

## County of Santa Clara Airports Commission



County Government Center – 70 West Hedding Street  
San Jose, California 95110. Phone (408) 299–5001. Fax (408) 298–8460

**DATE:** November 7, 2006  
**TIME:** 6:00 PM  
**PLACE:** Room 157

### AGENDA

In compliance with the Americans with Disabilities Act, those requiring accommodations in this meeting should notify the Clerk of the Board's Office 24 hours prior to the meeting at (408) 299–5001, or TDD (408) 993–8272.

### Special Meeting

1. Call to Order/Roll Call.
2. Public Presentations: This portion of the meeting is reserved for persons desiring to address the Commission on any matter not on the agenda. Speakers are limited to two minutes. The law does not permit Commission action or extended discussion of any item not on the agenda except under special circumstances. All statements that require a response may be placed on the agenda for the next regular meeting of the Commission.
3. Consider further from the October 3, 2006 meeting (Item No. 6) the draft Palo Alto Airport Business Plan and staff recommendations.

#### Possible Action:

Forward recommendations to the Board of Supervisors through the Housing, Land Use, Environment and Transportation Committee.

4. Adjourn to a workshop session.

### Workshop Session

5. Consider Director's verbal reports (Honaker)

- A. Airport Projects
    - a. South County (E16)
    - b. Reid–Hillview
    - c. Palo Alto
  - B. Security Update
  - C. Update on Master Plans
    - a. Reid–Hillview
    - b. Palo Alto
    - c. E16
  - D. Noise Program Update
  - E. Reid–Hillview Joint Community Relations Committee (JCRC)
  - F. San Martin Planning Advisory Committee
6. Correspondence/ Announcements.
7. Adjourn to the next regular meeting on December 5, 2006 at 6:00 p.m. in Room 157, County Government Center, 70 West Hedding Street, San Jose.

**County of Santa Clara**  
**Roads & Airports Department**  
Airports Division



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AC RA03 100306

Prepared by: Michael Murdter  
Director, Roads & Airports  
Department

DATE: October 3, 2006

TO: Airports Commission

FROM: *M. J. Murdter*  
Michael Murdter  
Director, Roads & Airports Department

SUBJECT: Palo Alto Airport Business Plan

**RECOMMENDED ACTION**

Accept report relating to the draft Palo Alto Airport Business Plan and forward to the Housing, Land Use, Environment and Transportation (HLUET) Committee with a favorable recommendation.

**FISCAL IMPLICATIONS**

There are no fiscal implications to the General Fund. Fiscal implications to the Airport Enterprise Fund are outlined in the draft PAO Business Plan.

## **REASONS FOR RECOMMENDATION**

The draft PAO Business Plan presents an overview and analysis of the lease between the County and the City of Palo Alto, the airport's finances including future capital investment needs and recommended actions in anticipation of the City/County lease expiration in 2017.

The fundamental business issue facing the airport is a structural financial problem: operating costs are rising faster than revenue and additional capital investment in the airport infrastructure will be necessary, yet future opportunities to generate new sources of revenue will be extremely limited. If the airport is to avoid generating progressively larger annual operating deficits, existing revenue streams must be increased to keep pace with operating expenditures and capital investment.

Aside from modest projected increases in Fixed Base Operator (FBO) lease revenue, the only opportunity to increase existing revenue sources is to raise tiedown rates and/or fuel flowage fees. Given the opposition to large one-time increases in tiedown rates, staff has projected the annual increases necessary over the remaining term of the lease that would be necessary to generate sufficient operating revenue to recover operating expenditures, capital expenditures and the existing balance of the Outstanding Advance (the difference between the County's total capital investment in the airport and the net revenue generated over the life of the lease).

Assuming current rates of expenditure growth and modest net capital project spending averaging \$50,000 annually, a one-time increase in the fuel flowage fee from 10 cents per gallon to 20 cents per gallon combined with 8% to 8.5% annual increases in tiedown rates through 2017 should generate sufficient operating revenue to recover operating expenditures, capital expenditures and the existing balance of the Outstanding Advance. Implementing annual increases of this magnitude, which more closely reflect the actual rate of expenditure growth instead of the broader Consumer Price Index (CPI), will be the key to maintaining the airport's financial viability.

Increasing the fuel flowage fee takes some pressure off tiedown rates. Since all airport users who buy fuel at the airport would pay the higher fuel flowage fee (including transient aircraft), this fee increase would be spread over a broader cross-section of airport users compared to increases in County tiedown rates. The Department was initially reluctant to propose an increase in the fuel flowage fee due to the current high cost of fuel but the apparent broader

appeal of this increase compared to an increase in just tiedown fees warrants reconsideration of the initial proposal.

A ten-cent increase in the fuel flowage fee from \$0.10 per gallon to \$0.20 per gallon would generate an additional \$60,000 in annual revenue assuming total annual fuel sales of 600,000 gallons. For a typical flight training aircraft that burns 10 to 15 gallons of fuel per hour, the fee increase equates to a \$1.00 – \$1.50 increase in the aircraft's hourly operating cost. Typical hourly rental rates for this type of aircraft (including fuel) are in the neighborhood of \$100 – \$150.

The annual tiedown rate increases will be adjusted upward or downward based on the airport's actual financial performance and corresponding adjustments to projected growth rates in operating and capital expenditures.

The ability to implement future fee increases ultimately depends on market forces of supply and demand. If the market cannot sustain these rate increases in the future and new revenue sources are not identified, the goal of financial self-sufficiency may become infeasible and additional subsidies beyond federal and state grants may be required from the airport sponsor.

## **BACKGROUND**

The Palo Alto Airport (PAO) Master Plan is part of an update to the 1982 Master Plan for the three general aviation airports in the County of Santa Clara. However, unlike the other two airports – Reid Hillview Airport and South County Airport – which are owned and operated by the County, PAO is owned by the City of Palo Alto but operated by the County pursuant to a 50-year lease executed in 1967 and expiring in 2017.

As the property owner, the City has sole discretion over the future of the airport after expiration of the lease. The Master Plan is an objective, stand-alone document that recognizes the City's sovereignty with respect to the airport regardless of whether the County is involved in its operation after 2017.

A companion document to the Palo Alto Airport Master Plan is the Business Plan, which addresses the County's involvement in the operation of the airport. The Business Plan is a

separate document because, unlike the Master Plan, it will be acted upon by the County Board of Supervisors.

**ATTACHMENTS**

- DRAFT – PAO Business Plan

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# PAO Business Plan

## INTRODUCTION

The Palo Alto Airport (PAO) Master Plan is part of an update to the 1982 Master Plan for the three general aviation airports in the County of Santa Clara. However, unlike the other two airports – Reid Hillview Airport and South County Airport – which are owned and operated by the County, PAO is owned by the City of Palo Alto but operated by the County pursuant to a 50-year lease executed in 1967 and expiring in 2017.

As the property owner, the City has sole discretion over the future of the airport after expiration of the lease. The Master Plan is an objective, stand-alone document that recognizes the City's sovereignty with respect to the airport regardless of whether the County is involved in its operation after 2017.

A companion document to the Palo Alto Airport Master Plan is this Business Plan, which addresses the County's involvement in the operation of the airport. The Business Plan is a separate document because, unlike the Master Plan, it will be acted upon by the County Board of Supervisors.

This document:

- Presents an overview and analysis of the airport lease between the County and the City;
- Presents an overview of the Airport Enterprise Fund (AEF);
- Presents an overview and analysis of the airport's finances;
- Identifies the airport's future capital investment needs;
- Recommends County actions in anticipation of the City/County lease expiration in 2017.

## **CITY/COUNTY LEASE OVERVIEW**

### **TERM & RENT**

The lease specifies a term of 50 years and expires on June 11, 2017 according to City documents. The rent is \$25 for the entire term of the lease.

### **USE AND DEVELOPMENT OF AIRPORT REAL PROPERTY**

The County's use of the leased premises is limited to constructing, operating and maintaining an airport and airport facilities; non-aviation industrial or manufacturing uses are prohibited. All improvements must conform to the City's building codes and are subject to City plan approval. A development plan was included as an exhibit to the original lease (Exhibit C); execution of the development plan was contingent upon availability of funds and whether "the aviation needs and economic justification warrant such development." Exhibit C, which was subsequently modified twice and incorporated into the lease by lease amendment number one in October 1968 and amendment number two in December 1969, designates the use of various areas of the leasehold for runways and taxiways, hangar/tiedown areas and Fixed Base Operator (FBO) leasehold areas, among other uses.

The City is required to support the County in all applications to financial assistance agencies concerning the development and operation of the airport.

The County is required to operate the airport in accordance with Federal Aviation Administration (FAA) regulations and has full power, authority and responsibility in regard to the operation, management and maintenance of the airport "as though it were the sole owner thereof."

The City is prohibited from entering into agreements, executing any leases or licenses, or granting any rights to the airport premises without the express written consent of the County. The City is required to prevent off-airport development from interfering with the airport safety zones.

In addition to the two lease amendments discussed above that incorporated the revised development plans into the lease, lease amendment number three in May 1980 established a requirement for the County to obtain City concurrence to apply to the FAA for approval of a second runway or expansion of permanent aircraft tie-downs above 510 spaces. The fourth and final amendment to the lease in 1983 clarified the County's responsibility with respect to utility charges related to the stormwater pumping plant.

### **USE OF REVENUE**

Net operating revenue generated at the airport, if any, is first applied against the running balance of the County's unrecovered investment in the airport, which is termed the "Outstanding Advance." All remaining revenue, if any, is to be used for maintenance, operation or capital improvement of the airport premises. In other words, once sufficient net revenue has been generated to recoup the County's investment in the airport, any additional net revenue must be reinvested in the airport and cannot be used to fund operations or improvements at the other airports. The lease is silent with respect to whether the Outstanding Advance accrues interest.

### **ASSIGNMENT AND SUBLETTING**

The lease may not be assigned without the City's written consent but the County may sublet the premises without the City's consent.

### **TERMINATION**

The lease may be terminated by either party in the event of breach by the other party. The party in default has 30 days to remedy the breach from the date of notice by the other party. There is no provision for unilateral termination of the lease in the absence of a breach by the other party.

## SUMMARY

The lease clearly places all business risk related to operation of the airport on the County. The City has no financial obligation or risk with respect to the airport's operation. Moreover, if the County were to generate positive net operating revenue at the airport after recouping its initial investment, it must be reinvested in the airport and could not be exported to the other County airports.

## AIRPORT ENTERPRISE FUND OVERVIEW

The Board adopted the following policy regarding the AEF:

*"The Airport Enterprise Fund should be self-sustaining without subsidy from the General Fund. Revenue from fees and charges, state and federal grants and other sources should be sufficient to fund operating and maintenance costs, capital improvements and an appropriate level of reserves."*

Pursuant to Board policy, the AEF must pay for all costs – direct and indirect – associated with operating the airports, including costs for services received from other County departments. Some of these services are billed directly – for example, legal services are billed directly to the department based on County Counsel's established hourly rate. Other services such as Clerk of the Board costs for processing Board transmittals and providing staff support to the Airports Commission are distributed through the County Cost Plan. The AEF therefore provides full cost visibility for the myriad costs – some obvious and some not-so-obvious – incurred across the County to support the airports.

Although the AEF captures all airport finances in a single budget unit, the revenue and expenses associated with each of the three airports are tabulated for financial reporting and internal management accounting purposes. Revenue and expenses directly attributable to each airport such as FBO lease revenue, aircraft storage space rental revenue, operations staff salaries, etc. are easily identified. General and administrative expenses not attributable directly to an individual airport (insurance, management staff salaries, Cost Plan charges, etc.) are captured in an expense pool and prorated to each airport based on a weighted formula that uses cost drivers such as the number of based aircraft, number of aircraft operations and number of major facilities at each airport.

Total annual projected AEF revenue is approximately \$3.2 million<sup>1</sup>; 76% of which is generated from County-owned aircraft storage spaces (i.e. hangars, shelters and tiedowns). Rental rates for County-owned aircraft storage spaces (hangars, tiedowns and shelters), fuel flowage fees and other airport-related fees are established through a Schedule of Fees and Charges approved by the Board of Supervisors by resolution.

The next largest revenue component (11%) is lease revenue from the 12 FBOs<sup>2</sup>. Most of the FBO leases specify an annual ground rent equal to 8.5% of the fee simple value of the leasehold premises (not including improvements), and provide for adjustments every five years pursuant to a reappraisal of the premises. Given the long-term nature of the FBO leases, the revenue from this source is essentially fixed aside from the occasional minor adjustment to the lease rate (the reappraisal completed in December 2004 resulted in no rate increase). All other revenue categories including property rental, fuel flowage fees, transient aircraft fees and interest income collectively generate only 13% of AEF revenues.

Reid Hillview Airport (RHV) generates approximately 56% of the total AEF revenue primarily due to the income from the 145 County-owned hangars. Prior to the recently-completed South County Airport (E16) hangar project, RHV was the only one of the three airports to have County-owned hangars. Historically, RHV revenue has exceeded expenditures and the surplus has been used to subsidize operations at PAO and E16. However, revenue from the E16 hangars should enable that airport to be financially self-sustaining.

## **PAO REVENUE AND EXPENDITURES**

### **PAO FINANCIAL PERFORMANCE 1967 - 2005**

In November 1997, the City contracted with Deloitte & Touche (D&T), an independent auditing firm, to audit the County's financial data related to the airport and prepare a set of financial statements in response to concerns expressed by the Palo Alto Airport Association (PAAA) and the airport's Joint Community Relations

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<sup>1</sup> Including revenue from the 100 hangars recently completed at South County Airport.

<sup>2</sup> There are nine FBOs at RHV, two at PAO and one at E16.

Committee (JCRC) regarding the County's accounting for costs and revenues associated with PAO.<sup>3</sup>

The D&T audit, which was funded jointly by the City and the County at a total cost of \$39,000, produced a set of baseline financial statements and alleviated the concerns raised by the PAAA and JCRC. Subsequently, County staff and City staff agreed on a format for the annual financial statements to be provided by the County to the City. The attached draft financial statements for FY 2005 are typical of the data provided each year to the City.

Perhaps the best measure of the airport's long-term financial performance is the "Outstanding Advance", which is the difference between the County's total capital investment in the airport and the net revenue generated over the life of the lease. Additional County capital investment and/or net operating losses increase the Outstanding Advance; net operating profits decrease the Outstanding Advance. Since only the local (i.e. County-funded) component of capital projects adds to the Outstanding Advance, the Outstanding Advance serves as a benchmark of the County's financial exposure resulting from its involvement with the airport.

In the 38 years from inception of the lease through the end of Fiscal Year (FY) 2005, the County's investment in the airport has exceeded net revenue by over \$681,000. Moreover, this capital investment-to-profit imbalance has not been limited to the early years of the lease when the County made large initial capital outlays to develop the airport property. From FY 1997 to FY 2005, the Outstanding Advance soared over 75% (from \$387,815 to \$681,349) as a result of the County's capital investments of \$335,734 (not including federal and state grants) and operating profit of only \$42,200 over this time period. Since FY 2006 is also projected to produce a net loss (due in large part to a one-time expenditure for a levee maintenance project), an increase in the Outstanding Advance equal to the FY 2006 net loss is expected to appear on the final FY 2006 financial statements.

As mentioned earlier, the lease is silent as to whether the Outstanding Advance should accrue interest for accounting purposes given the lease requirement that any net revenue generated at the airport must stay at the airport once the County recoups its capital investment. As part of the D&T audit review, the County and City agreed that the Outstanding Advance (and any surplus, should one occur) would not accrue interest due to the lack of any language in the lease specifically addressing this issue. Therefore, the value of the Outstanding Advance does not reflect current dollars.

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<sup>3</sup> City Manager's Report CMR:371:97 to the Palo Alto City Council dated September 8, 1997.

The fact that the Outstanding Advance does not accrue interest makes it all the more significant that the County's investments in the airport have not been recovered. At RHV and E16, capital investments financed by loans from the County General Fund or by revenue bonds accrue interest that must be paid for as part of the operating budget. If a similar scenario applied at PAO, the Outstanding Advance would be much higher.

## PAO BUDGET OUTLOOK

The airport's projected FY 2006 revenue is \$725,400 (approximately 23% of total AEF revenue). Each revenue component and its dollar amount and percentage of total PAO revenue is as follows:

- **Tiedowns** - \$489,000 (67.4%). The County operates 360 of the 468 tiedown spaces at PAO<sup>4</sup>. Although demand for aircraft storage is projected to remain strong in the foreseeable future, the AEF's reliance on this revenue source makes it vulnerable to downturns in the general aviation market.
- **FBO lease revenue** - \$133,600 (18.4%). The ground rent paid by the two FBOs at the airport, Roy-Aero Enterprises LLC and Airport Management Group, Inc. (AMG), is adjusted periodically pursuant to a reappraisal of the underlying land value<sup>5</sup> as specified in the master leases. In 1994 Roy-Aero disputed the County's reappraisal and the matter was brought to binding arbitration. The arbitrator ruled that the fair market value of the Roy-Aero leasehold should be discounted from the appraisal for the AMG and RHV FBOs due primarily to its flooding potential and soil conditions.

At current annual rates of \$0.19/square foot (SF) (approximately \$8300/acre), the Roy-Aero lease generates ground rent of \$80,000 annually. The Roy-Aero lease also entitles the County to 6% of the revenue from 29 of the FBO's hangars, which totals an additional \$27,600 per year. The current annual ground rent for the smaller AMG leasehold is \$0.2025/SF (approximately \$8800/acre), which generates \$26,000. The ground rent remains fixed until the next reappraisal (December 2009 and December 2014 for Roy-Aero and December 2008 and December 2013 for AMG).

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<sup>4</sup> All hangars at PAO are owned and operated by the FBOs.

<sup>5</sup> The FBO ground lease appraisals are based on the specific use for which the property is being leased: airport-related activities as described in the leases' "Use of Premises" clause.

- **Fuel flowage fees** - \$60,000 (8.3%). The County collects a \$0.10 per gallon fuel flowage fee for all fuel dispensed at the County airports.
- **Transient Aircraft Revenue** - \$24,600 (3.4%). Transient aircraft (i.e. aircraft not based at PAO) are required to pay a fee when occupying a County tiedown. Certain tiedowns are designated for transient use.
- **Miscellaneous** - \$18,200 (2.5%). This category captures all revenue not attributable to one of the above categories, such as auto parking charges, etc.

Revenue generated at the airport from sales taxes and personal property taxes does not accrue to the AEF. City documents estimate these amounts as \$150,000 and \$200,000, respectively.

The AEF is experiencing a structural problem with respect to the airport's finances in that costs are rising faster than revenue. Labor costs have risen an average of 6.2% annually over the last five years and overhead has risen 8.3%. Since labor and overhead costs comprise about 80% of PAO operating costs, total operating expenditures are projected to outstrip total operating revenue by increasing margins as time goes on.

In an effort to cut costs, one vacant PAO Airport Operations Worker position was deleted to save a total of \$92,027.<sup>6</sup> Deleting the position reduces staff coverage at the airport from an average of 15.7 hours per day to 10.7 hours per day, seven days per week. Despite this cost reduction, the airport is projected to generate operating losses totaling nearly \$1.7 million over the remaining life of the lease if tiedown rates increase only 3% annually (the average Consumer Price Index (CPI) increase over the three-year period from 2004 to 2006) and no new revenue sources are identified.

## FUTURE CAPITAL INVESTMENT NEEDS

In addition to operating expenditures discussed above, additional capital investment in the airport will be required throughout the remainder of the lease term and beyond. Current projects include repairs to a portion of Embarcadero Way, installation of an Automated Weather Observation System (AWOS), and physical security improvements. Although each of these projects has a certain amount of AEF funding and federal funding already budgeted, the impact of these projects on the PAO financial statements will not

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<sup>6</sup> The total savings of \$92,027 is comprised of \$73,992 in salary and benefits plus \$18,035 in allocated overhead.

be fully recorded until the projects are completed. In other words, projects currently in the development pipeline will eventually increase the Outstanding Advance.

In addition to projects currently under development, other projects will likely be required prior to lease expiration in 2017 to maintain and repair the airfield pavements and other airport infrastructure as well as enhance safety and security.

As discussed in the Master Plan, the airport has an elevation of only 4 feet above mean sea level (MSL) and is located in a FEMA-designated Special Flood Hazard Area. Therefore, as the existing airport building infrastructure reaches the end of its useful life and needs replacement, any new or substantially rebuilt airport structure such as a new Terminal Building must have its first floor raised above the 8-foot Base Flood Elevation (BFE) or be dry-floodproofed, which will add substantially to construction costs. The BFE for the airport is anticipated to rise upon conclusion of a FEMA study of the San Francisco Bay levee system. The higher the BFE, the higher the additional construction costs.

In addition, a large-scale project to improve flood protection to the City by raising the elevation of the existing levees surrounding the airport is inevitable and it is likely that the airport, as a beneficiary of the improvements, will be expected to pay a share of the project's construction and maintenance costs.

The County, the City and the Santa Clara Valley Water District (SCVWD) are currently parties to a maintenance agreement related to the existing levee system surrounding the airport. Under this agreement, the County is responsible for maintenance of the levee parallel to the runway. Since the levee system provides flood protection benefits to the City of Palo Alto extending far beyond the airport property, it does not appear appropriate for the Airport Enterprise Fund to subsidize maintenance of the City's flood protection infrastructure. Therefore, the County should exercise its right pursuant to the termination clause in the agreement to end its participation.

A related issue is pedestrian use of the levees on the County's leasehold, which was never approved by the County. According to the lease, the "City shall make no further agreements nor execute any leases, licenses or grant any rights in and to the premises without the express written consent of County." Pedestrian use of the levees on the County leasehold presents potential liability issues for the County. Therefore, the County should pursue a change to the leasehold boundaries to exclude the levees in conjunction with termination of its involvement in the levee maintenance agreement.

In addition to the projects discussed above, the Master Plan identified the following specific projects:

- New Taxiway D
- Reconfiguration of Taxiway G
- Heliport
- Aircraft washrack
- General Aviation Terminal Building replacement and parking lot
- Replacement tiedowns
- New hangars

A number of the above projects are eligible for funding assistance under the FAA Airport Improvement Program (AIP). Currently, eligible AIP projects selected for funding receive 95% federal funding and qualify for an additional 2.5% state match from Caltrans Aeronautics, subject to availability of funds. Therefore, the local match required for AIP projects can be as low as 2.5%. However, the actual percentage of total project costs paid by the AEF is usually much higher. In addition to the local match, the airport sponsor is responsible for 100% of the costs related to any element of the project ineligible for AIP funding as well as the difference between actual costs and estimated costs, which together can total a significant share of the overall project costs. For example, the total AEF funding component approached 20% of the \$2.8 million capital project completed at PAO in 2001.

It is important to note that only the AEF-funded component of capital projects affects the Outstanding Advance. Depreciation related to the grant-funded portion of capital projects is not included in the calculation of the OA because the OA is a benchmark of the County's financial exposure resulting from its involvement in the airport; the pass-through of outside grant funding does not impact the County's financial stake in the airport.

Under current federal legislation, Palo Alto Airport, by virtue of its designation as a "reliever" airport, is eligible for AIP entitlement funds in the amount of \$150,000 annually. Funded projects are counted against this entitlement amount, which in effect serves as a funding floor. Unfortunately, the Bush Administration is proposing a \$1 billion cut (from \$3.7 billion to \$2.75 billion) to the AIP as part of the FY 2007 Department of Transportation budget, which if enacted would eliminate all entitlement funding to general aviation airports. Even with full entitlement funding, some projects will not be eligible for grant funding and must therefore be funded

locally. Therefore, a reasonable minimum projection for average annual capital expenditures (net of federal and state reimbursement) over the remaining term of the lease is \$50,000.

Airport Improvement Program grants are accompanied by a lengthy list of conditions ("grant assurances") that remain in force for 20 years. Some of the grant assurances relate to project implementation (consultant selection, construction contracts, wage rates, inspection, record keeping, environmental compliance, etc.) while others are broader in scope, such as the requirement to keep the airport open for 20 years and the prohibition on diverting airport revenue to non-airport purposes.

Since the grant assurances accompanying any new grants will remain in force well beyond the expiration of the lease in 2017, the City must determine whether to apply for and accept the grants and thereby assume responsibility for the grant assurances after expiration of the lease. Therefore, all future AIP grant applications prepared and recommended by the County must be forwarded to the City for signature and submission to the FAA.

The County would retain full responsibility for compliance with the FAA grant assurances until expiration of the lease. The grant assurances relating to project implementation will have been met by the County prior to expiration of the lease. Other assurances, such as the requirement to keep the airport open and the prohibition on exporting airport revenue, will remain operative for the entire 20-year life of the grant assurances. Since the City is already required by the lease to support the County in all applications to financial assistance agencies concerning the development and operation of the airport, this recommendation represents mainly a change in administrative procedure versus a change in policy.

## **OPTIONS TO INCREASE REVENUE**

### **INCREASE EXISTING RATES WHERE FEASIBLE**

Aside from modest projected increases in FBO lease revenue pursuant to reappraisals in 2008/2009 and 2013/2014 as discussed above, the only opportunity to increase existing revenue sources to avoid large operating deficits in the out-years (and corresponding increases in the Outstanding Advance) is to raise tiedown rates and/or fuel flowage fees.

Assuming current rates of expenditure growth and modest net capital project spending averaging \$50,000 annually, a one-time increase in the fuel flowage fee from 10 cents per gallon to 20 cents

per gallon combined with 8% to 8.5% annual increases in tiedown rates through 2017 should generate sufficient operating revenue to recover operating expenditures, capital expenditures and the existing balance of the Outstanding Advance. Implementing annual tiedown increases of this magnitude, which more closely reflect the actual rate of expenditure growth than the broader CPI, will be the key to maintaining the airport's financial viability.

For a typical flight training aircraft that burns 10 - 15 gallons of fuel per hour, the fuel flowage fee increase equates to a \$1.00 - \$1.50 increase in the aircraft's hourly operating cost.

It must be recognized that the ability to implement future fee increases ultimately depends on market forces of supply and demand. If the market cannot sustain these rate increases in the future and new revenue sources are not identified, the goal of financial self-sufficiency may become infeasible and additional subsidies beyond federal and state grants may be required from the airport sponsor.

#### **DEVELOP NEW REVENUE SOURCES**

The County recently entered into a lease with Enterprise Rent-A-Car for counter space in the terminal building and parking spaces in the terminal building parking lot, which will generate revenue of approximately \$25,700 annually starting in FY 2008. This revenue has been included in the budget projections discussed earlier.

Leasing the area near the terminal building as a material laydown area for contractors working on City projects used to be allowed by the City and generated additional revenue for the airport. However, the City no longer allows this use of the property.

Future opportunities to generate significant additional revenue will be extremely limited. The airport is severely constrained from physical, environmental and policy standpoints; existing City policies seek to prohibit physical expansion of the airport into open space areas, significantly increasing the intensity of operations or adding a third FBO. In light of these constraints, only minor changes to the airport's airfield area were identified in the Master Plan. No change to the airport's role with respect to the type of aircraft to be accommodated is contemplated due to runway limitations. If a runway extension were feasible, it would have the potential to increase revenue by catering to corporate aircraft.

Due to the nonstandard clearances between taxilanes and parked aircraft, any conversion of existing tiedown rows to T-hangars would result in a significant reduction of available aircraft basing capacity. Moreover, the economics of building hangars over tie-

downs are inherently poor because the tie-downs that would be eliminated currently generate about one-quarter the revenue of hangars with no additional capital investment required.

With respect to the airport's building area, the only possible area for additional revenue-generating development is on a portion of the vacant eight-acre parcel fronting Embarcadero Road. The Embarcadero parcel is designated by Exhibit C for hangars and an FBO; the draft Master Plan identifies the construction of 29 permanent new hangars on the parcel as a development option. However, skyrocketing construction costs, rising interest rates and the high cost of the likely mitigations required diminish the economic attractiveness of the project. Moreover, extremely stiff opposition to the project is virtually guaranteed and the approval process is anticipated to be lengthy, arduous and expensive.

However, shorter-term revenue-generating uses of the Embarcadero parcel conforming to Exhibit C are possible and could alleviate much of the pressure on tiedown rates. Although City policies seek to prohibit development of the Embarcadero parcel, staff's analysis concludes that these policies do not supersede or override the lease. Therefore, the lease governs the nature and extent of the development allowable on the airport.

## **FUTURE COUNTY INVOLVEMENT IN PALO ALTO AIRPORT**

The existing lease arrangement is awkward and untenable for the County. The County shoulders all of the business risk related to operating the airport but unlike Reid-Hillview Airport and South County Airport does not have the final say over airport development. Since the lease does not place any business risk on the City, there is no incentive for the City to cooperate with the County to increase revenues. The airport faces a structural financial problem in that operating costs are rising faster than revenue and additional capital investment in the airport infrastructure will be required, yet future opportunities to generate additional revenue will be extremely limited. In order for the airport to fulfill the Board's mandate of financial self-sufficiency, annual fee increases reflecting the actual rate of expenditure growth will be required.

Moreover, staff cannot identify a compelling reason for the County to continue shouldering the business risk of operating the airport beyond the expiration of its lease with the City in 2017 regardless of the changes to the lease that the City may be willing to make. Staff recommends terminating its involvement in the airport at the expiration of the City/County lease in 2017 to eliminate the possibility that RHV will need to subsidize PAO in the future and to al-

low staff to concentrate on executing the Master Plans for Reid-Hillview Airport and South County Airport.

As noted earlier, the airport has historically operated at a deficit when examined on a full-cost basis including capital investment expenditures. The fact that the County's investment in the airport has exceeded net revenue by \$681,000 over 37 years (not including interest) despite the fact that the great majority of capital project costs have been funded by outside sources highlights the airport's reliance on subsidies to fund maintenance and improvements. Moreover, this capital investment-to-profit imbalance has not been limited to the early years of the lease when the County made large initial capital outlays to develop the airport property. For example, the Outstanding Advance ballooned over 75% from FY 1997 to FY 2005.

The basic business risk that costs could continue to exceed revenue over the long term could manifest itself in myriad ways. The airport could experience reduced demand from aircraft owners due to a downturn in general aviation caused by high fuel prices or some other factor. Although the Master Plan assumes that Moffett Federal Airfield will not become available for civilian general aviation use, the possibility exists that it could become available for such use, which would have a severe negative impact on the demand for PAO. Other possibilities include reduced federal grant revenue, unanticipated expenses or even a natural disaster such as a flood or earthquake.

#### **IMPACTS OF REMOVING PAO FROM THE AEF**

The loss of PAO as a County facility would not present any operational impacts because each County airport's aeronautical activities are independent. Financially, eliminating PAO from the AEF would result in the loss of the airport's revenue, which would be more than offset by the reduction in direct operating costs, capital investment and overhead. The business risk currently shouldered by the County would be eliminated, thereby removing the possibility that RHV may need to subsidize PAO in the future, and allowing County airports staff to focus on executing the master plans for RHV and E16.

Regardless of whether the City operates the airport itself with City employees, hires a contractor to operate the airport on a day-to-day basis or leases the airport to a new lessee after 2017, the airport's structural financial problem and business risk must be addressed. Reallocating some of the business risk from the lessee to the City would help attract potential lessees but would not address the underlying problem. For example, if the City were to assume some risk by limiting the lessee's responsibility for certain costs such as

capital investments, it may be possible to attract a lessee willing to pay rent but the overall risk would not change – it would merely be reallocated along with some of the compensation associated with said risk.

Operating costs could be lowered by hiring a contractor having lower labor and overhead costs than the County or the City to operate the airport on a day-to-day basis.

The City or a new lessee could take over the FBO facilities upon expiration of the FBO leases in order to generate revenue, particularly from the hangars. Both FBO leases expire simultaneously with the expiration of the City/County lease, and ownership of improvements constructed by the FBOs reverts to the airport sponsor upon expiration of the FBO leases. However, the revenue will be offset to a significant extent by the reinvestment required in the FBO facilities for maintenance, major repairs, code upgrades and replacement.

## RECOMMENDED ACTIONS

The County should:

1. Continue to fulfill its lease obligations until expiration of the lease in 2017 provided the City does the same, including allowing the County to develop the airport as agreed upon in the lease.
2. Terminate its involvement in the airport upon expiration of the lease with the City, or earlier if desired by the City.
3. Limit future County capital investment in the airport to the following 1) revenue-generating projects that will produce an acceptable rate-of-return prior to expiration of the lease; and 2) the local match necessary for essential, non-deferrable, AIP-eligible maintenance projects or security-related projects mandated by the FAA or Transportation Security Administration (TSA). Non-revenue projects ineligible for AIP funding should not be undertaken.
4. Forward all future AIP grant applications to the City for signature and submission to the FAA. Since the 20-year grant assurances will remain in force well beyond the expiration of the lease in 2017, the City must determine whether to apply for and accept the grants and thereby assume responsibility for the grant assurances after expiration of the lease.
5. Raise tie-down rates and the fuel flowage fee to 1) help ensure the airport is financially self-sustaining (on a full-cost

basis) from now through expiration of the lease (i.e. prevent the Outstanding Advance from growing); and 2) recover as much of the Outstanding Advance as possible prior to the lease expiration in 2017.

6. Pursue revenue-generating uses of the Embarcadero Road parcel in accordance with the development plan currently in force under the lease.
7. Terminate involvement in the levee maintenance agreement with the City and the SCVWD and pursue a lease amendment to remove from the leasehold the levee parallel to the runway.