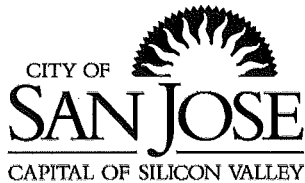


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City Manager's Office



Memorandum

**TO: HONORABLE MAYOR
AND CITY COUNCIL**

**FROM: William F. Sherry, A.A.E.
Director of Aviation**

**SUBJECT: Airport Competitiveness
Strategy Update**

DATE: December 2, 2010

Approved

Date

12/3/10

INFORMATION

BACKGROUND

On May 25, 2010, the City Council approved direction to the City Manager and Director of Aviation to take the necessary steps to ensure the ability of Mineta San Jose International Airport (SJC) to successfully compete for air service and to continue to keep its costs to airlines at a nationally competitive level. Since May, the Airport has accomplished significant cost reductions, and has made successful progress on several measures to achieve competitive cost goals for FY2011-12. This memo is an update on the current status of the Airport's Competitiveness Strategy.

Specifically, Council directed staff in May to:

- Reduce the Airport's target for "cost per enplaned passenger" (CPE) from \$15 to less than \$12. This was recommended by staff based on additional research that showed that \$12 for CPE was at the high end of the range for medium-hub airports such as SJC.
- Evaluate alternatives for 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.
- Hold in reserve excess unallocated Airport bond funding from the Terminal Area Improvement Program to help reduce the CPE to reach the \$12 target if other cost cutting measures were insufficient. Currently the amount of these funds is estimated at \$78.5 million, but this amount is subject to change and would not be available until after the TAIP is closed out in 2012.
- Council also adopted Competitive Principles that have guided the staff and its partners as they have evaluated proposals to reduce costs in balance with other strategic goals (attached).

DISCUSSION

Airlines use “Cost per Enplaned Passenger” 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. All things being equal, CPE will get lower as passenger activity increases.

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 remain cost-competitive for its airline partners. The Airport’s net debt service allocated to its CPE calculations for airline rates and charges has doubled from \$20 million last fiscal year to \$37 million this 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, and the number of daily flights has declined from about 190 to 125 in the same period.

Prior to the actions taken by the Airport to reduce costs over the past year, the Airport had projected that its CPE would have increased to approximately \$25 in 2013-14. 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 \$25 to \$12 will require ongoing cost savings totaling approximately \$50 million per year.

Recent actions to reduce costs

The cost reduction steps the Airport has taken over the past two years include:

- **Reduction in overall Airport Department staffing levels from 400 authorized positions in 2008 to approximately 200 now.** This was done in several phases starting with mid-year budget actions in February 2008 through June 2010, and it has included reductions in every Airport Division and at all levels of the organization. The reduced staffing level also reflects the change to contract custodial services and the planned dismantling of the capital project team associated with the completion of the airport modernization program. The ongoing savings from these staff reductions is approximately \$20 million per year.
- **Contracting out Airport custodial services.** The City Council approved this step as part of the budget action in June 2010, and the transition to contract service took place this summer. The cost savings from replacing 54 City custodial positions with contract staff will save approximately \$3 million annually, which is part of the \$20 million in personnel savings noted above.

- ***Relocation of Airport administrative offices into new airport space in Terminal B.*** The move was completed in November this year and will result in ongoing savings of \$2 million per year. The consolidation of staff into one location also will bring operational efficiencies, improved communications, and closer staff alignment with Airport customers and partners. The move became possible in part because the significant reductions in staffing levels meant that Airport employees now could be accommodated in terminal space.
- ***Restructured the Airport Communications Center to an Airport Operations Center.*** This was an efficiency measure that became possible as a result of the consolidation of Airport staff in Terminal B. It was approved by the City Council in October and will save approximately \$500,000 annually.
- ***Aggressive expenditure control.*** Through very conservative financial management, Airport staff has exercised extreme constraint for expenditures. This allowed the Airport to complete FY 2009-10 with one-time expenditure savings of approximately \$11 million, which will help with future budget balancing and CPE reduction for FY 2011-12.
- ***Deferred public art funding for the Terminal Area Improvement Program.*** This was a one-time reduction of \$3 million, and funding would be restored for the public art program when passenger traffic reaches 12.2 million per year, the same growth trigger for beginning design and construction on terminal expansion.

Alternative Service Delivery Options for Airport Public Safety

Staff identified many options for evaluation that could enhance Airport competitiveness, with the highest priority items being those that can significantly lower the Airport's costs to airlines and reduce the CPE. Together, these changes have the potential to reduce Airport costs by an estimated \$10 to \$12 million per year, and thus lower the CPE by nearly \$3.

The largest potential savings would come from outsourcing public safety services at the Airport. For both functions, the Airport and the Administration will develop a business case under Council Policy 0-41 – Service Delivery Evaluation that requires the evaluation of service delivery changes that could result in the addition, deletion, or reclassification of four or more fulltime equivalent employees. The possibility of contracting services also triggers “meet and confer” requirements with the affected bargaining units and stakeholders, and this will take place in early 2011. At the same time, staff will develop a Request for Proposals for contract police and fire services at the Airport. Final recommendations for service proposals will be brought to the City Council in spring 2011 for approval in order to implement, achieve budget savings, and reduce the Airport CPE by the beginning of FY 2011-12.

Both the San Jose Police Department and San Jose Fire Department worked with the Airport to identify additional cost reductions that would not involve contract services, and in October they proposed staffing reduction plans that would provide significant overall budget savings to the

Airport. However, the Fire Department proposal was \$1.1 million short of meeting the Airport's budget forecast and goal to ensure a competitive CPE for airlines. The Police Department proposed an excellent police staffing reduction plan, but it was \$4 million short of meeting the Airport's financial requirements. Both the San Jose Police and Fire Departments' efforts to reduce costs in collaboration with the Airport were outstanding, but both compensation levels and overhead charges combined resulted in an insufficient cost reduction for the Airport.

The Airport's competitiveness target for reducing ongoing public safety costs is \$10-\$12 million per year, which would be achieved by contracting out these services. The Police and Fire Departments' staffing proposals together would fall short of this target by more than \$5 million per year.

In order to close this gap, the Airport would face alternatives that may be impossible to achieve. These would include further substantial reductions in Airport costs, services, and staff – roughly the equivalent of 50 additional positions – which would create the real risk of not being able to meet federal and airline requirements for airport operations; a subsidy from the General Fund in some form, such as a direct transfer of funds or a waiver of City overhead charges for Airport staff and public safety personnel, which would complicate the City's own budget challenges; or increases in Airport rates and charges that would increase the CPE to a non-competitive level for airlines as well as costs to passengers.

Until there is a substantial increase in air service and passenger activity that will generate the necessary revenue for stable operations, none of these alternatives is feasible. Proceeding with the options to contract out law enforcement and airfield fire fighting services, therefore, is the only viable alternative at this time to meet the Airport's difficult objective to maintain its cost competitiveness.

- ***Contracting out Airport law enforcement services.***

Staff is pursuing contract law enforcement services at the Airport to replace services provided by San Jose Police Department – Airport Division (SJPD-AD). When Airport staff first presented the Strategic Competitiveness Strategy to Council at the March 8, 2010, study session, SJC police costs were \$11.9 million. SJPD cost and staffing reduction measures at the Airport were implemented in July 2010 that resulted in savings of approximately \$900,000.

Staff estimates that the use of contract law enforcement could further reduce the Airport's annual costs by approximately \$7.5 million and provide comparable levels of service, safety, and security. With full implementation in FY 2011-12, the Airport's annual budget for law enforcement would fall to approximately \$3.5 million, a decrease of 76% and a total savings of \$8.4 million annually compared to FY 2009-10.

Most of the 41 police officers currently assigned to the Airport would be reassigned and absorbed by the San Jose Police Department, although a small number might be laid off depending on available vacancies in SJPD. Once the transition is completed, General Fund

annual revenues will be reduced by approximately \$2 million as a result of the elimination of the 42% police service personnel overhead that is charged to the Airport enterprise fund.

Transportation Security Regulation 1542 allows commercial airports to use private law enforcement personnel, or contract security services, to meet TSA-mandated security requirements. Hawaii Airports operated by the State of Hawaii, including Honolulu, Maui and Kona airports, have successfully used contract law enforcement to meet TSA requirements for the past twelve years.

There are several potential advantages to contract law enforcement for the Airport, including:

- It would result in significantly lower costs while providing staffing levels greater than proposed SJPD-AD staffing to support the Airport's security program.
- The Airport would be able to meet budget forecasts and ensure its cost-effective service delivery to maintain a competitive CPE and competitive operating costs for airlines at SJC.
- The Airport also would be able to establish and assign other duties for contract law enforcement staff relating to customer service enhancements and Airport operation's support that do not exist today.
- Contract law enforcement could result in greater consistency in operating protocols and procedures by eliminating the regular staff transitions that currently occur with SJPD staffing through semi-annual shift bidding, duty changes and changes in unit leadership.
- Contract law enforcement staff would be trained and certified to meet appropriate TSA and California standards.

A potential challenge from the use of contract law enforcement would be in the area of interagency communication and coordination. This is a vital concern in the event of a significant security-related incident at the Airport. In a large incident, the Airport would continue to require the support of SJPD, much as the current case with any large corporate campus in San Jose such as at eBay or Cisco. Although contract law enforcement would be responsible for the initial response at the Airport, any escalation in the scale or complexity of an incident likely would require additional support from San Jose Police Department. In conjunction with SJPD and other agencies, the Airport will establish effective communication and response protocols for security incidents of this nature or emergencies, and ensure that training, exercises, and coordination for back-up will be managed effectively.

- ***Contracting out Aircraft Rescue and Fire Fighting services.***

Contracting out Aircraft Rescue and Fire Fighting (ARFF) services for the Airport could replace services provided by San Jose Fire Department that in March were budgeted at approximately \$4 million per year. The Fire Department implemented cost reduction measures in July 2010 that

yielded Airport budget savings of approximately \$570,000 in the current fiscal year. ARFF services are a very specialized airport function in order to respond to incidents on the airfield. Because of FAA requirements, SJFD personnel at Station 20 at the Airport do not respond to off-airport incidents.

The use of contract ARFF services could further reduce the Airport's annual costs by approximately \$2.25 million while providing the levels of service, safety, and response required under FAA regulations. With full implementation in FY 2011-12, the Airport's annual budget for ARFF services would therefore fall to approximately \$1.25 million, a decrease of 69% and an annual savings estimated at \$2.75 million compared to FY 2002-10.

Most of the 12 fire fighters currently assigned to the Airport would be reassigned and absorbed by the San Jose Fire Department, although a small number might be laid off depending on available vacancies in SJFD. Once the transition is completed, General Fund annual revenues will be reduced by approximately \$671,000 as a result of the elimination of the 39% fire service personnel overhead charged to the Airport.

FAA regulations establish the training and competency requirements for personnel performing ARFF services at commercial service airports. These requirements are very specific to the aviation environment and are very different from the requirements that SJFD firefighters are required to meet in other San Jose fire stations. One of the primary advantages of contract ARFF services is that a contractor could focus on meeting the specialized needs of the aviation environment without being required to satisfy the other rigorous training requirements of SJFD that are unrelated to airport operations. Such focused training would allow significant budgetary savings over services delivered by SJFD personnel.

Bob Hope Airport in Burbank, California, has comparable size and regulatory requirements as SJC. Staff conducted a site visit to Burbank to meet with its operations staff, contract ARFF representatives, and public safety and airport management staff. Burbank officials described their use of contract services as a significant improvement due to the ability of the contract staff to specialize in ARFF services as required by the FAA.

There are several advantages to contract ARFF services for the Airport, including:

- It would result in significantly lower costs while providing staffing levels greater than proposed SJFD staffing to support the Airport's ARFF program.
- The Airport would be able to meet budget forecasts and ensure its cost-effective service delivery to maintain a competitive CPE and competitive operating costs for airlines at SJC.
- The Airport also would be able to establish and assign other duties for contract ARFF staff relating to customer service enhancements, Airport safety enhancements and Airport operation's support that do not exist today.

- Contract ARFF services could result in greater consistency in operating protocols and procedures by eliminating the regular staff transitions that currently occur with SJFD staffing through routine bidding and changes in unit leadership.
- Contract ARFF staff would be trained and certified to meet appropriate FAA and California standards.

Burbank officials did note that there were challenges during the original transition phase that required changes to mutual aid agreements, communication standards and inter-agency protocols. This is a vital concern if there is an incident requiring off-site assistance from SJFD or other fire agencies providing mutual aid. In conjunction with SJFD and other agencies, the Airport will establish effective communication and response protocols for major incidents or emergencies, and ensure that training, exercises, and coordination for back-up will be managed effectively.

Other Competitiveness Options Under Consideration

Council directed staff in May to explore other possible methods to enhance Airport competitiveness, either by finding new efficiencies or by reducing airline operating costs. These include:

- **Review Living Wage rates and policies for parity.** At the request of SJC carriers and as directed by Council, the Airport has evaluated the City's Living Wage Ordinance for the Airport that was adopted in fall 2008 and compared San Jose policies and practices with other Bay Area and California airports. The goal of this analysis has been to identify opportunities to align SJC into parity with them and reduce possible competitive disadvantages while still accomplishing the Council's policy goals for Living Wage requirements. This is the subject of a separate report to the City Council that will be considered at the Council meeting on December 7.
- **Establishment of an airline consortium for specific operating and maintenance functions.** An airline O&M consortium potentially could either reduce actual costs as a result of economies of scale, specialization, and efficiencies, or it could remove specific cost centers from the calculation of CPE that could then benefit the Airport's competitive position. Consortia have been successfully established at major airports across the country, but each is unique in its responsibilities and governance structure.

Airport staff has started discussions with SJC carriers to plan a thorough study to benchmark certain SJC operations and maintenance functions against other similar domestic airports as they relate to airline operational costs. The goal of this benchmarking study is to provide an objective framework for the Airport and its carriers to explore possible costs, benefits, and other issues associated with an airline consortium that could provide these services at San Jose. A critical concern for this benchmarking study will be defining the Airport's required

levels of service, quality standards, preventive maintenance requirements, and customer satisfaction standards so that any proposed consortium services can be properly evaluated before any decisions are made.

A benchmarking study would be targeted for completion in spring 2011 so that the results could be used by the Airport and the carriers to determine the feasibility of further work toward establishing a consortium at SJC. Before any action is taken to form a consortium, however, the Airport will have the opportunity to improve the efficiency of its own operations if the study identifies areas with that potential.

- **Reduction or restructuring of the VTA Flyer bus service.** 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 Santa Clara Caltrain station. This service currently costs the Airport approximately \$1.2 million annually and is an environmental mitigation measure associated with the approval of the Airport Master Plan in 1997.

The Airport has begun discussions with VTA to explore the possible restructuring of the Airport Flyer service to reduce costs for both agencies. A promising possibility that retains the access and convenience for both passenger and people working at the airport would separate the shuttle service into two operations: one could be operated by the Airport's current bus shuttle operator that would connect the terminals with the VTA light rail stop, and the other operated by VTA between the terminals and the Caltrain station. Under this model, the Airport's costs would be lower and the contract operator could use smaller vehicles that are more efficient.

This is still in the preliminary stages of discussion with VTA, and further analysis on costs, staffing and equipment, schedules, shuttle operator contract amendments, liability issues, and VTA negotiations still needs to be done. Airport staff expects that it will be able to make recommendations for Airport Flyer cost reduction alternatives in late spring 2011.

CONCLUSION

Since May, the Airport has made significant progress for reducing costs, and this effort has been recognized by its airline partners. During this same period the Airport also has completed and opened the major elements of its modernization program, continues work to wrap up the remaining improvement projects by spring, moved its offices into the airport, and has adjusted to extensive changes in staffing structures and levels. Much has been done, but much more remains to be done despite severe reduction of available resources.

The best solution for the Airport's current financial challenges is to obtain more flights, new carriers, and more passengers that would increase the Airport's revenue. Although the Airport has achieved outstanding results to reduce its costs to keep its CPE competitive, growth in enplanements would make a great difference. To this end, staff is also focusing on air service

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development in collaboration with the Mayor's Office and the Office of Economic Development. Since mid-year passenger activity has stopped the steady decline over the past three years, and it has slightly increased in September and October. Alaska Airlines and Southwest Airlines, SJC's largest carriers, have been adding routes and frequencies. Southwest Airlines will be adding six daily flights at SJC over the next six months, including new service to Austin that started in November, and Alaska/Horizon starts service to Mexico (Guadalajara and Cabo San Lucas) in December, and to Kauai in March 2011 along with its other successful launches to Austin, Maui, and Kona earlier this year. Staff continues its active efforts to recruit carriers and restore flights.

While the economy recovers slowly, Mineta San Jose International Airport's short-term financial outlook remains a challenge, and its continued focus to reduce costs and find efficiencies is of vital importance. Staff is confident, however, that SJC is well positioned for long-term growth and success. The new airport that fully opened in June this year offers outstanding passenger amenities and comfort; it is centrally located for the very strong Silicon Valley business travel market; airlines can operate very efficiently and benefit from excellent weather and on-time performance record, there is ample airfield and terminal capacity for growth, and it has clearly demonstrated the City's firm commitment to ensure competitive costs for airlines.

/s/

William F. Sherry, A.A.E.

Director of Aviation

For questions, please contact William F. Sherry, A.A.E., Director of Aviation, at (408) 392-3611.

Attachment A: Strategic Principles for Airport Competitiveness (adopted May 25, 2010)

ATTACHMENT A

STRATEGIC PRINCIPLES FOR AIRPORT COMPETITIVENESS

Approved by San Jose City Council on May 25, 2010

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.