



COUNCIL AGENDA: 05-25-10
ITEM: 6.1

Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Lee Price, MMC
City Clerk

SUBJECT: AIRPORT COMPETITIVENESS
STRATEGIC PLAN

DATE: 05-12-10

RECOMMENDATION

As recommended by the Rules and Open Government Committee on May 5, 2010 and outlined in the attached memo previously submitted to the Rules and Open Government Committee, approve the strategic planning principles for the Airport that will guide the staff and Council decisions on the individual components of the Airport competitiveness strategic plan.



Memorandum

TO: Rules and Open Government
Committee

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

SUBJECT: Airport Competitiveness
Strategic Plan

DATE: April 26, 2010

Approved

Date

4/29/10

RECOMMENDATION

Staff recommends that the Rules Committee:

1. Recommend that the City Council approve the strategic planning principles for the Airport listed in Attachment A that will guide the staff and Council decisions on the individual components of the Airport competitiveness strategic plan.
2. Approve the staff's approach to developing the Airport's competitiveness strategic plan, including:
 - a. Conducting analyses of policies, staffing, alternative service delivery methods, and best practices in the airport industry in order to identify opportunities to ensure SJC's competitive parity with other airports, and particularly airports in the Bay Area.
 - b. Evaluating alternatives for significantly reducing the Airport's "cost per enplaned passenger" by providing Airport services in the most cost-effective manner, and return to Council with recommendations for alternative service delivery with timelines that will make it possible to implement them by the beginning of FY2011-12.
3. Request staff to return to the Rules Committee with a report on the status of the Airport competitiveness work plan by fall 2010.

BACKGROUND

On March 8 staff presented information at a City Council study session regarding the Airport's need, ability, and constraints to successfully compete for air service. This included a review of the state of the airline industry; Bay Area air service trends and the competitive marketplace; cost challenges facing the Airport beginning FY2011-12; budget and policy issues that constrain

the Airport's competitive position; and options for addressing those challenges. At the study session Council directed staff to develop a work plan for developing a strategic plan that will keep the Airport competitive and bring it to the Rules Committee. The Mayor's March Budget Message approved by Council on March 23 provided further direction, requesting that effort to develop competitiveness options should include cost/benefit analyses; evaluation of the impacts on quality of life of neighbors and workers; a business development strategy; and appropriate community and stakeholder outreach.

DISCUSSION

Airlines use "Cost per Enplaned Passenger" (CPE) as a key indicator for their decisions about where to locate air service. CPE represents the total costs of airport operations that are allocated to airlines and are charged to them in landing fees, rents or other specific charges, divided by the total number of passengers boarding planes each year. CPE is a ratio, not a specific charge: as enplanements decrease, CPE will increase; or as costs increase, CPE will increase.

The combination of major new debt service associated with the modernization program, steeply falling passenger traffic, and strong competition from other airports in the Bay Area and across the nation now severely challenges SJC's ability to keep its CPE cost-competitive for its airline partners. The Airport's net debt service allocated to its CPE calculations for airline rates and charges will double from \$19.8 million this fiscal year to \$40.2 million next year. The Airport's net debt service is projected to increase to \$58 million in FY2013-14, yet San Jose passenger traffic now is 25 percent lower than it was in 2007.

Under current forecasts for increased costs and reduced traffic, the San Jose CPE is projected to increase to approximately \$22 in 2011-12. Based on feedback from carriers, San Jose's cost per enplaned passenger needs to be "substantially lower" than the CPE at San Francisco International Airport in order for SJC to remain competitive, or else SJC will risk losing even more flights and passengers. The cost per enplanement at SFO is projected to be \$18.50 in 2012, and staff's goal is to keep the San Jose CPE at a level no higher than \$15. Even at \$15 in FY2011-12, the CPE for San Jose would still be at the high end for medium-hub airports in the United States.

These factors mean that the CPE will become very uncompetitive beginning in FY2011-12 unless the Airport can find ways to significantly reduce costs allocated to airlines. At current enplanement levels (approximately 4.1 million per year), one dollar of the CPE is roughly equivalent to \$4 million in the Airport's budget. Reducing the CPE projection from \$22 to \$15 will require ongoing cost savings totaling approximately \$28 million per year.

Therefore, solutions that significantly reduce the CPE for the airlines are the Airport's highest priority, and decisions leading to the reduction of Airport costs must be made no later than fall 2010 so that administrative and operational steps to implement those measures can be completed and in place no later than July 1, 2011.

Strategic Principles for Airport Competitiveness

Staff recommends that the Airport's strategic competitiveness plan should be based on fundamental principles to ensure ongoing and long-term airport capabilities. The following strategic principles will guide the priorities, research and analysis, and recommendations for ensuring the planning, construction, and operation of a competitive world-class airport that meets the needs of air transportation for San Jose and Silicon Valley residents and businesses:

1. **Airport operational safety and security is the highest priority.** Staff will not propose any action that would impair its ability to meet standards for safety or security affecting passengers or aircraft.
2. The Airport needs to **remain fully functional in its core areas**, including operations, maintenance, planning, information technology, finance and administration, and marketing. Staff will avoid staffing reductions in core service areas that would create undue risk, impair the Airport's ability to compete for air service, or degrade its ability to meet safety, legal, operational, and administrative requirements.
3. The Airport will continue to **be cost-competitive for airlines** and seek opportunities to reduce costs allocated to airlines through greater efficiencies, benchmark with the airport industry best practices, and identify the most cost-effective alternative service delivery methods in all areas of service.
4. The Airport will continue to **provide an excellent customer experience** and ensure good service for both passengers and airlines to remain competitive and attractive. Staff will not recommend options that would degrade the customer experience at the Airport.
5. The Airport will continue to **aggressively seek to increase air service in partnership with the community** to gain more routes, frequencies, and carriers that meet the needs of Silicon Valley businesses and residents. To increase passenger traffic, the Airport needs more flights. This will require active marketing to airlines and the development of more effective community and business engagement to help achieve this goal.
6. The Airport will continue to **seek opportunities to increase revenues**, as it has done through its new concessions programs. An example of future revenue growth is the potential redevelopment of the Airport's west side for general aviation purposes that could yield significant new revenues for both the General Fund and the Airport.
7. The Airport will continue to **work in partnership with carriers to minimize obstacles to doing business at the Airport.** Business goes where it is welcome and stays where it is appreciated, and the airlines' perspective, ideas, and suggestions for improvement are essential to the Airport's success.

8. The Airport will **take the long-term view on costs and opportunities**. Policy changes and investments may take time to realize benefits, and short-term solutions to long-term challenges may be counterproductive to long-term competitiveness.

Competitiveness Strategic Plan Options

Staff identified many options at the March 8 study session that could enhance Airport competitiveness. The highest priority items are those that will lower the Airport's costs to airlines and reduce the cost per enplanement (CPE). The Airport will continue to evaluate these options and bring specific recommendations to Council as it completes its analysis.

- The City Manager's advance budget summary released on March 29 referred to Airport proposals to be included in the upcoming proposed FY2010-11 budget that will be issued on May 3. These include the contracting out of custodial services both for the Airport and for other City facilities, which would reduce ongoing Airport costs by approximately \$3 million annually; deferral of public art funding for the Terminal Area Improvement Program, a one-time reduction of \$3 million; and the elimination of 39 other Airport positions that would further reduce costs by \$3.8 million. Since then the Airport has also proposed the relocation and consolidation of Airport administrative offices to space at the terminals, which could provide ongoing savings of nearly \$2 million per year starting in FY2011-12 and create further opportunities for functional efficiencies and potential reductions next year.
- By this fall, the Airport will evaluate potential alternatives that could reduce the CPE starting July 2011 and bring recommendations to the City Council. These include identifying the most cost-effective methods for delivering police and fire services at the Airport; the possible reduction or restructuring of the VTA Flyer bus service; the reduction of City overhead charges to the Airport in keeping with airport industry standards; and the possible establishment of an airline consortium that could take over specific operating and maintenance functions. Together, these changes have the potential to reduce Airport costs by at least \$12 million per year, and thus lower the CPE by about \$3.
- The Airport will complete an economic impact study in relation to the issue of potential downtown obstructions and "one-engine inoperative" (OEI) flight path alternatives as soon as practical. Resolving the downtown obstruction issue will support the Airport's long-term efforts to secure transcontinental and transoceanic flights, and remove a significant competitive issue with other airports. Council's decision on how to appropriately balance the future success of the Airport and the future development of downtown would ultimately result in more flights, more passengers and more revenue to reduce the CPE and support the economic development of San Jose and Silicon Valley.
- The Airport will compare its living wage rates and policies with those at other Bay Area airports to identify whether there are opportunities to align SJC into parity with them and reduce possible competitive disadvantages. Living wage is a core value established by the City Council, and staff does not seek to eliminate living wage policies at the Airport. The

parity review would focus on comparative administrative matters such as cure periods, enforcement methodology and reporting requirements, and penalties; comparative live wage rates and benefits; worker retention policies, and other relevant competitive issues. Staff would return to Council with any recommended adjustments to the current ordinance that would bring SJC into closer alignment with competing airports that also apply living wage to their operations. Such review and adjustments should eliminate airline concerns about a competitive disadvantage at SJC compared to other Bay Area airports.

Options Not Recommended for Strategic Competitiveness

Two options discussed at the March 8 study session are not recommended by staff for the Airport competitiveness strategic plan. These are:

- *Use of excess unallocated TAIP bond funding to reduce short-term CPE*

As discussed at the March 8 study session, staff does not recommend using excess unallocated TAIP bond funding to reduce short-term CPE for several reasons. Most importantly, it would not address the Airport's need to reduce ongoing operating costs to remain competitive. This likely would be viewed by the airlines as a lack of commitment by the City to contain costs and weaken their confidence in the City's ability to remain cost competitive. The use of long-term debt to reduce CPE could actually have the unintended impact of encouraging further erosion of service and passengers, and to the possibility of losing carriers altogether.

Use of bond funds is subject to legal limitations based upon the underlying bond provisions and applicable law. Any proposed use of excess Airport bond proceeds will require review by the Finance Department, the City Attorney's Office, and bond counsel. In addition, funds would not be available until the current TAIP program is completed March 2011 and closed out approximately one year later. The need for CPE reduction begins July 2011, but the soonest that any excess bonding capacity might be available would be spring 2012. Finally the use of bond funds for CPE reduction would eliminate their potential use for essential eligible capital improvements, such as the public parking garage for Terminal B.

- *Modifying or eliminating the current Airport curfew*

Staff also does not recommend changing the Airport curfew as discussed at the March 8 study session. Environmental review for any curfew proposal would take between 12 and 18 months to complete, and could cost several hundred thousand dollars for consultant services in addition to staff resources better used for other priorities. During that time, no development on the Airport could take place, which would suspend the planned development of general aviation facilities on the west side of the airfield, thus postponing potential annual revenues estimated at approximately \$4 million to the General Fund and \$4 million to the Airport.

There likely would be minimal benefit for new air service resulting from a change in the curfew, and the benefits of any potential increase in flights and passenger traffic would be outweighed by the costs of making the change, opportunity costs from not doing other development, and

negative impacts on the community. In addition, potential changes to the curfew would likely be challenged, which could become a further drain on available financial or staff resources.

Administrative Efficiencies

In addition to the options recommended for the Airport's strategic plan, Airport staff will also review other policies and practices that impact Airport efficiency, staff resources, and therefore competitiveness. While these administrative practices are significant, they do not require specific policy direction from the City Council at this time. These issues include:

- *Updating 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 these Master Plan requirements would reduce potential capital and operating costs in the future.
- *Applying more rigorous cost/benefit analysis to 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. While the Airport benefits from most of these initiatives, future environmental measures should weigh the impact on Airport and airline operational costs.
- *Streamlining multiple cost accounting systems:* The Airport needs to manage its finances using three sets of financial accounting systems to provide information to various stakeholders. These include: 1) cost accounting for airline lease agreements and rates and charges; 2) budgeting for internal operational functions; and 3) the City's Core Service Area budget structure. Maintaining these multiple cost accounting systems is creating additional workloads that are becoming increasingly difficult to sustain as the Airport reduces its staff. Staff will review opportunities to streamline these systems to improve efficiency.
- *Simplifying taxi 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 had an Airport concession. This made concession oversight relatively straightforward and cost-effective. The management of the open system is more complex and has significantly added to staff's workload as the number of staff available to manage this more dynamic system has been reduced significantly. With many diverse stakeholders in the taxi system continuously seeking changes to the model, the staff's ability to administer the open system cannot be sustained over the long term. Returning to a concession system at some point in the future could reduce the administrative time required to oversee taxi services without reducing the quality of service to travelers.

Limitations of a Five-Year Competitiveness Strategic Plan

As staff explained during the March 8 study session, the airline industry is subject to extreme swings in demand and profitability compared to other industries, which makes accurate projections for traffic, flights, revenues, and costs nearly impossible. This volatility requires any long-term competitiveness strategy to focus on the Airport's own abilities to operate with resilience and flexibility in an extremely competitive environment. The effort to set priorities, identify planning and operating principles, and making financial forecasts are valuable and essential exercises, but none of them can predict conditions affecting the Airport and airlines over the next five years.

The Airport Master Plan effectively has served as the Airport's strategic plan since the City Council approved it in 1997. Since that time, events have occurred that could not have been anticipated. Looking back over the past dozen years since the adoption of the Airport Master Plan in 1997 and the subsequent "dot.com" boom, the following events that have affected air travel, the aviation system in general, and the Airport, San José, and Silicon Valley specifically:

- September 11, 2001, terrorist attacks that tremendously affected air travel and security.
- "Dot-com" bust in 2001-02 and the subsequent prolonged Silicon Valley recession.
- American Airlines' dismantling of its small hubs including SJC after 2000, and the loss of overseas routes.
- Growth of Southwest Airlines and low-cost carriers.
- The downsizing of the Terminal Area Improvement Program in 2005 from \$4.5 billion over ten years to \$1.3 billion over three years.
- Rapidly rising fuel prices in 2008 and the sharp reductions in airline capacity across the nation in response.
- Impact on the Bay Area air service market when Virgin America entered SFO in 2007, creating a "herding mentality" among air carriers that resulted in 592 more flights a week at SFO and reduced flight service opportunities for San José and Oakland.
- Worst recession since the Great Depression and its severe and continuing impact on travel demand and air service both in Silicon Valley and across the nation.
- Completion of the Airport modernization program, ahead of schedule and under budget in FY2010-11.

As the Airport develops its competitiveness plan, it will be informed by an awareness of the limitations of any strategic plan articulated by the renowned management consultant Peter Drucker:

"Strategic planning is necessary precisely because we cannot forecast....Strategic planning does not deal with future decisions. Decisions exist only in the present. The question that faces the strategic decision-maker is not what his organization should do tomorrow. It is: What do we have to do today to be ready for an uncertain tomorrow?"

CONCLUSION

The recommended components for the Airport competitiveness strategic plan are essential for the Airport's ability to keep its current airline partners and air service, and to attract new flights and airlines in the future. Even with significant commitment to keep its costs and policies competitive, success is not guaranteed. As staff stressed in the March 8 study session, reducing and controlling the Airport's costs will not ensure long-term success, but not controlling costs will certainly ensure failure.

PUBLIC OUTREACH

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

CEQA

Not a project

COORDINATION

This memorandum has been coordinated with the City Manager's Office and City Attorney's Office.

/s/

WILLIAM F. SHERRY, A.A.E
Director of Aviation

For information or questions about this report, contact William F. Sherry at (408) 501-7669.

Attachment A: Strategic Principles for Airport Competitiveness

ATTACHMENT A

Strategic Principles for Airport Competitiveness

1. **Airport operational safety and security is the highest priority.** Staff will not propose any action that would impair its ability to meet standards for safety or security affecting passengers or aircraft.
2. The Airport needs to **remain fully functional in its core areas**, including operations, maintenance, planning, information technology, finance and administration, and marketing. Staff will avoid staffing reductions in core service areas that would create undue risk, impair the Airport's ability to compete for air service, or degrade its ability to meet safety, legal, operational, and administrative requirements.
3. The Airport will continue to **be cost-competitive for airlines** and seek opportunities to reduce costs allocated to airlines through greater efficiencies, benchmark with the airport industry best practices, and identify the most cost-effective alternative service delivery methods in all areas of service.
4. The Airport will continue to **provide an excellent customer experience** and ensure good service for both passengers and airlines to remain competitive and attractive. Staff will not recommend options that would degrade the customer experience at the Airport.
5. The Airport will continue to **aggressively seek to increase air service in partnership with the community** to gain more routes, frequencies, and carriers that meet the needs of Silicon Valley businesses and residents. To increase passenger traffic, the Airport needs more flights. This will require active marketing to airlines and the development of more effective community and business engagement to help achieve this goal.
6. The Airport will continue to **seek opportunities to increase revenues**, as it has done through its new concessions programs. An example of future revenue growth is the potential redevelopment of the Airport's west side for general aviation purposes that could yield significant new revenues for both the General Fund and the Airport.
7. The Airport will continue to **work in partnership with carriers to minimize obstacles to doing business at the Airport.** Business goes where it is welcome and stays where it is appreciated, and the airlines' perspective, ideas, and suggestions for improvement are essential to the Airport's success.
8. The Airport will **take the long-term view on costs and opportunities.** Policy changes and investments may take time to realize benefits, and short-term solutions to long-term challenges may be counterproductive to long-term competitiveness.