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UNITED STATES OF AMERICA
DEPARTMENT OF TRANSPORTATION
OFFICE OF THE SECRETARY
WASHINGTON, D.C.

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on the 8th day of October, 2003

INTRA-ALASKA BUSH AND
MAINLINE SERVICE MAIL RATES

Docket OST-03-14694
Docket OST-03-14695

PRELIMINARY FINDINGS AND SHOW CAUSE ORDER

Summary

By this order, the Department makes preliminary findings in the base-rate investigation of bush mail rates required by the Rural Service Improvement Act (RSIA), which became law on August 2, 2002. It follows our Request for Comments (RFC) issued April 16, 2003. This order does not establish any rates, but rather addresses a number of surrounding methodological issues on the calculation of the rates and the Postal Service's tendering of the mail. A show-cause order tentatively setting rates must wait for additional data to be submitted and compiled by our Bureau of Transportation Statistics (BTS). We must act now, however, on some of the data-reporting issues, and therefore we are directing parties to comment within 15 days of the service date of this order on those issues, as discussed below and in the ordering paragraphs.

The RFC raised eight specific issues involved in the interpretation and implementation of the RSIA (Section 3002 of Public Law 107-206), and other related matters. We also received comments on two issues for which we did not specifically seek comments and we have included them as issues nine and ten. Initial comments were received on June 2, and rebuttals on June 17. After carefully reviewing all of the comments, we make the following tentative determinations. For ease of reference, we will repeat each of the eight issues directly from the RFC.

Issue 1: *paragraph (k)(4) of RSIA requires that:*

"(4) Carriers qualified to be tendered nonpriority bypass mail shall submit to the Secretary the number and type of aircraft in the carrier's fleet, the level of passenger insurance covering its fleet, and the name of the insurance company providing such coverage."

Consistent with this paragraph, we have prepared an attachment, as a sample of what we would tentatively require carriers to report monthly. We request comments on the sample report, particularly comments on whether there are alternative reporting requirements that would meet the statutory requirements in less burdensome ways.

Issue 1 Responses: In response, a number of carriers argue that insurance and fleet information should not be reported on a monthly basis because it changes infrequently. Also, many carriers already submit aircraft-type data to the Department under Part 205 of the Department's regulations, which requires that carriers report information only as it changes.

We believe the carriers' proposals to avoid duplicative reporting are correct. We have, with the Federal Aviation Administrations' (FAA) assistance, reviewed the carriers' Operation Specifications. The documents show which aircraft in the carrier's fleet operate under Part 121 and Part 135, and specify the number of seats for Part 121 aircraft. The carrier's airport specifications indicate which airport the carrier is authorized to operate into for each aircraft type and therefore by Part 121 or Part 135. Carriers are already required to report to BTS whether or not a segment is operated on an amphibious or wheeled basis. We have asked the FAA to make the Operation Specifications for each carrier available to the Postal Service.

RSIA has separate provisions for carriers by certificated seats—19-, 5-, and 3-seats, and these are the only data that are not readily available from the Op Specs. We will therefore tentatively require carriers to report that data for their fleet on a one-time basis, or as they acquire different aircraft types.

***Issue 2:** The law requires that the Postal Service tender mail to bush carriers based on the outbound passengers and freight the carriers transport in individual city pairs, relying on T-100 On-Flight O&D statistics. The Department's Bureau of Transportation Statistics (BTS) states that the T-100 will give different results depending on how carriers depict their flight schedules. For example, for the same multi-stop route, if one carrier chose to assign two flight numbers and another only one, the results of the T-100 On-Flight report would be inconsistent and carriers could manipulate the new system to receive more mail than appropriate.¹ We ask the carriers for comments about how to address this problem. As an interim solution, we will tentatively require that beginning 60 days after the issuance of this notice carriers wishing to participate in the tender of mail assign flight numbers such that single-plane operations between hubs be assigned only one flight number in the T-100. That does not resolve what to do for the data from*

¹ Differences in how flight numbers are assigned would distort how traffic is reported. For example, assume a carrier operating Hub to A to B assigns one flight number from Hub to A and a different flight number from A to B. If 10 passengers boarded the plane at the Hub and 3 were bound for point A and 7 were bound for B, the carrier would report 10 Hub to A passengers and 7 A to B passengers. In contrast, if the carrier assigns a single flight number for the itinerary, the carrier would correctly report 3 Hub to A passengers and 7 Hub to B passengers. This reporting inconsistency could affect the carriers' relative standing for mail tender.

July 1, 2002, until the tentative solution above is implemented. The law says that for the first tender of mail under the new system, the Postal Service will rely on an annual pool of data, and we anticipate the YE 6/30/03 will be that period. It must thus be decided whether mail tender in the initial period will be determined on less than a full year of data, on the basis of potentially inconsistent annual data, thereby delaying the implementation of the new tender system, or by requiring the carriers to resubmit prior data in a consistent format as discussed above. We request that the parties comment on this issue.

Issue 2 Responses: Larry's Flying Service believes it will suffer from not having its inter-village traffic recognized. However, inter-village traffic, in general is extremely small, and thus would have minimal impact. The T-100 On-Flight Report is different from the Schedule T-1 it replaced, because it tracks O&D traffic by flight number. The RFC recognized this drawback and tentatively required carriers to make flight numbers start at a hub and end at a hub. Upon further review, we find that the T-100 On-flight data, which were not available when the RFC issued, show that the T-100 provides reasonably accurate traffic at each community as the Postal Service requires for its tender under RSIA. We will not, as we had contemplated in the RFC, dictate to carriers how to number their flights. We acknowledge that a carrier could attempt to construct a flight-numbering system to maximize its carriage of mail. However, we also note that that same system could actually have the opposite effect. That is, if carriers change flight numbers at every segment, that service would be displayed as requiring multiple connections for passengers, whereas the competing carriers' service would appear as direct service, which would put that carrier at a marketing disadvantage compared to the direct service and could actually *decrease* the number of passengers using the service.²

Grace Period

BTS has created a website where all parties can review the reports that the Postal Service will use to rank carriers for tender. The RSIA provides for severe penalties if carriers intentionally overstate their results in order to qualify for mail. However, even unintentional overstatements can affect the tender of mail for all carriers in a market. Each carrier therefore has a responsibility to undertake appropriate internal controls to ensure that the data that it submits and that are shown on the BTS website are accurate. We think it is appropriate that carriers be afforded a 15-day grace period to review the initial BTS website results. In this period of time, BTS will notify them in writing if it suspects that the initial data on the website are erroneous.

BTS will also notify the Postal Service of its initial finding and its basis. It will be the carrier's responsibility to review, resubmit, and recertify its data to BTS within this 15-day grace period. If after further review it appears the problem persists, BTS will discuss with the carrier the basis for its findings and, if necessary, withhold the carrier's suspect data. BTS will again notify the Postal Service of the results.

² We will decrease the ability of carriers to manipulate the numbering of their T-100 flight schedules by relying on traffic from a single hub-to-bush city-pair, instead of including outbound inter-village traffic.

Traffic Reporting

We believe the definitions are clear for all the different traffic classifications. On top of its industry-wide reporting directives, in several meetings with the carriers in Alaska this last year, BTS has made clear the reporting distinction between charter and scheduled passengers and freight, as well as between baggage and freight. Carriers cannot report traffic as they see fit, but must rather conform to all official reporting requirements. Those requirements have been added to the BTS website for easy access.

Issue 3: section (k)(5) of the law provides that:

“(5) Not later than 30 days after the last day of each calendar month, carriers qualified or attempting to be qualified to be tendered nonpriority bypass mail shall report to the Secretary the excise taxes paid by city pair to the Department of the Treasury and the weight of and revenue earned by the carriage of nonmail freight. Final compiled data shall be made available to carriers providing service in the hub.”

We have discussed this issue with BTS and the Postal Service. Some carriers have informally stated that quantifying excise taxes by market would prove difficult, if not impossible. It is not clear from the legislative history what the purpose is of carriers reporting excise taxes by route. We thus request comments on the best method to meet the requirements of the law.

Issue 3 Responses: In response to the RFC, many carriers said they were fearful the law would be thwarted by carriers' misreporting data. The law provides that only carriers transporting significant shares of passengers or non-mail freight will be tendered mail. For a few carriers, the bulk of their revenue and traffic is mail. In other words, those most dependent on mail revenue are those most at risk to have it taken away.

The law recognizes this concern by penalizing carriers that significantly overstate their passenger or cargo carriage by taking them out of tender, for increasingly extended periods of time with each violation.³ To attempt to ensure that carriers' passenger and cargo reports are accurate, the RSIA requires carriers to submit excise taxes by city-pair each month, with the expectation that, given such information, the Department and Postal Service could more readily detect misreporting of traffic. Many carriers state that excise taxes by city pair will be burdensome to report, because excise taxes are paid by the carrier selling the ticket or waybill, not necessarily by the carrier providing the service. They also argue that since excise taxes are paid when the sale is made, they may not reflect when passengers or freight are actually transported and the revenue earned. Warbelow's Air Ventures (Warbelow's) notes that excise taxes are a straight percentage

³ One month for the first offense, six months for the second, one year for the third, and permanently for the fourth.

of revenue,⁴ so in lieu of directly reporting excise taxes by each market, carriers could meet the requirements of the law by reporting revenue by market. We note too that for the freight pool, unlike the passenger pool, RSIA permits the Postal Service to use either the weight of the freight transported in the market, as reported on the T-100, or the associated revenue to determine qualification for tender, and this further supports our tentative decision to require the reporting of revenue.

While we recognize that the statute is designed to ensure accurate mail tender by the Postal Service and is not our primary responsibility to interpret, we believe the carriers raise serious problems with implementation of the excise tax report. We will continue to consider those concerns, but tentatively require that carriers report the data described in Appendix A on an interim basis. Since excise tax is a straight percentage of revenue, rather than directly reporting excise taxes by market, the same goal can be accomplished by reporting revenue by market. Because the Postal Service has said it will tender mail based on annual results, perhaps updated every three months, it would serve no purpose to collect this information by month, so we will require only quarterly submissions of the data in Appendix A. The information (consistent with the overall intent of the law) is to be made public and will accordingly be placed on the BTS website. As with the T-100 On-Flight O&D reports, which it crosschecks, we will afford carriers a 15-day grace period after the information is published on the BTS website to report corrections. We believe this interim reporting, along with that in Appendix B, will fully accomplish the intent of the legislation and considerably lessen the carriers' reporting burden.

The intent of this part of the legislation is to substantiate passenger and freight counts, and to reward carriers that transport significant passenger and freight levels with mail tender. Thus, carriers that do not expect to qualify for bypass mail do not need to submit the data on Appendix A.

We note that the Postal Service has said that it intends to modify its tender of non-priority, non-bypass mail to conform with the RSIA requirements for tender of bypass mail, even though the RSIA does not so require. The Consolidated Carriers⁵ object, stating that any special RSIA reporting cannot be extended beyond bypass mail. We agree, but the Postal Service can undertake its own data collection as necessary to administer its tender policy for non-priority, non-bypass mail. Of course, consistent with our rules, all carriers are still required to report the T-100 passenger and freight traffic, even those that do not transport any bypass mail.

⁴ Excise tax is applied at 7.5% of passenger revenue and 6.25% of freight revenue. In addition, at a few non-rural airports in Alaska, carriers collect an excise tax of \$3 per segment. Charter revenue is taxed similarly to scheduled revenue, except that aircraft with certificated take-off weight of less than 6,000 pounds are not taxed unless they operate with some degree of regularity between definite points.

⁵ The Consolidated Carriers consist of: Alaska Seaplane, Baker, Bellair, Cape Smythe, Grant, Iliamna, Island Air, Katmai, LAB, Larry's Flying Service, Olson, Servant, Skagway, Smokey Bay, Tanana, Taquan, Wings, and Wright.

Additional Reports, Appendix B

Larry's Flying Service recommends that the Department have carriers report a more detailed income statement, in lieu of excise taxes, stating:

“Scheduled passenger revenue follows the Net Income line on [Schedule F-1 and] should not be flawed by any code-sharing or ticket stock issued by other airlines. If reported accurately, this should give the same or better information as would a creative exercise with excise taxes. We would not be averse to an added line for passenger charter revenue or (taxable) freight revenue as well.”

Again, we think RSIA imposes ultimate responsibility for data use on the Postal Service. While we consider this additional concern, this revised interim Schedule F-1 will serve as a proxy. Moreover, it requires minimal additional detail, will tentatively be submitted quarterly, not monthly, beginning with the QE 9/30/02, and is shown in Appendix B.⁶ Under the RSIA, Freight Revenue is an alternate way to rank carriers for inclusion in the freight pool. Also, having Charter Revenue will be useful as a check on carrier reporting, because many carriers are currently claiming that other operators are misclassifying charter passenger and freight operations as scheduled service.⁷ We will also tentatively require carriers to report, from the first page of IRS Form 720, *system* excise taxes for persons by air and property by air, beginning with QE 9/30/02. It is very easily reported, and should enable us to conduct reviews of carriers to pinpoint where on-site reviews might be required or where the Postal Service should be alerted to a potential problem. We will hold confidential the information on Form 720.

Issue 4: in paragraph (s), the law provides that:

“(d) Actions of Air Carriers To Qualify--Beginning 6 months after the date of enactment of this Act, if the Secretary determines, based on the Secretary's findings and recommendations of the Postal Service, that an air carrier being tendered nonpriority bush bypass mail is not taking actions to attempt to qualify as a bush passenger or nonmail freight carrier under section 5402 of title 39, United States Code (as amended by this title), the Postal Service shall immediately cease tender of all nonpriority bypass mail to such carrier.”

Carriers making no effort to carry traffic other than mail are to be excluded from mail tender, but the law does not state how the Department is to determine whether the carrier is making an effort to become a passenger or freight carrier. This provision also raises the question as to whether carriers must carry passengers or freight in all markets to receive mail. Conversely, if a carrier carries only one passenger in one market, should it

⁶ The only additional data that must be submitted are charter revenue, mail revenue, and freight revenue. The other additional lines are simply subtotals and totals of those data.

⁷ We believe Department instructions are clear: charter operations, including part charters, are those where customer(s) contract for the entire plane, without individual tickets or waybills. Comparing flight regularity with scheduled service is often not determinative in Alaska.

be eligible to carry mail in all markets it serves? An option would be to require the mail-only carriers to demonstrate to the Department the steps that they have taken to begin carrying passengers or freight. We request comments on this issue.

Issue 4 Responses: The law provides that, effective February 2, 2003, the Postal Service shall take carriers out of tender that do not take “actions to attempt to qualify as a bush passenger or non-mail freight carrier.” There were two categories of comments on this issue, one contending that the Department should focus on recent or current attempts by carriers to transport passengers and freight without reference to any results, and the second category requesting that the Department focus on results, historical shares and trends of passengers and freight.

The Consolidated Carriers state that the RSIA addresses attempts by mail-only carriers to become passenger or freight carriers, and not results. They enumerated a number of actions for the Department to examine: changes in liability insurance (buying passenger insurance), purchasing different or additional aircraft or facilities, media advertising, Yellow Pages’ advertisements, and strict adherence to published flight schedules in their scheduled operations. Unlike the Consolidated Carriers, others felt that failure to publish schedules in electronic distribution systems or the *Official Airline Guide* in an attempt to carry passengers or freight should disqualify carriers from tender.⁸

Other carriers argue that the RSIA addresses results, *i.e.*, how much scheduled non-mail traffic a carrier actually transported and whether the trend has been upward. In summary, if a carrier does not qualify for the passenger or freight pool in any market or sub-group or show upward trends in passenger and freight traffic, that should be grounds for taking them out of tender entirely, including from the 10% mail-only pool that RSIA provides for carriers who do not qualify for either the passenger or freight pools in a particular market.⁹

Some carriers essentially desire a standard that effectively would never take a carrier out of tender, which is effectively no standard at all, while others prefer the most stringent test that it itself could pass. We believe the Consolidated Carriers are correct in pointing out that the law focuses on actions *attempted*. However, the mere enumeration of qualifying attempts does not establish criteria that would enable us to enforce this

⁸ For the Consolidated Carriers, failing to place its schedules in commercial, computerized reservations systems, does not entail sufficient “inaction” to take a carrier out of tender. In support of this position, they state that several carriers would in fact qualify for mail tender but do not list their schedules in commercial computerized reservations systems, that local traffic does not use such systems, and that requiring such listing might only increase carrier costs and passenger and freight rates.

⁹ To clarify some apparent confusion in carrier comments, the creation of a 10% mail-only pool by RSIA does not imply that the Postal Service should ignore this provision of the law and continue tender to carriers relying solely on mail in every one of their markets. Rather, RSIA created the 10% pool for those carriers that enter new markets in the future to compete for passengers or freight and, thus, would not initially qualify for mail tender, as they would not have carried passengers or freight in the market in the prior quarters.

provision. Without such a standard, the Consolidated Carriers' position provides no effective guidance to the Department.

We believe the intent of Congress was for the Department to focus on actions taken by carriers, but be guided by results as well. For now, we will tentatively consider any carrier that qualifies for tender under either the passenger or freight pool in any single market for the YE 6/30/03 to be a *bona fide* passenger or freight carrier for the purpose of this provision.¹⁰ The Consolidated Carriers argue that failure to list its services in the electronic publishing system by itself is no basis for taking a carrier out of tender. We agree. However, if a carrier is not in the electronic publishing system and does not qualify under the freight or passenger pool in a single market on its system, and its mail revenue grossly exceeds its scheduled passenger and freight revenue through March 31, 2003, we will notify the Postal Service. Of course, we will carefully consider each case on an individual basis.

Issue 5: The law provides for preferential tender to carriers providing service under an FAA certificate issued under 14 CFR Part 121, large aircraft operations. Carriers cannot operate under Part 121 unless the FAA approves such operations under the carrier's own operation specifications. The USPS has taken the position that if an airport is certificated for Part 121 aircraft and if a Part 121 carrier is serving the market, it would pay the (lower) Part 121 rate, even if the service were actually provided with small Part 135 aircraft. We tentatively propose to require all carriers to report on a monthly basis, in Attachment A, any airports listed on their operation specifications certificated for Part 121 service. In addition, we also tentatively propose that they report all aircraft in their fleet that are Part 121 certified should they wish to qualify for such preference.

Issue 5 Responses: As discussed above in the RFC, by having carriers report on Attachment A all airports where they were authorized to operate with Part 121 aircraft, we intended to meet the concern expressed by the Postal Service that it not pay the presumably higher 135 rate in markets where the lower 121 rate should apply. We believed that this was the basis for the Postal Service's initial position that it should pay the 121 rate wherever a carrier with both 121 and 135 operating authority operated. However, the Postal Service has since then affirmed its interpretation of the law and has said that it would pay the Part 121 rate wherever a Part 121 carrier operates, regardless of the actual aircraft type that any carrier uses to serve the market.

¹⁰ An argument could be made that we should make an exception here, and remove from tender any carrier that does not have published schedules in the passenger or all-cargo OAG. However, before the RSIA was enacted, to qualify for mail tender carriers had to publish in the OAG a schedule showing three or more round trips a week in a market. There was a one-time expenditure required of approximately \$2,000 to secure a two-letter IATA code. We have learned that the OAG prepared a special publication showing published schedules strictly for the benefit of the Postal Service and not for passengers or freight. It appears that only one carrier is still not listed in the passenger or all-cargo OAG. Moreover, that carrier appears to carry virtually no traffic except for mail. The Postal Service is aware of this situation.

The Postal Service relies on the following language from RSIA, Section (c), paragraph 5 (new 39 U.S.C. 5402(h)(6)):

“(B) The Secretary shall establish a bush rate based on data collected under subsection (k) from 121 bush passenger carriers. Such rates shall be paid to all bush passenger carriers operating on city pair routes in the State of Alaska where a 121 bush passenger carrier is tendered nonpriority bypass mail.

(C) The Secretary shall establish a bush rate based on data collected under subsection (k) from 135 bush passenger carriers. Such rates shall be paid to all bush passenger carriers operating on bush city pair routes in the State of Alaska where no 121 bush passenger carrier is tendered nonpriority bypass mail.”

No carrier supports the Postal Service’s position on this issue. Those carriers taking a position argue that the Postal Service’s view is inconsistent with: 1) other parts of the law, 2) the goals of the law, and 3) the Department’s historical ratemaking methodology.

1. Consistency with other parts of the law. Peninsula Airways is a holder of both Part 121 and 135 authorities, and is one of the larger bush carriers in Alaska. It argues that Section 3002 (b)(12)(D) of RSIA (P.L. 107-206) suggests an intended caveat to the language cited above, by stating that the 121 rate should be established only “where such [Part 121] operations are supported by the needs of the community.” In other words, if the community is too small to support larger 121 aircraft, the 135 rate applies even if a “dual authority” carrier operates there. The Postal Service’s reading would particularly impinge on Peninsula’s operations, because it operates service to many small communities exclusively under Part 135. Peninsula might not be able to maintain service to those communities if the lower 121 rate automatically applied to markets where no Part 121 aircraft operated. Alternatively, Peninsula, and other dual-authority carriers, might be forced to choose between strictly 19-seat Part 121 operations and strictly Part 135 operations.

We would further note that 39 U.S.C. 5402(h)(3)(A), as amended by RSIA, provides that when a Part 121 passenger carrier inaugurates service “with 121 passenger aircraft” [emphasis added] the “qualifying Part 135 passenger carriers on that route shall convert to operations with a 121 passenger aircraft [emphasis added] within 5 years after the 121 passenger aircraft begins receiving tender on that route.”

2. Consistency with the goals of the law. Peninsula argues that this rate-applicability issue would be largely moot if there were no carriers that operate aircraft under both Part 121 and Part 135 regulations. In fact, Peninsula Airways operates a wide spectrum of “dual authority” service, from its service with Saab 340s, the largest bush-qualifying aircraft, to very expensive Grumman Goose amphibious aircraft, to very small 135 aircraft, so the Postal Service’s interpretation would have major practical implications.

All parties acknowledge that the law seeks to promote service with larger, more efficient 121 aircraft, and thus reduce Postal Service expenditures. However, we note that the Postal Service’s reading might undermine this goal, such as in the case of an airline

operating mainly small, Part 135 aircraft and just one Part 121 aircraft. Under the Postal Service's reading, that carrier would be paid the Part 121 rate for all the mail it carries. The carrier might well conclude that it would be beneficial to ground or sell its Part 121 aircraft so that it would receive the Part 135 mail rate system-wide. This would clearly not result either in increased service with 19-seat or larger aircraft or a reduction in the Postal Service's expenses.

3. Consistency with the Department's historical ratemaking methodology. The Postal Service refers to its proposal as a class-rate, and it dismisses using the three cost pools based on aircraft type/size as "aircraft" based rates. However, a fundamental tenet of class rates is that members of the class share certain characteristics, which would not be the case with the Postal Service's proposal. The "aircraft" based rate that the Postal Service dismisses actually is most reflective of the current class-rate methodology.¹¹ That is, the Department's approach would have the Part 121 rate based on the costs of operating 121 aircraft; the Part 135 rate based on the costs of operating 135 aircraft, and the same for amphibious aircraft.

Tentative Conclusion

As the Postal Service notes, the Department generally defers to the Postal Service regarding its tender policies. This is, in our view, primarily an issue of rate applicability, that is, the traditional relationship between the rate paid to a class of carriers and the costs of service incurred by that class. It is reasonable to believe that members of a class should have a stronger relationship to the rate paid in applicable markets than merely possessing one 19-seat Part 121 aircraft. The current class rates are based on the separate costs of mainline and bush aircraft. Indeed, the Postal Service in the recent mainline rate proceeding recommends that we add ERA to the pool of mainline carriers, because one of its two aircraft types is mainline. It appears reasonable that the various rates should be developed on an *aircraft* rather than *air carrier* basis.¹²

Postal Service is Concerned It Will not be Able to Administer an Aircraft-based Rate. The Postal Service argues that some carriers might use Part 121 aircraft in a market, not inform the Postal Service, and thereby cause the Postal Service to overpay that carrier and all other carriers providing service in the market. In an attempt to narrow the Postal Service's concern, in the request for comments, we tentatively proposed to require carriers to report on their operations specifications at which airports Part 121 operations are permitted. We were concerned that the Postal Service would apply the presumably

¹¹ Under current law, the Department sets "mainline" rates for large aircraft (more than 7,500 pound payloads) and a much higher "bush" rate for aircraft below 7,500 pounds payload. Nothing in the RSIA would have us undo that basic principle. In fact, RSIA requires that we further subdivide the currently single bush rate into three separate rates.

¹² Should the Postal Service insist on paying a "121" rate in any market served by a carrier holding a Part 121 certificate, regardless of whether the aircraft actually operated by any or all carriers in that market were operated under Part 121, rates paid would diverge radically from the actual costs of service. The USPS' position cannot be rationalized as an extension of the practice of "rate equalization" allowed by the CAB and DOT: the latter was voluntary by bush carriers, whereas the effective USPS rate would be mandatory.

lower 121 rate to markets where there was no possibility of service with 19-seat 121 equipment. Carriers are encouraged by the RSIA -- from its preference for 121 aircraft and because of passenger preference for larger aircraft -- to market their use of 121 aircraft, rather than conceal it. The Postal Service will be able to determine those airports that carriers provide Part 121 service to by reviewing the carriers' FAA Operations Specifications.

Additional controls are possible. Published schedules show prospectively not only which carrier but which aircraft type a carrier proposes to operate in a market, and with the advent of the T-100, for the first time there will be automatic tracking of operations by aircraft type by segment, albeit after the fact. Perhaps closer scrutiny of dual authority carriers by the Postal Service is appropriate, and we invite comments on this matter. If the Postal Service were overcharged for any services, it could require the carriers to repay the overage. Also, the penalty provisions provided in 39 U.S.C. 5402(o), as amended by RSIA, for carriers that misstate their results are applicable to carriers that mislead the Postal Service as to the aircraft type they operate. The Postal Service faces the same problem now with carriers that operate both mainline and bush aircraft whereby a carrier could substitute a mainline aircraft for a bush aircraft.

We will continue to work with the Postal Service to achieve a workable interpretation of RSIA that gives due regard to several important, but potentially conflicting factors. In that regard, some carriers have argued that the minimal criteria for the 121 rate to apply to a market should be that a carrier must operate at least three scheduled round trips a week with qualifying 121 aircraft, the continuing minimum level of frequency before a carrier's scheduled service qualifies for tender. There clearly must be some minimal threshold of service with qualifying 19-seat Part 121 aircraft for that rate to apply. One operation by such aircraft in the course of a year would seem unreasonable. Reading together both the cost-based rate-making mandate and the large-aircraft conversion guidelines that focus on Part 121 aircraft service, such as 39 U.S.C. 5402(h)(3)(A) and (6)(B) (as amended by RSIA), we tentatively suggest to the Postal Service that scheduling and operating a minimum of one round trip a week as shown on the T-100 segment report might be sufficient to establish the Part 121 rate as the applicable rate for all carriers in the market.

Issue 6: In paragraph 18, the law defines as a "121 bush passenger carrier a bush passenger carrier providing passenger service on bush routes under part 121."

Elsewhere, under Section 5(h)(2)(B), the law provides that 19-seat Part 121 aircraft are to receive preferred tender compared to part 135 aircraft. Finally, the law provides that the Department shall establish three bush mail rates: for Part 121, Part 135, and amphibious aircraft.

"6(B) The Secretary shall establish a bush rate based on data collected under subsection (k) from 121 bush passenger carriers. Such rates shall be paid to all bush passenger carriers operating on city pair routes in the State of Alaska where a 121 bush passenger carrier is tendered nonpriority bypass mail."

Some aircraft types operating under Part 121 are not 19-seat aircraft, and might not receive the favored treatment explicitly contemplated under Section 5(h)(2)(b). We ask for comment on whether the Department should only include the costs of 19-seat Part 121 aircraft in determining the Part 121 rate? If so, what is to be done with the costs of Part 121 aircraft certificated for fewer than 19 seats? Should they be assigned to the Part 121 cost pool, the Part 135 cost pool, disregarded, or should they be used to establish yet a fourth bush rate, i.e., a Part 121 rate for aircraft with fewer than 19 seats?

Issue 6 Responses: In the RFC, the Department expressed concern that the law was not clear, and to meet its intent, a fourth class rate might need to be established to account for aircraft having fewer than 19 seats but operated under Part 121. In their responses, no party argued that a fourth class rate should be established, but none directly addressed the reason for the apparent confusion, as outlined in the RFC above.

The Consolidated Carriers argue that the 121 rate should apply where aircraft exceeding 19 insured and available seats operate, while Peninsula Airways argues that the focus must be on certificated seats, rather than seats insured or available for sale. Peninsula notes that in some markets it operates Part 121 aircraft certificated for 19 seats that in fact have only 16 seats because it has taken seats out to make room for a lavatory, and so the 121 rate should continue to apply. Hageland Aviation contends that Twin Otters, even though they meet all the statutory criteria--certificated for 19-seats, operated under Part 121, and in passenger operations--should not be part of the 121 pool, because such aircraft are not really what the law intended, because they are slower than 19-seat Beech 1900s or Metros. ERA, which operates Twin Otters, disagrees with Hageland, and argues that Twin Otters should be included in the Part 121 calculations.

Regarding the apparent confusion in the law, upon further review, we note that 39 U.S.C. 5402(h)(2)(B), as amended by RSIA, establishes minimum standards for three tender and cost pools, with one pool for "aircraft type certificated to carry at least 19 passengers; [another] for operations under part 135, [requiring] aircraft type certificated to carry at least 5 passengers; and [thirdly], for operations under Part 135 [requiring] aircraft type certificated to carry at least 3 passengers" for amphibious aircraft. We read this provision as establishing minimum aircraft standards for participation in each pool. In other words, an aircraft must meet all of the criteria of a class to be included in that class: the 19-seat certificated seat minimum with passenger aircraft is the standard for the Part 121 class. If an aircraft meets all of those standards except one, then it is placed in the Part 135 class, the next less stringent class, which requires operations with aircraft having a minimum of 5 certificated seats in either a passenger or all-cargo configuration, and finally a 3-seat minimum for amphibious operations. Therefore, by extension, we would place 121 aircraft with fewer than 19 seats in the Part 135 cost pool.¹³

¹³ The T-100 segment report will allow us to ensure that no costs of all-cargo aircraft are included in the 121-pool.

Regarding the issue of whether the 19-seat Twin Otter should be assigned to the 121 cost pool and be treated like other, faster 19-seat aircraft, the law provides no statutory basis for excluding the Twin Otter. We believe that on a policy basis, the Twin Otter should be included as well. Although the Twin Otter is much slower than Metros or Beech 1900s, over a short stage-length that slower speed is not a factor to either operating costs or passengers. Also, the payload of the Twin Otters, which greatly exceeds that of the typical single-engine bush aircraft, should make them competitive with the other 121 aircraft for short-stage-length operations.

Issue 7: A number of new ratemaking issues will arise under the base rate investigation we are to conduct. There will be a narrow window between when the final data is submitted and when the Department issues an order. Because this will be an investigation rather than a simple update, we encourage the parties to submit preliminary comments about any potential ratemaking issues before the show-cause order issues. To assist the parties in their comments and to expedite matters, we will provide a quarterly profile of the bush industry when the data becomes available. [Footnote omitted.]

Issue 7 Responses: As indicated above, we sought in the RFC to evoke any ratemaking issues sooner rather than later. In response, the parties raised several ratemaking issues, as discussed below. There are some issues that we will not dispose of at this time before having the benefit of looking at the actual data.

1. The Postal Service raised the issue of having the Department establish separate priority and non-priority rates for bush carriers as we traditionally have for mainline carriers. We are not theoretically against making separate priority and non-priority rates. No carrier commented on this issue. Given the need to act expeditiously here, our preference is to defer this issue to the next base rate investigation. We would need greater detail about implementation before proceeding to consider priority and non-priority rates.
2. Several carriers raised the issue, especially in light of RSIA's favoring passenger operations, whether passenger service costs, including liability insurance, should be excluded from the rate. Paragraph (k)(1) of 39 U.S.C. 5402, as amended by RSIA, states that "...the Secretary shall not take into account the cost of passenger insurance rates or premiums paid by the passenger carriers or other costs associated with passenger service" in setting mail rates. The statute is clear on this issue.
3. Should there be any special reporting to isolate mail, passenger, or freight costs? Both the Postal Service and the carriers have highlighted various costs that they argue should either be directly assigned to the cost of moving the mail or strictly excluded. We will tentatively treat these costing issues consistent with our treatment in the previous base-rate investigation. That investigation assigned weights of 1 to passengers and mail, but only 0.75 to ton-miles of freight, in order to reflect, among other things, the lower boarding priority of freight. Also, the previous investigation did not directly assign any terminal costs, to either mail or non-mail operations, and instead used a regression of terminal costs against volumes of mail and of other traffic to isolate those terminal costs which

should be assigned to mail. There would be great difficulty and burden on the carriers to accurately calculate which costs are directly assigned to the Postal Service and which to the costs of moving other traffic. Under the circumstances, we intend to apply the same techniques in the last base rate investigation,¹⁴ unless law or circumstances dictate otherwise.

4. The Consolidated Carriers contend we should consider the directional costing of mail. Even though we have never recognized it in practice, in other orders the Department has recognized in principle that under some narrow circumstances directional costing of mail might be appropriate.¹⁵ We note that notwithstanding a two-year freeze of the bush rate, all-cargo carriers are still eager to be tendered mail. Because directional costing is not currently built into the rate, this tends to support the position that the rate is sufficiently remunerative even without directional costing. We see no reason to propose directional costing in this investigation, although we will consider the merits of any argument that may be raised by the carriers after experience with the new law.

5. Should costs be based on Available Ton Miles (ATMs) or Revenue Ton Miles (RTMs)? The Postal Service urges us to use a cost per ATM, but it is not clear whether it is referring to updates of the rate, or calculation of the rate itself. We have used unit costs per ATM to update the mainline linehaul for some time, and believe that this is far superior to the block hour costs we relied on to update the bush linehaul. An update method based on RTMs would be identical to an ATM update, except it would incorporate load factors. For mail rate updates, we would prefer ATM to RTM unit costs, because load factor can vary with the business cycle. If, however, the Postal Service was referring to using a cost per ATM to determine the base mail rate, it is not clear how that would work in practice--the Postal Service pays carriers on the basis of mail revenue ton-miles transported and revenue tons of mail enplaned, and in a base rate investigation, we have to establish those costs before mail rates can be established. We accordingly ask the Postal Service to clarify its position.

6. Calculation of Rate of Return and Taxes. The Consolidated Carriers are the only party to raise the issue of calculating rate of return and taxes. They propose that we simply use a 5 percent markup on expenses to determine those cost elements, and this would obviate the need to collect balance sheet information from the carriers, which would provide the basis for determining return on the basis of carrier investment.¹⁶ In anticipation of using such a technique, and in view of the many new reporting requirements imposed by RSIA on the carriers, we had not asked them to submit any special Balance Sheet reports,

¹⁴ The Consolidated Carriers have stated that only T-100 segment traffic is critical for establishing mail rates. That overlooks the terminal regression, which regressed two independent variables, deplaned tons of mail and of all other traffic combined against one dependent variable, terminal costs. If the carriers misstate deplaned traffic, the results of a new regression could be problematic.

¹⁵ In Alaska, approximately 50% of passengers flow outbound from the origin, while 80% or more of the mail and freight flow outbound from the hub to the bush community and 20% from the bush to the hub.

¹⁶ Although the mainline and bush base rates did not use the markup approach, the effective markup was about 10 percent on both linehaul and terminal elements

although we did in the last investigation. Determining the appropriate rate of return on equity even with Balance Sheet information available is also extremely difficult from a methodological standpoint. As the Consolidated Carriers recommend, we anticipate using a percentage markup of costs, based on the historical relationship of return and tax elements to total operating costs, as a proxy to replicate the current return on investment calculation, especially considering the limited time remaining.

7. The Postal Service is pursuing the possibility of providing fuel directly to the carriers on the theory that, by buying in bulk, it could command lower prices than the individual carriers could obtain. Should the Postal Service be able to separately pay the carrier's cost of fuel, we would exclude fuel costs in determining the mail rate.

8. Should the cost of bush aircraft operating over mainline routes, with longer stage lengths and higher load factors, be included in the calculation of Part 121 bush rates? Order 2002-9-6, page three, noted "including Alaska Central Express (in the mainline pool) is even more problematic, because it operates primarily bush equipment" on mainline routes. That is similar to the issue here. We will examine this issue closely when all of the data are available.

Issue 8: Paragraph k(2) requires that

"(k)(2) In order to ensure sufficient, reliable, and timely traffic data to meet the requirements of this subsection, the Secretary shall require--` (A) the monthly submission of the bush carrier's data on T-100 diskettes, or any other suitable form of data collection, as determined by the Secretary; and` (B) the carriers to retain all books, records, and other source and summary documentation to support their reports and to preserve and maintain such documentation in a manner that readily permits the audit and examination by representatives of the Postal Service or the Secretary."

"(3) Documentation under paragraph (2) shall be retained for 7 years or until the Secretary indicates that the records may be destroyed. Copies of flight logs for aircraft sold or disposed of shall be retained."

In addition, under this provision, it would appear necessary that all flight logs would have to indicate the aircraft type, the pilot, the entire routing, the day of the flight. In addition, in order to document the reported traffic, it would appear that carriers would have to retain copies of invoices of passenger tickets and freight bills. We also request comment regarding other documents that carriers normally produce and can readily retain, as well as less burdensome means for carriers to document their schedule integrity and traffic reported. [Footnote omitted]

Issue 8 Responses: The RFC noted that the RSIA required carriers to have sufficient internal documentation, both source and summary, to enable reviews (data reviews) to determine quickly the accuracy of a carrier's reports to the Department.

The Consolidated Carriers indicated that all parties favored being allowed to maintain computerized databases in lieu of paper records wherever possible, especially in light of the requirement of keeping the information for seven years.¹⁷ Warbelow's says that the FAA requires carriers to create and retain a "load manifest" for all multi-engine operations for a period of 30 days, which ties together the flight record with tickets and air bills. Warbelow's recommends that the Department direct carriers to retain this information for several years, and require load manifests for all single-engine operations as well. For the multi-engine operators, the only additional burden would be that of storing the information, and permitting electronic storage as requested should minimize this burden. Mr. Ken Acton's letter, dated March 21, says the carriers should be required to record and retain in digital format the following information: Date of the flight, Flight Number, Flight Type (Scheduled or Extra Section), Tail Number, Aircraft Type, Flight Routing and Departure/Arrival Times, including actual elapsed block time and flight time, and finally Origin and Destination traffic, for all categories of traffic. Hageland Aviation indicates that we should require carriers to include flight and block times on their flight logs. We have noted in preliminary review of T-100 segment data that carriers often report ground time -- the difference between flight and block time -- to be zero, which is impossible.

All of these are good suggestions. However, it is the carriers' responsibility to be able to document its reports. If necessary, we will discuss with carriers better ways to summarize and retain their information so that, if an on-site review is required, it may be more speedily concluded and the carrier can return to tender more expeditiously. We ask that the carriers discuss with BTS what internal reporting formats would best aid in this endeavor.

Issue 9: Composite Equalization

In their initial comments, the Postal Service and Warbelow's raised the issue of Composite Rates. Generally, from Fairbanks and Anchorage, the two largest hubs, passengers, freight, and mail are flown on mainline equipment to regional hubs where the bush-destined traffic is transferred to bush carriers for final delivery. Composite equalization begins when a bush carrier provides direct service from an acceptance point (Anchorage or Fairbanks) directly to a bush point, thereby eliminating an intermediate stop at the regional hub. In the past, the Postal Service has paid the equalizing bush carrier the same rate it would have paid if the mail had traveled from Anchorage or Fairbanks to the regional hub at the mainline rate and then from the regional hub to the bush community at the bush rate -- thus the term "equalization." Warbelow's indicates that the Postal Service intends to modify its procedures and pay an equalizing carrier an amount equal to the mainline linehaul rate based on the nonstop distance from Anchorage or Fairbanks to the regional hub and the bush linehaul rate based on the nonstop distance from the regional hub to the bush community consistent with past practice; however, for the terminal element it would allow the bush charge but delete the heretofore recognized mainline charge. In response, Warbelow's contends that it is not the purpose of

¹⁷ We believe computerized databases would need to clearly identify reviewing officials and those responsible for the original documentation, and how and where those parties could be contacted.

composite rates “to match the compensation to the work performed,” and further states that even if it were, it should be the higher bush terminal charge that is paid, rather than the lower mainline terminal charge (initially) proposed by the Postal Service, because that is more reflective of the service actually provided.

We believe the RSIA explicitly deals with composite rates. Under 39 U.S.C. 5402(a)(8), as amended by RSIA, a “composite rate”:

“(A) means a combination of mainline and bush rates paid to a bush carrier for a direct flight from an acceptance point to a bush destination beyond a hub point; and

(B) shall be based on [not necessarily equal to] the mainline rate paid to the hub, plus the lowest bush rate paid to bush carriers in the State of Alaska for the distance traveled from the hub point to the destination point;”.

Also, 39 U.S.C. 5402(g)(2)(F) provides that:

“(3)(F) [the Postal Service] may offer tender of nonpriority bypass mail to a passenger carrier from an acceptance point to a destination city beyond a hub point in the State of Alaska at a composite rate if the Postal Service determines that—

(i) the carrier provides passenger service in accordance with the requirements of subsection (h)(2);

(ii) the carrier qualifies under subsection (h) to be tendered nonpriority bypass mail out of the hub point being bypassed;

(iii) the tender of such mail will not decrease efficiency of delivery of nonpriority bypass mail service into or out of the hub point being bypassed; and

(iv) such tender will result in reduced payments to the carrier by the Postal Service over flying the entire route;”.

Warbelow’s primary concern is that the less expensive composite rates will eventually become, under the Postal Service’s tender treatment, the only rate paid to all carriers serving a bush community, both those with direct and connecting service, or that the Postal Service will favor those carriers with lower rates with increased tender of mail. We note that the RSIA changes the old tender system and attempts to make it more competitive by having mail flows track passenger and freight flows, which are determined by the deregulated passenger and freight markets. The RSIA aims to provide the communities with better service while minimizing Postal Service expenditures and providing a reasonable return to the carriers. Accordingly, the RSIA provides its own answer to Warbelow’s concern: mail generally will follow the path chosen by passengers. If bush-bound passengers wish to fly directly from Anchorage or Fairbanks, as measured by reported passengers, the mail should follow. Thus, both the Postal Service and the community will benefit from additional choices. If the community is too small to support direct service from an acceptance point, then the Postal Service will continue paying the rates required by connecting service. Finally, Warbelow’s concern

may be misplaced--the Postal Service should have an incentive to maintain the connecting service--because if there is only direct bush service from an acceptance point to a bush community, then the basis for paying a composite rate evaporates and a much higher bush rate would apply.

Issue 10: Effective Date of the New Law

Section 3002(g)(2), P.L. 107-206 (RSIA); provides that the Postal Service's determination of which carriers qualify for mail tender in the various pools (under 39 U.S.C. 5402) "shall take effect 15 months after the date of enactment of this Act," which is November 2, 2003.

The Consolidated Carriers maintain that

"The Act envisions a three-stage process for implementation. In the first six months, all carriers remain in tender while management determines if or how it will comply with the terms of the Act. The next period, a transition before the selection period, allows carriers to make efforts necessary to qualify for tender based on market share....The third period, beginning November 3, 2003, is the 12-month test period for determining which carriers will be excluded from tender. In either the transition or selection period, carriers can be removed from tender only if they do not make efforts to qualify for tender."
(July 1 reply, page 4)

The Postal Service maintains that there is no provision in RSIA for an initial test period, and that the Consolidated Carriers are reading that into the law. We tentatively agree with the Postal Service.

The Postal Service has asserted that it is not responsible for ensuring that the accuracy of the passenger and freight data that dictates which carriers are eligible for mail tender, but that it will begin implementing the new law on November 2, regardless. Since the Postal Service holds the Department and carriers responsible, we urge the Postal Service not to begin its initial tendering of mail under the RSIA until the Department can certify the data as reliable based on available information. As discussed under *Issue 3*, we will work closely with the Postal Service to advise them of data shortfalls. The Postal Service states that it must have the data from the Department by October 1 to meet the November 2 deadline, but there is no such provision in the law. Likewise, Section 3002(f) of the law provides that the Department will report to Congress on the progress of implementing the RSIA. We will continue to work with the carriers and the Postal Service to implement the law on a timely basis and ensure that all the data are accurate.

ACCORDINGLY,

1. We issue these preliminary findings, as discussed in the order, regarding the implementation of the Rural Service Improvement Act;

2. We will issue a show-cause order establishing the various mail rates required by the Rural Service Improvement Act after we receive the necessary data;
3. We direct all parties to show cause within 15 days of the service date of this order, why all carriers should not submit the requested data in Appendices A and B by November 1, 2003; and
4. We will serve this on the parties to this proceeding.

By:

MICHAEL W. REYNOLDS
Acting Assistant Secretary for Aviation
and International Affairs

(SEAL)

An electronic version of this document is available on the World Wide Web at
<http://dms.dot.gov>

Quarterly Revenue Report for Communities by Carriers
Interested in Being Tendered ByPass Mail

	Outbound	Outbound	Outbound	Inbound	Inbound	Inbound
	<u>Skd Pass.</u>	<u>Skd Freight</u>	<u>Charter</u>	<u>N-Skd Pass</u>	<u>N-Skd Freight</u>	<u>Charter</u>
Community A	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$
Community B	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$	\$\$\$\$

1/ All figures are in dollars.

2/ Consistent with BTS definitions, revenue reflects funds going to the carrier for service on its system.

3/ These revenue figures should correspond to traffic figures for Table 3 and 4 on the BTS Website.

As such, they reflect the remuneration received by the carrier for the service provided on its system.

4/ Outbound refers to traffic originating at the hub/acceptance point, outbound to the bush community.

Quarterly System Report Submitted by Carrier, Replacing Schedule F-1 1/

Name of Carrier

	<u>Revised</u> <u>Schedule F-1</u>	<u>Current</u> <u>Schedule F-1</u>
1 . Scheduled Passenger	\$\$\$	\$\$\$
2 . Scheduled Freight	New	
3 . Charter	New 2/	
4 . Mail	New	
5 . <u>Other</u>	<u>New</u>	
6 . Total Operating Revenue	\$\$\$ 3/	\$\$\$
7 . <u>Non-Operating</u>	<u>New</u>	
8 . Total Revenue	New	
9 . Expense per Schedule F-2	\$\$\$	
10 . <u>Other Oper. Expense</u>	<u>New</u>	
11 . Total Operating Expense	\$\$\$	\$\$\$
12 . <u>Non-Operating</u>	<u>New</u>	
13 . Total Expense	New	
14 . Net Income	\$\$\$	\$\$\$

1/ Carriers should separately report the first page of IRS Form 720 to BTS, which will keep the information confidential.

2/ Charter revenue is the revenue when a single entity purchases the entire use of the plane.

3/ Passenger, Freight, Mail, and Charter Revenue is for Air Transportation only.

The related revenue from activities such as hotels, guides, camping, etc., are excluded.

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