COUNCIL STUDY SESSION: March 8, 2010

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: William F. Sherry, A.A.E.

SUBJECT: **Budget and Policy Issues Affecting the Competitiveness of Mineta San José International Airport – City Council Study Session**

DATE: March 3, 2010

Approved [signature] Date 3/3/10

COUNCIL DISTRICT: City-Wide

PURPOSE: Challenges and Solutions to Maintain Airport Competitiveness

Like the City of San José itself, Mineta San José International Airport (SJC) is facing extraordinary budget challenges. Because of its unique competitive environment, federal regulatory requirements, and current financial pressures, the Airport has little flexibility to increase revenues or raise rates and charges to airlines. It also is already approaching the practical limit of staffing and budget cuts without raising potential operational concerns.

For this reason, staff will be asking Council to consider budget proposals and policies that would be considered entirely off-limits in the past, so that the Airport will be able to remain competitive, keep its carriers, and obtain more air service.

As a result of the study session, the City Council will have a deeper understanding of the competitive and financial challenges facing the Airport that are very different from other City programs and services. Budget and policy decisions by Council over the next several years will affect the Airport's ability to maintain a cost-competitive position so that it can both retain current air service and attract new service to meet the travel priorities for Silicon Valley residents and businesses. This study session will provide the context for Council's ongoing budget and policy decisions, both this spring and in the near-term future, that can support the City's strategic goal of having a world-class airport that will continue to be an asset for the economic prosperity for the people and businesses of San José and Silicon Valley.

The study session is intended to provide perspectives and information on:

1. The intense market-driven competitive environment for airports and airlines both within the Bay Region and across the nation;

2. The Airport's current and projected financial challenges resulting from the severe recession; airline reductions in system-wide capacity; declining passenger traffic that reduces Airport revenues, services and budgets; and new debt service from the Airport's successful modernization program;

3. City policies that affect the Airport's ability to compete for air service; and

4. Alternative futures for the Airport contingent on its ability to address market and competition issues.

CONTEXT: What has Changed to Affect Airport Competitiveness

The combination of new debt service, falling passenger traffic, and strong competition both from other airports in the Bay Area and across the nation now severely challenge SJC's ability to remain cost-competitive for its airline partners. In addition, some City policies affect the Airport's ability to effectively compete for the air service needed in the region by making it more difficult for carriers to operate cost-effectively in San José.

The Airport's revenues come from a variety of sources, but broadly speaking they are mostly generated by passenger traffic and airline activity through rents and charges to carriers, concession fees, rental car revenues, and parking. Fundamentally the Airport must offer quality services at competitive prices to attract and retain airlines, flights, and passengers. Contrasted with other City enterprises such as its water and wastewater utilities, airlines and passengers have other choices to take their business elsewhere if costs, efficiencies or amenities at SJC are not competitive.

Since 2007 SJC has seen a 25% decline in the number of passengers and a 33% reduction in the number of flights, which in turn has reduced Airport revenues and resources. This has been largely caused by high fuel costs for airlines in mid-2008 that forced carriers to shrink their system capacity by cutting flights and seats, reducing their fleets of airplanes, and laying off tens of thousands of employees; the prolonged and deep economic recession that has significantly reduced business and leisure travel demand and put further pressure on airline profitability; and competitive business decisions made by airlines to locate their aircraft assets to other routes in order to compete for market share at certain airports or to increase their yields and improve returns on their aircraft investment.

At the same time that SJC passenger enplanements and revenues have dropped significantly, the Airport must now begin to pay a much larger debt service for the funds borrowed through Airport revenue bonds and commercial paper that financed the highly successful $1.3 billion modernization program now nearing completion.

Together these issues adversely affect the Airport's long-term budget trends, thus making it essential for the Airport to revise its competitive cost position and policy framework so that it can both keep current carriers and flights for San José and Silicon Valley and successfully compete for new air service and passengers even as airlines continue to cut and optimize flights overall.

The study session will provide Council with an opportunity to review, discuss, and ask questions about the Airport's current and long-term operating environment; current and future economic, policy and budgetary challenges facing the Airport; and the need for the Airport to restructure its ability to compete. Staff seeks Council's input and direction to build and operate a competitive world-class airport that will continue to be a vital contributor to the economy and creation of jobs in Silicon Valley.

In response to the declining activity in recent years, the Airport has taken many steps to reduce its operating budget costs. This has included a phased reduction of Airport Department staffing levels from 400 positions in 2008 to 305 positions today, and approximately 35 additional positions will be proposed for elimination in the FY2010-11 budget. These steps have reduced Airport staffing to one-third less than its former levels.

In addition, the Airport has aggressively sought to increase revenues over the past several years. Through its new concessions program, the Airport has increased the number of shops and restaurants going into new terminal space, and its contracts with concessionaires now require a minimum annual guarantee that will result in higher revenue when the concessions program is fully built out. Similarly, the advertising concession through Clear Channel has increased the opportunities for advertising at the Airport, thus increasing revenue.

Because of the drop in passenger traffic and the prolonged recession, however, the Airport will not see further growth in these sources of revenue until flights and passengers also increase in the future. Consideration also was given to raising parking rates, but the Airport determined that an increase would not be appropriate at this time after reviewing competitive parking rates at the other airports in the region.

POLICY AND BUDGET CONCERNS

1. Competition

Unlike any other City service or department, Mineta San José International Airport is a self-supporting enterprise that must compete in the marketplace to generate revenues from its customers to pay for day-to-day operations and for capital improvements. There is no local taxpayer support for the Airport's operations and capital programs; the Airport pays the City's General Fund for services such as police and fire, administrative support, and overhead charges.

The Airport's revenues are mostly generated by passenger traffic and airline activity through rents and charges to carriers, concession fees, rental car revenues, and parking. Fundamentally the Airport must offer quality services at competitive prices to attract and retain airlines, flights, and passengers. Contrasted with other City enterprises such as its water and wastewater utilities, airlines and passengers have other local choices to take their business elsewhere if costs, efficiencies or amenities at SJC are not competitive.

Airlines can locate their aircraft at any airport in the world in their constant efforts to increase profitability; local passengers can fly from the two other commercial airports in the Bay Region if they can find better schedules, destinations, or fares. During periods of economic contraction, both locally and nationally, the Airport's market environment has become ever more challenging as airports throughout the nation compete for fewer flights and aircraft that are available from airlines.

SJC does not determine airline routes or schedules or set airline fares; airlines make those decisions. There are several major factors that airlines use to determine SJC's competitive position and their decisions to add or eliminate flights here. These include:

- Airport operational costs that are paid by carriers through rates and charges.
- Other local airline operating costs for labor and services.
- Airport operating efficiencies.
- Airline competition for local market share and fares.
- Other local policy factors that affect airline operations.
- Community market demographics.
- Active community engagement and business support for air service.

Cost per Enplanement is a Key Airport Competitive Indicator
Airlines use a key indicator for measuring airport costs known as "Cost per Enplanement" (CPE). This represents the total costs that an airport charges to airlines in landing fees, rents or other specific charges, divided by the total number of passengers boarding planes each year. CPE is not a specific charge, but is a ratio; as enplanements decrease, CPE will increase. If costs increase, CPE will increase. The Airport's current challenge is to reduce its costs sufficiently to keep its CPE at competitive levels despite falling enplanements. Throughout this memo the impact of various budget and policy concepts are expressed in terms of cost per enplaned passenger to provide a basis of comparison for cost impacts.

Landing fees and terminal rents are set in accordance with rate-setting methodologies outlined in the airline lease agreements. The airline lease agreement approved by the City Council in 2007 sets landing fees on a "residual" basis. Under the residual methodology, the airlines assume the financial risk associated with airfield costs and revenues. Terminal rents are calculated using a commercial "compensatory" method and is based upon the square footage of the terminal space. Under the compensatory methodology, the airlines pay only for the facilities they use. There is no crediting of revenues generated from other cost centers such as parking and concessions.

CPE does not reflect an airline's own local operating costs for its staff and contractors at an airport. A significant benefit of the SJC modernization program is the improved efficiencies for carriers, especially as a result of the automated baggage system that will reduce the amount of labor required to move luggage from check-in to the aircraft. In addition, CPE does not capture the full benefits from the Airport's new common-use technology system that supports airline ticket counter and gate operations. These systems reduce their local operating costs, but that reduction is not reflected in the CPE. As airlines evaluate comparative costs at airports, however, they start with CPE.

2. Declining Flights and Passenger Traffic and Budget Impacts

At its peak level of traffic in FY 2000-01 during the Silicon Valley "dot.com" boom, the Airport had 13.9 million annual passengers. The combination of the dot.com bust in 2001 and the subsequent Silicon Valley recession, the impact of 9/11 on the nation's aviation system and airlines, and the American Airlines corporate decision to dismantle all its smaller hubs, including San José, reduced SJC passenger traffic from its peak in 2000 to approximately 11 million annual passengers over the following seven years. In 2007 the Airport was starting to see passenger growth again until the combination of the national credit crisis, aviation fuel cost spike, and global recession in 2008-09 caused traffic to fall sharply.

In the 2007 calendar year, SJC had 10.7 million passengers arrive and depart at the airport. In calendar 2009, this number had fallen nearly 23% to 8.3 million, and the projection for 2010 is estimated at 8.0 million. As a rule of thumb, the Airport estimates that each passenger generates approximately $15 in Airport revenue from the airlines, parking fees, rental car activity, and concessions. The loss of nearly three million passengers from 2007 to 2010 translates to revenue loss of approximately $40 million. Over the same period, daily departures have fallen from approximately 190 in 2007 to about 125 today, a drop of more than 33%. The last time SJC has seen this level of activity was in the early 1990s.

In 2005 the City Council approved a revised plan to modernize the Airport based on revised financial projections for growth in passengers and revenues. The new plan reduced the scale of the new airport from an anticipated $4.5 billion project to be built over seven to ten years to a $1.3 billion modernization project to be built in three years. Expansion would occur later when specific growth triggers were met for increases in passengers or flights. These revised plans were developed in consultation with SJC's carriers and community stakeholders.

In 2007 the Airport issued $725 million in General Airport Revenue Bonds to support the modernization program, supplementing prior bond issuance and short-term commercial paper. Part of this Airport debt is secured by other sources of revenue such as federal grants, Passenger Facilities Charges, and Customer Facilities Charges, which are not allocated to airline rates and charges.

As new facilities are completed and placed in service, the Airport will begin paying debt service on the funds it has borrowed, much as a homeowner has mortgage payments. In FY2010-11, the Airport's net debt service allocated to CPE calculations (airline rates and charges) will double from $19.8 million this year to $40.2 million next year. The Airport's net debt service is projected to increase to $58 million in FY2013-14. Opportunities to use additional Passenger Facility Charges to pay debt service or restructuring of the existing bonds to defer principal payments may offer timing relief in future years, but this does not address the need for a true reduction of costs if enplanements do not increase (PFCs are airport charges on passenger tickets permitted by the FAA).

3. Strategies to Reduce Airport Costs Affecting CPE

The Airport's current challenge is to reduce its costs sufficiently to keep its CPE at competitive levels despite falling enplanements. Throughout this memo the impact of various budget and policy concepts are expressed in terms of cost per enplaned passenger to provide a basis of comparison. At current enplanement levels, one dollar of the CPE is equivalent to about $4 million in the Airport's budget.

a. Contract out Certain Airport Services to the Private Sector

Under City Council Policy 0-41 that was updated last year, a change to a method of service delivery such as contracting out that affects City employees would require a thorough study and competitive analysis before a decision could be made. According to the City Manager's Office, this mostly likely would require a period of 18 months to two years to complete. The following services at the Airport could be considered to reduce operating costs estimated to be approximately $12 million per year, or $3.00 per enplaned passenger, contingent on the results of the analysis. If contracting out services is not pursued, then the Airport must identify other budget savings alternatives.

- **Custodial services.** The Airport Facilities & Engineering Division currently employs a staff of 54 City custodians to maintain the cleanliness of the terminals and auxiliary buildings throughout the Airport in a 24/7 operating environment. The Airport estimates that it could reduce its operating budget by more than $3 million annually by contracting out custodial services to the private sector. This is about $0.75 per enplaned passenger. This would also have the additional potential benefit of increasing the level of service appropriate for the expanded terminal space at the Airport.

  The Airport's current budget proposals submitted to the City Manager's Office for consideration to be included in her proposed budget for next year is the contracting out of custodial services. General Services is also including a similar proposal for custodial services at other City facilities. In order to comply with the time required to study impacts and alternatives, the Airport will need to identify an additional $3 million in budget cuts for the coming year.

- **Fire services.** The San José Fire Department provides required aircraft fire protection services at SJC. Aircraft Rescue and Fire Fighting (ARFF) costs using SJFD personnel are significantly higher than what the Airport might pay by contracting out this service, which is done at other US commercial airports. Data from those airports indicate that SJC could reduce costs for ARFF services by as much as 50 percent, or approximately $2.6 million per year, or about $0.65 per enplaned passenger. This has not been proposed in the current budget, but it could be considered for study for future budgets.

- **Police services.** The San José Police Department currently provides law enforcement and security services at SJC to meet requirements of the Transportation Security Administration. In the recent mid-year budget revision, Council reduced police staffing levels at the Airport by five positions, and staff will recommend a sixth position for elimination in the budget proposals for the coming year. This reduction in police positions was developed in coordination with SJPD in recognition of the significantly lower passenger traffic at the Airport, and it will allow the Airport to reduce its police services budget by approximately $1.5 million in FY2010-11, or about $0.38 per enplaned passenger.

TSA also allows airports to use "private law enforcement officers" to satisfy its security staffing requirements. Data from other airports that have converted from sworn LEOs to "private LEOs indicate that SJC could reduce the costs of airport law enforcement services by half, or approximately $6.4 million per year, or about $1.60 per enplaned passenger. This has not been proposed in the current budget, but it could be considered for study for future budgets.

b. Defer Airport Public Art Commitments for Terminal Area Improvement Program
In partnership with the Office of Economic Development, the Airport is recommending that $3.0 million of the public art funds allocated in FY2010-11 through FY2013-14 be deferred until total passenger activity reaches 12.2 million passengers per year, the level of passenger activity anticipated with the completion of Phase I of the Terminal Area Improvement Program. A one-time allocation of $70,000 from the TAIP capital program is recommended next year, FY2010-11, to enable staff to provide supervision of a contracted art technician and to seek sponsorships for public art operations and potential future commissions. Sponsorship funding is expected to fund the operating and maintenance costs of the art installations in the future; if sponsorship funding is insufficient to cover the operating costs, the Airport and OED will review funding options for FY2011-12.

In addition to the prior two specific budget proposals, the Airport has indentified additional opportunities that could help reduce operating costs by revising current budget and staffing practices. These include:

c. Reduce San José Fire Department Staffing Levels to be Consistent with FAA Staffing Requirements
At the Airport's current reduced level flight activity, the FAA now requires SJC to operate an ARFF facility at an Index Level C rather than at the previous higher Index Level D when it had more flights. At Level C, the Airport must staff and operate two specialized ARFF vehicles, compared to three at Level D. This allowed the Fire Department to reduce ARFF staffing by six positions, a reduction to the Airport of $1.4 million per year.

Under current Fire Department staffing standards required by the City's union contract with fire fighters, the Airport is required to operate its apparatus with a minimum of two personnel, which is double the FAA standard. Reducing this staffing level to be consistent with FAA standards could also reduce the personnel cost by an additional $1.4 million per year, or approximately $0.35 per enplaned passenger.

d. ***Reduce City Overhead Charges to the Airport***

Collectively, all overhead charged to the Airport Operation and Maintenance Fund over the last 10 years has ranged from $0.88 per enplaned passenger in FY2000-01 to $2.42 per enplaned passenger in FY2008-09. In November 2005, 16 airports responded to a survey regarding overhead rates. The average overhead amount was $0.45 per enplaned passenger, only about one-fifth of the overhead costs at SJC. The overhead amount charged to the Airport's operating fund, exclusive of Police and Fire overhead, amounts to approximately 7% of the Airport's personal and non-personal budget. Excluding shuttle bus service, the overhead amount represents the Airport's largest non-personal budgeted item. The airlines have been very sensitive to Airport overhead charges as the return on investment is difficult to measure and justify.

The Finance Department develops overhead rates in accordance with OMB Circular A-87 and FAA policy concerning the use of airport revenue. These rates are applied to labor in the Airport funds to reimburse the General Fund for indirect services provided from other City departments. Over the last ten years, the overhead rate charged to the Airport Operation and Maintenance Fund, exclusive of Police and Fire overhead rates, has ranged from a low of 14.97% to a high of 37.11%, and has amounted to $3.7 million to $7.1 million annually. FY2010-11 overhead amount for the Airport is estimated at $3.4 million, or approximately $0.82 per enplaned passenger.

e. ***Reduce Police and Fire Overhead Rates Paid by the Airport***

The Finance Department develops separate overhead rates for Police and Fire personnel that are applied against labor costs paid directly by the Airport. Over the last ten years, overhead rates for Fire Department staff have ranged from 33.57% to 46.04%, and overhead rates for Police have ranged from 29.00% to 46.22%. Together, the amount of overhead charged to the Airport for police and fire services during the past decade has ranged from $1.7 million to $3.5 million annually in addition to direct costs for salaries and benefits.

When the Airport's independent police unit was consolidated with the San José Police Department in 1990, the Council established the Police overhead at a flat rate of 29%. Since FY2004-05, however, Police overhead rates have ranged between 41.15% and 46.22%, which amounts to more than $3 million per year for Airport operating costs, or approximately $0.75 per enplaned passenger.

f. ***Restructure, Reduce, or Eliminate VTA Airport Flyer Service***

As an environmental mitigation measure associated with the approval of the Airport Master Plan in 1997, the Airport funds half the cost of providing the free VTA shuttle service between the Airport and the Light Rail stop on North First Street and the Caltrain station in Santa Clara. This service currently costs the Airport approximately $1.2 million annually.

The Airport estimates that a cost reduction of at least 50% could be achieved by using a private contractor that provides smaller vehicles, thus an annual reduction in Airport operating costs of approximately $600,000, or about $0.15 per enplaned passenger. Cost reduction would be shared with VTA, which is also facing significant budget challenges. To achieve this change, the Airport would need to explore the contractual, policy, and employment issues associated with VTA.

In addition the Airport also could consider reducing Flyer frequencies at certain times of the day when travel demand is lower to reduce operating costs. The actual amount of savings would be determined by number of buses and operators that could be reduced after analysis and negotiations with VTA.

Finally, if the VTA Flyer were eliminated altogether, this would reduce costs by $1.2 million, or $0.30 per enplaned passenger. This would require a review of the environmental mitigation requirements for the Airport Master Plan.

4. Strategies Affecting Local Operating Costs for Airlines

a. Issues Associated with the Airport Living Wage Ordinance
Council adopted the Airport Living Wage Ordinance in October 2008 that went into effect on January 1, 2009. Council could consider several possible changes to the ordinance that might improve SJC competitiveness. These include extension of the exemption for passenger carriers; reduction of the Living Wage rate to match levels at San Francisco International Airport (SFO) or Oakland International Airport (OAK); suspend the Living Wage tenant training program; and move to a complaint-based enforcement model.

Staff originally estimated that the cost to tenants' subcontractors to implement Living Wage requirements would be approximately $3 million annually. This did not include dollar amounts for employees of direct tenants to the City because airlines stated that their employees already earned more than the Living Wage rate. The basic Living Wage rate set for SJC is $14.08 per hour (without benefits). This is 13% higher than the equivalent rate at OAK ($12.45), and 22% higher than at SFO ($11.54).

Staff had recommended a complaint-based enforcement model with a private right of action for impacted employees that would have been consistent with similar programs at San Francisco and Oakland airports and would help SJC remain competitive for future air service in the region as well as reduce Airport costs. The complaint-based enforcement model was estimated to cost $156,000 annually to fully support one new position in Office of Equality Assurance in the Public Works Department. However, Council established a proactive enforcement model similar to that required by the City's Living Wage Policy for the City's contracted services. Three OEA positions to provide active enforcement were budgeted at $423,500 this year to be paid by the Airport, but OEA filled only two positions. The third vacant position was eliminated in Council's mid-year budget action, reducing the Airport's anticipated costs by $109,000.

Moving to a complaint-based enforcement model would further reduce OEA staffing for this function to one position instead of the two positions currently budgeted. Additionally, the workload for the airlines to provide detailed information on a quarterly basis adds costs to their doing business in San José. These reporting requirements could be reduced through a complaint-based system.

Since adoption of the ordinance, OEA staff has identified seven Airport Living Wage violations affecting 116 tenant employees who were underpaid a total of $221,000. Additionally, one of the food and beverage concessionaires was found to be in violation of the City's Living Wage Policy and has paid restitution in the amount of $34,500 to 26 workers. Pro-active enforcement was appropriate for a new ordinance, as some companies were either unaware of the ordinance or interpreted it incorrectly the initial year. Now that tenants are aware of the requirements, shifting to a complaint-based enforcement model may be more practical for both the Airport and its tenants while still achieving the Council's policy goal.

A second consideration for the Airport Living Wage Ordinance is to designate a "cure period" to give non-compliant companies time to correct the issue prior to being assessed fines or liquidated damages. The City's Living Wage Ordinance does not currently have a cure period, but San Francisco, Oakland, Los Angeles, and San Diego airports provide for a 30-day cure period where no fines are levied if businesses cure wage violations within 30 days of notification.

Finally, Council exempted SJC passenger airlines from the Living Wage requirements for two years to December 31, 2010, because of their vital role for the Airport's success and for the Silicon Valley economy. For the same reasons, the Council could consider an extension to passenger airline exemption to the Living Wage Ordinance.

The actual cost impact to tenants and airlines is difficult to determine because of the variety of employment models they use and access to private data. SJC has not conducted any study of economic, operational, or market impacts from the Living Wage Ordinance. This would require direction from the City Council to determine the competitive benefits for the Airport and its carriers and tenants, as well as the use of scarce Airport resources for either staff time or funding.

b. Waive Prevailing Wage Requirements on Tenant Construction and Contract Services
Current City policy requires that "prevailing wage" be paid on all construction work performed for the City, including construction done by tenants of the City. Airport tenants frequently construct their own facilities in their leased space and are required to pay prevailing wage under the existing policy.

Council does not have the discretion under state and federal law to waive prevailing wage requirements for City construction contracts, but it can allow third parties to construct their facilities in their leased space at the Airport without paying prevailing wage. Waiving this requirement could potentially allow Airport tenants to build at a lower cost.

In addition to construction contracts, the costs of Airport services contracted for many years through RFP/contract awards are steadily increasing due to prevailing wage and employee retention policies. For example, the difference between "living wage" and prevailing wage for shuttle bus operators and parking lot attendants causes the Airport to pay 10 to 20% more for those services than required by either "living wage" or actual market-based labor rates in this region.

5. Consider Other City Policies Affecting Airport Competitiveness

a. Explore Economic, Environmental, and Operational Tradeoffs from Modifying the Curfew

Mineta San José International Airport is one of very few commercial airports in the nation with a nighttime curfew that prohibits most landings and departures by commercial aircraft. The curfew has been a long-standing policy commitment by the City Council to ensure that the Airport continues to be a good neighbor and reduce the impact of noise on nearby residents from airline operations. With the passage of the Airport Noise and Capacity Act (ANCA) in 1990, federal law has preempted any further local restrictions on the operating hours at commercial airports. When the SJC curfew was threatened by litigation several years ago, the Airport successfully worked with the Federal Aviation Administration to restructure and legally protect the curfew so that it is now based on specific aircraft noise levels rather than by the proxy measure of aircraft weight, and continues to comply with ANCA requirements.

Although the curfew has been very effective to minimize nighttime airport noise, it also reduces the Airport's ability to gain market share and passengers by restricting aircraft operations seven hours a day, from 11:30 p.m. to 6:30 a.m. SJC staff found there currently are 31 flights by scheduled commercial carriers during this curfew period at San Francisco Airport, out of more than 900 daily flights at SFO. At Oakland International Airport, there are 10 night flights, and at Sacramento International there are 11. There are no regular commercial flights at these three airports between approximately 1:00 a.m. and 5:00 a.m.

In addition, the Airport and the FAA have invested more than $170,000,000 over the past two decades for the Acoustical Treatment Program that has successfully mitigated noise for nearly 2700 homes in neighborhoods near the Airport. The Airport used more than $70,000,000 from local Airport Passenger Facility Charges (PFC) for this purpose, as allowed by FAA. If not used for neighborhood investments, these PFC funds could have been used to help pay the debt service associated with the Terminal Area Improvement Program.

Airlines often use "red-eye" flights to test or build a market for a new route due to aircraft availability and operational efficiencies. For example, in July 2009 Volaris Airlines selected Oakland International Airport over San José to launch its first two flights to Mexico after 1:00 a.m. because it desired to test the new service. Today Volaris has four daily flights to Mexico from Oakland. Volaris indicated that it still is very interested in serving San José and is currently reassessing the market here and its plans for expansion in the Bay Area.

There would be several alternatives to consider for any modification of the curfew: Hours could be trimmed either at the night end or the morning end; the minimum noise threshold could be raised; operations could be limited to arrivals only; or no change. SJC has not conducted any policy, economic, operational, or market analyses of any of these alternatives or their impacts. This would require direction from the City Council to determine the competitive benefits for the Airport and carriers, as well as community, economic and environmental tradeoffs associated with curfew changes.

b. Prevent Downtown Obstructions That Could Limit Long-Distance Air Service

The Airport Obstruction Study was initiated in January 2006 to assess the compatibility of aircraft operations and high-rise building development, particularly in the downtown area. Over the past four years staff has worked with the San José Redevelopment Agency, Chamber of Commerce, and Downtown Association to develop a set of recommendations for Council consideration to address and resolve the incompatibilities between existing Federal Aviation Administration regulations, the resultant airline safety procedures for aircraft departures, and potential high-rise building development in the downtown area south of the Airport that is directly under the primary aircraft approach and departure paths for the Airport.

In the review of high-rise building proposals, the City historically has relied upon the FAA issuance of a project-specific "No Hazard Determination" as the finding that the development would not adversely impact airspace or Airport operations. Airlines, however, also must satisfy other operational criteria mandated by the FAA that often are more restrictive regarding obstructions and can constrain their ability to fly economically from SJC.

Uncertainty regarding the availability of airspace protection for long-haul flights, such as transcontinental, trans-oceanic, and other international service, is a significant disincentive for airlines to start up new airline service, especially considering the scale of an airline's investment of several hundred million dollars to allocate long-haul aircraft to serve this market. The lengthy period of policy indecision affects both potential future airlines as well as current airlines. Additional downtown buildings at the maximum heights that FAA may find acceptable could block the Airport's ability to restore long-haul flights to Europe and Asia as well as significantly constrain nonstop flights to Washington, D.C., New York, Boston, and Hawaii.

The Administration intends to recommend that the City adopt a policy preserving the Airport's capability to attract international and long-haul non-stop service while still encouraging vibrant downtown development.

c. Preserve Long-Distance Service in Light of Potential Reduction of Intra-State Service by High Speed Rail

The proposed California High Speed Rail (HSR) project includes a mainline San José station in the Diridon area that would serve downtown and be a multi-modal connection point between HSR, BART, Caltrain/ACE, light rail and bus lines. A principal goal of HSR is to add transportation capacity in the state to serve anticipated growth in traffic between the Bay

Area and Southern California. This is a primary market currently served by carriers at SJC, and approximately one-third of the current flights from San José go to the Los Angeles area.

According to recent projections reported by the Metropolitan Transportation Commission, HSR could potentially siphon off approximately 12 percent of SJC air passengers by 2035 by competing with existing airline service. HSR likely will be heavily supported by government subsidies in order to keep ticket prices competitive. The airlines, as private entities, will receive no such subsidy and might not be in a position to compete with HSR on an economic basis.

In the long-term anticipation that High Speed Rail would reduce the potential growth of short-haul air service at SJC, it is imperative that the City takes steps to preserve the Airport's ability to serve long-haul routes, such as resolving the Downtown Obstruction issue. The combination of constricting both short-haul and long-haul air service in the future would be severely detrimental to the City's significant investment in the Airport and would impair the Airport's ability to contribute to the Silicon Valley economy in the coming decades.

6. Prudent Use of TAIP Program Savings/Excess Bond Funds

At the onset of the Airport design-build modernization program in 2006, Hensel Phelps (the Airport's design-build contractor) estimated that the Terminal Area Improvement Program (TAIP) was over budget by approximately $150 million. Staff and project designers worked to reduce program scope and identify "value engineering" measures to reduce project costs. Among the major scope reductions was the elimination of the 1800-stall Terminal B Public Parking Garage to bring the Program back within budget.

Through prudent management of the improvement program and successful pursuit of federal grant opportunities, the Airport currently estimates program savings of approximately $171.4 million, a positive swing of more than $300 million since the beginning of the overall $1.3 modernization program. This has allowed certain TAIP requirements to be added back in, amounting to $33.5 million. Some of this has already been funded from the issuance of the 2007 General Airport Revenue Bonds, and some was contemplated to be issued from the Airport's available capacity to issue commercial paper (short-term debt). If commercial paper is not used, then a balance of $78.5 million is anticipated to be left "in the bank" at the completion of the Program. These excess restricted bond proceeds can only be used to fund "qualified eligible projects" or to pay debt service.

While it is difficult and unusual to justify using long-term funds for short-term purposes, consideration could be given to using these excess bond proceeds to pay debt service, given the extraordinary financial challenges currently facing the Airport. If the economy does not recover sufficiently and passenger levels do not increase significantly, these funds could be used to pay partial debt service and assist in keeping the San José CPE at a competitive level.

On the other hand, if appropriate measures can be taken to balance the Airport's Operating Fund, there is an opportunity to fund and build the Terminal B Public Parking Garage now. Construction prices have fallen dramatically, and a 2000-stall garage project could now be built for under $55 million, approximately half of the 2006 estimate of $88 million. Staff is evaluating the ongoing costs and benefits of implementing this public parking garage relative to the use of savings needed to reduce the airline's cost of operating at the Airport.

7. Other Operational, Administrative and Budget Issues

Although the Airport is not proposing specific changes to the following issues, they represent some of the challenges, complexities, and costs that contribute to the Airport's ability to manage with diminishing revenue and much reduced staffing levels.

a. Master Plan Implementation Requirements
The Airport Master Plan, as amended to date, identifies approximately 70 facility improvement projects to be implemented in a phased program to adequately serve commercial aviation demand projected out to the year 2017. Given progress toward completion of Master Plan projects and changed conditions at the Airport, in the aviation industry, and in the community, many of these requirements are no longer relevant or necessary. Updating them could reduce potential capital and operating costs in the future.

b. Environmental Initiatives
The Airport has achieved significant environmental goals in recent years. These include the "greening of its shuttle bus fleet and ground services equipment, development of solar power, solid waste recycling now approaching 90%, the installation of a recycled water system, and new LEED Certified facilities. Future environmental initiatives at the Airport should be reviewed, however, with the perspective of how they could affect Airport and airline costs.

c. Multiple Budget Systems and Duplicate Cost Accounting
The Airport must manage its finances using three sets of financial structures to provide information to various stakeholders. These include cost accounting for airline lease agreements and rates and charges; budgeting for internal operational functions; and the City's Core Service Area budget structure. This creates additional workload that is becoming increasing difficult as the Airport reduces its staff. The value of providing financial information under these structures needs to be evaluated to determine how they could be streamlined.

d. Taxi Services Administration
Several years ago, the City changed the Airport's taxi system from a "closed" concession system to an "open" permit/dispatch based system. Under a closed system, all taxi services are assigned to specific companies that have an Airport concession, and the concession oversight is straightforward. The management of the open system is more complex, and has added to the staff burden, especially as the many diverse stakeholders in the taxi system continue to seek changes to the model. Returning to a concession system could reduce administrative time required to oversee taxi services.

CONCLUSION

The combination of new debt service, falling passenger traffic, and strong competition both from other airports in the Bay Area and across the nation severely challenge SJC's ability to remain cost-competitive for its airline partners, which is critical to its ability to retain and attract carriers, flights, and passengers. In addition, some City policies affect the Airport's ability to effectively compete for the air service needed in the region by making it more difficult for carriers to operate cost-effectively in San José.

The Airport has little flexibility to increase revenues or raise rates and charges to airlines. It also is already approaching the practical limit of staffing and budget cuts without raising potential operational concerns. For this reason, staff will be asking for Council consideration of budget proposals and begin the review of policies that have been of long-standing importance to the Council and the community so that the Airport will be able to remain competitive. This consideration will be necessary for San José and Silicon Valley to build and operate a world-class airport that is vital for regional prosperity long into the future.

PUBLIC OUTREACH/INTEREST

Notification of the Council Study Session and distribution of this report has been given to community and Airport stakeholders, and has been posted on the City and Airport websites.

☐ **Criterion 1**: Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**

☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

COORDINATION

This report has been coordinated with the City Manager's Office, Budget Office, and Office of Economic Development.

William F. Sherry, A.A.E.
Director of Aviation

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