

Memorandum

To: Bob Juettner
Aleutians East Borough

From: Mike Fisher and Pat Burden
Northern Economics, Inc.

Date: May 20, 2008

Re: King Cove – Cold Bay Hovercraft Link Pro Forma Financial Statements

This memo presents pro forma financial statements for the King Cove-Cold Bay hovercraft link for fiscal years 2008 to 2012 and discusses the assumptions used in the analysis.

Summary

The following table provides a pro forma income statement for FY 2008 to 2012. Under the base scenario in FY 2008, revenues are \$716,000 and expenses prior to depreciation and amortization of the hovercraft debt are \$1,104,000, resulting in the hovercraft achieving an operating (cash) loss of \$388,000. This cash loss improves in FY 2009 and then gradually increases.

	Fiscal Year Beginning July 1				
	2008	2009	2010	2011	2012
Revenues					
Passengers	522,689	554,675	588,632	624,682	662,957
Vehicles	59,400	66,268	73,675	81,656	90,251
Freight	34,223	39,477	45,220	51,490	58,329
Mail	<u>99,418</u>	<u>210,161</u>	<u>222,132</u>	<u>234,785</u>	<u>248,159</u>
Total Revenues	<u>715,730</u>	<u>870,581</u>	<u>929,659</u>	<u>992,613</u>	<u>1,059,696</u>
Expenses					
General (salaries, maintenance, and training)	549,775	584,087	620,117	732,941	697,643
Hovercraft (insurance, parts and supplies, and fuel)	539,233	577,222	618,097	662,082	709,422
King Cove Terminal and Cold Bay Landing (generator fuel, utilities, furniture and equipment, supplies, and insurance)	14,615	14,979	15,353	92,496	85,008
Total Expenses	<u>1,103,623</u>	<u>1,176,288</u>	<u>1,253,567</u>	<u>1,487,519</u>	<u>1,492,073</u>
Operating Profit (Loss)	<u>-387,893</u>	<u>-305,707</u>	<u>-323,908</u>	<u>-494,906</u>	<u>-432,377</u>

In addition to covering operating profits, the Aleutians East Borough may want to set aside money annually to cover the cost of replacing the hovercraft at the end of its useful life. The hovercraft is assumed to have a useful life of 25 years. Based on the rate of inflation, assumed to range between 3 and 6 percent, the annualized replacement cost would be \$737,000 to \$1.5 million. This represents the amount of money that would have to be set aside each year to cover replacement of the hovercraft.

The borough may wish to allow charter operations with the hovercraft. The charter rate will depend on the extent to which the Borough wishes to cover costs. A charter rate of \$714 per hour would cover variable costs, while a rate of \$1,635 per hour would cover all operating costs.

Assumptions

The Borough has a great deal of financial information about the hovercraft from test operations. Other information must be assumed for the first five years of operation, as shown below.

- The King Cove passenger terminal and hovercraft's capital costs are obtained from grant agencies and therefore require no debt service.
- Straight-line depreciation is used for the hovercraft and King Cove terminal. The hovercraft's initial cost of \$8.8 million and the terminal's cost of \$7.0 million are depreciated over 30 years.
- The King Cove terminal will be constructed in FY 2011.
- The hovercraft's use of non-fuel consumables, such as lube oil, parts, and overhauls, will cost \$180 per hour, based on 675 hours of operations annually.
- Hovercraft operation requires four pilots, two crew members, and a half-time chartered maritime engineer. Salaries and benefits are estimated based on input from the Aleutians East Borough.
- Marsh provided the hovercraft insurance costs. Other insurance costs are based on the Cordova Consulting report.
- The hovercraft makes two daily round trips between King Cove and Cold Bay.
- Passenger, freight, and mail volumes are forecasts based on Bureau of Transportation Statistics records for calendar year 2006, adjusted annually based on growth rates developed using the Aleutians Aviation System Plan prepared by Aries Consultants, Inc.
- The hovercraft captures all of the passenger traffic between King Cove and Cold Bay. The ticket price is \$83 one-way between King Cove and Cold Bay, based on the price for a comparable segment on PenAir for reservations made one day in advance. Ticket prices increase 5 percent annually.
- The hovercraft transports approximately 1.2 million vehicle pounds annually. It initially captures 80 percent of the market, which increases 5 percent per year until FY 2012, which it reaches 100%. The charge for vehicles is \$0.06 per pound and increases 5 percent annually.
- The hovercraft transports freight, capturing 50 percent of the market share in FY 2008 (estimated by Aries) and increasing that share by 10 percent per year. The hovercraft also transports 100,000 pounds of seafood annually. The charge for freight is \$0.18 per pound and increases 5 percent annually. Freight handled by the hovercraft ranges from 190,000 to 267,000 pounds.
- The hovercraft transports mail to and from King Cove, sharing the market in 2007 with PenAir and taking over as the sole carrier in 2008. The U.S. Postal Service pays \$0.43 per pound of mail delivered in 2007 and increases the rate 5 percent annually. Mail pounds handled by the hovercraft ranges from 231,000 in the first year of operation to 475,000 in 2011.
- Fuel costs \$2.52 per gallon in King Cove, including a 4 percent sales tax. The Borough would be exempt from the tax and would pay approximately \$2.42 per gallon. The round trip fuel consumption is 50 gallons for King Cove to Cold Bay. Fuel costs increase 3 percent annually.