, in some ways the landscape has changed. First, FAA is facing a bleaker revenue forecast. Second, FAA is nearing completion of its cost accounting system. However, the contentious issues of who should pay what and whether each stakeholder is paying its fair share remain central unresolved matters. These issues are important given the diverse mix of users in the National Airspace System that include general aviation, high-end general aviation or business aircraft, and regional jets, in addition to cargo and other commercial carriers. User fees will likely generate winners and losers—i.e., some users may pay more than they currently do and some may pay less.

The most common user fee constructs are based on a combination of the weight of the aircraft and the distance flown. Weight and distance fees are used by more than 100 countries. Although a weight-and-distance charge is direct, and probably

more cost-related than an excise tax, it too is less than a perfect measure of a user's cost to the system. While distance is a measure of cost to the system, an aircraft's weight does not materially affect the costs of providing Air Traffic Control services but instead is primarily a surrogate for that aircraft operator's presumed ability to pay.

Despite the difficulties, a positive feature of an equitable and defensible user fee system is that it should provide powerful incentives to control costs in an effort to contain increases to user fees, provided that an appropriate oversight mechanism, other than FAA, is developed. This should also translate into greater user involvement in investment decisions.

An option for formalizing this oversight mechanism is through the creation of a board that would set user fees and adjust them upward or downward over time. The NCARC report proposed a "public interest board" made up of Presidential appointees with at least three members knowledgeable in aviation but none with any financial stake in the industry. Another alternative, which is not mutually exclusive, is a "stakeholder board," like the one currently used by Nav Canada, with representation from key aviation segments (i.e., commercial aviation, general aviation, unions). In any case, decisions would need to be made regarding the board's authority beyond the setting of rates and the extent of its duties and responsibilities, including the preparation of business and financial plans.

Bonding/Borrowing Authority

Another funding mechanism that is being discussed is the question of bonding or borrowing. This is not a new idea. In 1997, the NCARC report recommended that services related to the air traffic system be placed in a Performance Based Organization and given authority for long-term borrowing from the U.S. Treasury or from private capital markets as part of a shift to user fees. Bonding/Borrowing was a major topic at FAA's recent Trust Fund Forum.

The rationale behind allowing FAA (or some entity on its behalf) to sell bonds is to provide it with a large infusion of funds for capital projects, including air traffic control technologies. The bonds would need to be backed by a well-defined, predictable source of revenue. There are several important preconditions to consider—FAA needs to finalize its cost accounting system, demonstrate its ability to control costs, and determine how much capital is needed, when it is needed, and for what purpose.

Granting FAA any type of bonding or borrowing authority would require legislative changes, consideration of complex budgetary scoring issues, and the impact on the Federal deficit. Equally important is the fact that certain bonding

models do nothing to ensure that the entity making the investment operates cost effectively or that the acquisition funded by the investment performs as anticipated. A model that does not provide powerful incentives to invest wisely and control costs could result in a substantial infusion of capital but do little to ensure that the acquisition performs as expected and is delivered approximately on budget and on schedule.

Bonding Construct With Limited or No Issuer Accountability. Several years ago a proposal was set forth for Amtrak to issue bonds in an effort to raise funds for Intercity Passenger Rail. Under this construct, bonds are sold in the capital markets with a portion of the funds set aside to repay the principal upon maturity. Rather than cash, investors are provided with a tax credit to generate the return that *is guaranteed* as these bonds either have or are perceived to have the full faith and credit of the United States. A variation of this model would isolate a portion of an existing tax and “securitize” it, thereby providing a large inflow of funds to be paid off over a number of years from the dedicated source.

This is essentially “sovereign debt” and per se, requires no accountability on behalf of the issuer since the repayment is guaranteed. As such, there is no linkage between the bond instrument and the performance of an acquisition. The investor receives a specified return regardless of whether the investment performs or is delivered on time and on budget, and no discipline is imposed on the issuer to control costs. The goal here is not to simply provide more money, but to ensure that funds are used wisely to provide capital for the next generation air traffic control system.

Bonding Construct with Issuer Accountability. Another form of bonding authority is more akin to bonds issued in the private sector or by municipalities. These bonds are issued in the public markets without the full faith and credit of the United States. The borrowing entity needs to operate in a business-like manner so that investors/Wall Street are able to analyze the volatility of the revenue stream (which is the ultimate source of repayment), the associated costs, and the financial plan as a whole.

This type of borrowing authority is usually considered in conjunction with a financing system that charges cost-based user fees and is consistent with the NCARC recommendation. These fees provide a bondable stream of revenues and the flexibility to price those fees to cover costs. Under this framework, and assuming the existence of an oversight board aside from the issuer, there are powerful incentives from users to control costs and deliver systems on time as this will ultimately keep the fees that users pay from increasing.

There is also the oversight of the public markets in scrutinizing the business plan supporting the debt issuance since the return is not guaranteed by the full faith and credit of the United States. Further, if the capital investment does not perform, investors will require that the issuer increase its interest rates the next time it goes to market, which in turn will increase the issuer's costs resulting in pressure to increase fees to users. Therefore, this construct would also encourage improved strategic planning as users will demand that capital expenditure decisions are based on real needs and a rational cost-benefit tradeoff.

Regardless of what approach is used, it is critical that: (1) there is a clear understanding of what investment the FAA would be borrowing money for (i.e. long-term investments in order to meet future demand); (2) it is not simply a short-sighted vehicle to put off increased fees or taxes in the near term and; (3) accountability and discipline is established to ensure cost control and efficient, on-schedule implementation of capital investments.

Congestion Pricing Must Be Joined With the Debate

Finally, the debate about FAA financing needs to be joined with the issue of auction/congestion pricing at airports. The FAA is now soliciting comments on whether to continue the administrative controls at Chicago O'Hare for another three years—a regulatory approach that does not accommodate demand and can stifle competition. FAA is now funding research on auctions for landing rights for airports such as LaGuardia. Airports are also making the case for congestion pricing more broadly. We think this debate needs to be joined with the debate taking shape on financing FAA.

Aviation congestion is very clearly an issue that affects the national air traffic network as a whole, and it ought to be addressed at a national level. For example, recently a 10-minute delay for 15 jets approaching Newark affected 250 aircraft throughout the system, some as far west as Minneapolis.

Some difficult questions and policy issues have to be worked through. First and foremost is whether or not peak-hour pricing should be authorized. If so, a number of other policy questions will need to be addressed: Who sets the fees? Who gets the funds? The FAA? The airports? Some combination? What will the funds be used for? How will this affect General Aviation and commuter air traffic, and what will the impact be on service to smaller communities?

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Mr. Chairman that concludes my statement. I would be happy to answer any questions that you or other members of the Subcommittee might have.