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LAA Lease Review Consultation Report

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APPENDIX A

Summary of Work Components

1.0 EXECUTIVE SUMMARY

Introduction

In 1987, the federal government released A Future Framework for Airports in Canada, announcing a new policy for the management of its airports. The new policy emphasized the commercial orientation of airports, and announced the government's interest in transferring them to local parties.

In summer 1992, the first four Local Airport Authorities (LAAs) were established in Vancouver, Calgary, Edmonton and Montréal. In establishing the LAAs, the government directed that these airport transfers be reviewed after 5 years.

Over time, the government policy on the commercialization of airport operations has progressed. Following the introduction of the 1994 National Airports Policy (NAP), the Canadian Airport Authorities (CAAs) were established, based on different principles than the LAAs.

Transport Canada has been conducting a comprehensive LAA Lease Review, in consultation with LAA management and other key stakeholders. The LAA Lease Review Consultation Report discusses the key policy issues that have emerged from this review, and provides a starting point for a final round of key stakeholder consultations which is expected to begin in May 1999.

LAA Lease Review Findings

The first stage of the LAA Lease Review involved twelve work components: Environmental Stewardship; Asset Maintenance; Capacity Development; Crown Rents and LAA Financial Viability; Pricing Practices; Governance; Safety; Security; Service Levels; Economic Impact; Key Stakeholder Consultations; and a Public Survey. Two of these studies (Safety and Security) were prepared by Transport Canada technical experts, and the other ten were prepared by independent consultants. Summaries of these reports are provided in Appendix A.

Overall, it is recognized that the transfer of airports to LAA management has been a success – all stakeholders agree that program delivery has been enhanced through this initiative. Some improvements, however, are required. Some key findings of the work components include:

- Stakeholders recognize that the transfers were a good decision.
- LAAs are financially viable.
- LAAs have strong market power.
- Service levels have improved significantly under the LAAs.
- LAAs are generally providing capacity to a higher standard, faster and in a more timely fashion than Transport Canada would have had it continued to operate the airports.

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- Airport authorities respond quickly to operational issues.
- Safety standards have remained in compliance with the applicable regulations and standards.
- Compliance with the applicable security standards is satisfactory, and in some cases exemplary.
- LAAs have had a positive economic impact.
- Asset maintenance and environment issues require more monitoring by Transport Canada.

Key Policy Issues

The results of the work components have raised a number of key policy issues for discussion during the final consultation process. These issues are introduced below. Options for addressing these issues are discussed in Section 5 of this consultation paper.

Explicit and Comprehensive Airports Framework

The transfer of airports to the LAAs was carried out in a policy and legislative framework that was primarily focused on *transfer* objectives. While there were high level statements of continuing federal government responsibility for the safety and efficiency of the airport system, there was no comprehensive statement of federal roles, responsibilities and accountabilities. Similarly, the objectives for the LAAs were expressed in broad terms, leaving many issues open to the interpretation of the newly formed entities, without clear guidance from the federal government as to its expectations. Stakeholders are looking to the federal government to clarify its ongoing roles and relationship with the LAAs.

Checks and Balances in Governance Framework

The LAA model was based on the premise that there would be no need for formal regulatory/oversight processes, if a system of checks and balances were provided through:

- an appropriate form of corporate entity;
- an appropriate governance and accountability framework; and
- certain informal influences, such as capital markets.

It now appears that a number of these checks and balances have not operated as expected. While the actual performance of the LAAs does not appear to have been materially affected by deficiencies in the checks and balances, the concern is that such deficiencies may result in an inability to address problems should they arise.

Representation of User Interests

One of the expected checks and balances of the LAA governance model was the existence of meaningful consultations with stakeholders, which would ensure that the views of all affected parties would be considered in the decision-making process. The experience from the first five years of LAA operations is that meaningful consultations with users and other stakeholders have not developed to the same degree at all LAAs.

The primary users of the LAA airports are the airlines and the travelling public/passengers. The airlines agree that the LAAs have been more responsive to industry operational needs than was the case under federal government operation of the airports. However, they have expressed concern about a lack of influence over LAA decisions on capital expenditures and fee setting, and also about a lack of disclosure of information. The travelling public also presents special challenges from the standpoint of representation of interests as the airlines do not represent their interests.

Economic Oversight

Major airports, by nature, have a significant degree of market power. The four LAAs account for 45% of Canadian air passenger traffic, and O&D traffic accounted for between 65% and 84% of LAA passengers in 1997. In Canada, commercial entities with market power on the scale of the LAAs are typically subject to some form of regulation, and means of recourse for users, in respect of investment and/or pricing practices. The LAAs operate within a light form of self-regulation, without any formal avenue of recourse available to their users.

Airline associations (the Air Transport Association of Canada and the International Air Transport Association) have advocated enhancements to the present self-regulatory model related to the issues of user consultation, cost transparency, fairness in charges, and an appeal mechanism.

Rent Formula and Crown Rent

Canadian airports are federal assets that were developed and paid for by the general taxpayer and subsequently leased to non-governmental entities. This has given rise to the issues of the reasonableness of Crown rent and the complexity of the rental formula. There are different understandings of the government's original "no worse off" financial objective, which is central to the concept of a return to the Crown (the taxpayers of Canada) on Canadian commercialized airports.

The LAAs believe that the policy framework for the determination of rents is unclear, the resulting rents are too high, and the formula is too complex. In respect of the policy framework, they feel that the government has changed its financial objective from one of "no worse off" to one of "better off".

Airline associations feel that rents collected by the Crown are excessive, rents exceed what can be justified on a commercial basis, and characterize rents as a "hidden tax".

Airport Improvement Fees

Airport Improvement Fees (AIFs) have become a significant source of revenue for the LAAs, surpassing some of the major aeronautical charges. While AIFs were contemplated prior to the transfer of the airports, the significance of their current role was not expected. By their nature, AIFs present special issues that do not exist in respect of the major aeronautical charges which historically have been the mainstay of airport revenues. For instance, AIFs are collected directly from passengers, who are less able than airlines to influence charges.

Travellers and community residents appear to support the use of AIFs for airport improvements. However, concerns have been expressed by airline associations that the LAAs could use AIFs as a source of funding for activities other than capital improvement projects, such as airport operating expenses and subsidiary ventures. Airlines also expressed a desire for improved transparency of the use of AIF revenues.

Subsidiaries

Three of the LAAs have established for-profit subsidiaries to engage in a variety of commercial activities in Canada and/or abroad. While the policy framework allows the LAAs to become involved in ancillary activities, it is not clear that the current scope of such activities was anticipated in the design of the LAA model and governance structure.

Airlines have expressed concerns about a number of issues relating to subsidiaries. The most significant issues are: the risk profile of subsidiaries; the potential for revenue diversion; repatriation of profits; financial disclosure and transparency of information; the governance of subsidiaries; and the potential for unfair advantages to subsidiaries. Travellers have indicated that they wish to see subsidiary profits reinvested in the LAA airport.

Transparency

One of the key elements of a well functioning self-regulatory model is transparency of information and decision-making. A significant number of the LAA Lease Review work components have identified deficiencies in the transparency of the LAAs – this viewpoint was expressed repeatedly by non-LAA stakeholders. The most significant transparency issues pertain to the provision of cost data in support of user charges, data on ancillary activities through subsidiaries, and the financial interface between LAAs and their subsidiaries.

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Federal Income Tax

With the objective of assisting the financial viability of newly-formed LAAs, an exemption from federal income tax was provided in the *Airport Transfer (Miscellaneous Matters) Act* (1992). This legislation provides that an airport authority (which would include LAAs and Canadian Airport Authorities) would be exempt from federal income tax on income derived from an "airport business", provided that the corporation does not distribute any income or capital for the benefit of any member of the corporation and all, or substantially all, of the gross revenue of the corporation was earned from an airport business.

LAAs were pioneers, at the time, in alternative service delivery in the transportation sector. There was no precedent for commercializing a government function into not-for-profit organizations, and it was unclear as to whether LAAs would be financially viable. As a result, extra certainty in respect of taxation (through specific legislation) was deemed necessary.

The financial viability of the LAAs is now firmly established, and more recent transportation alternative service delivery initiatives have not found explicitly-legislated tax exemptions to be necessary. In general, not-for-profit entities are required, on an annual basis, to demonstrate to Revenue Canada that they are acting as not-for-profit organizations.

Ground Lease

The ground lease defines the contractual arrangements between the LAA and Transport Canada for the sixty-year lease of airport lands, buildings, machinery and equipment. It is primarily a commercial agreement, but also addresses a number of real property and governance matters.

The ground lease is a complex document, which extends to over 300 pages. The LAAs have criticized the ground lease as being overly complex, thereby creating a substantial administrative burden. Much of this criticism relates to the rental formula.

Another important issue is the lack of moderate enforcement levers available to Transport Canada in the ground lease. The only formal enforcement levers are notices of non-compliance and/or default.

Next Steps

Over the last 18 months, stakeholders have been involved in all stages of the LAA Lease Review Project. Transport Canada is now embarking upon the final round of formal consultations with key stakeholders. This process will begin in May 1999, once LAAs and other key stakeholders have had an opportunity to review the high-level policy issues in this Consultation Report.

2.0 OBJECTIVE

The objective of this paper is to provide a summary of the work completed to date on the LAA Lease Review Project and to serve as a starting point for a final round of consultations with key stakeholders to begin in May 1999. The paper reviews the results of each work component of the Project (see appendices) and identifies the key emerging policy issues. The key policy issues are accompanied by a brief discussion including the identification and assessment of options.

3.0 BACKGROUND

In 1987, the federal government made public a new policy for the management of its airports. Through the release of A Future Framework for the Management of Airports in Canada, the federal government announced that the Minister of Transport was prepared to receive proposals for the transfer of federal airports to local interested parties¹. The policy made it clear that the Minister of Transport would continue to be "responsible for ensuring a safe and efficient airport system". At this time, the Minister of Transport was also requested to report back to the Government on the results of the transfer initiatives.

The broad objectives of the transfer policy were to permit airports to better serve local community interests, to enhance regional economic development potential and to allow the national airport system to operate in a more cost efficient and commercial manner.

In 1989, Transport Canada released the Supplementary Principles for the Creation and Operation of Local Airport Authorities. The Supplementary Principles provided a set of detailed principles which were to guide the transfer negotiations with the Local Airport Authorities (LAAs). Lengthy negotiations proceeded on the basis of these principles.

In 1992, the federal government established the first Canadian transportation alternative service delivery model by approving the transfer of Vancouver, Calgary, Edmonton, Dorval and Mirabel² airports to LAAs. Thus, the LAAs were given the authority to commence the first commercialized airport operations in Canada. As part of these transfers, the Government required the Minister of Transport to conduct a major review of the LAA leases after five years of operation.

Over time, the government policy on the commercialization of airport operations has progressed. Following the introduction of the 1994 National Airports Policy (NAP), the Canadian Airport Authorities (CAAs)³ were established, based on different principles than the LAAs.

Following the NAP, the need for a LAA review was reiterated in 1997 when the Department amended several LAA leases, and the Government directed the Minister of

¹ The "Future Framework" also included a parallel initiative, which involved a new approach for the management of airports retained by Transport Canada that emphasized their "...commercial orientation, potential contribution to economic development and responsiveness to local interests and concerns."

² Dorval and Mirabel became part of a single Local Airport Authority, les Aéroports de Montréal.

³ These changes are mainly in the public accountability principles and in the lease.

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Transport to develop a policy framework within which any future lease re-negotiations would be conducted.

Transport Canada's five year LAA Lease Review is intended to respond to all of these requirements. This comprehensive Review was divided into 12 work components:

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|---|--|
| 1. Environmental stewardship | 7. Asset maintenance |
| 2. Facility planning and capacity development | 8. Crown rents and LAA financial viability |
| 3. Pricing practices | 9. Public survey |
| 4. Safety | 10. Security |
| 5. Service Levels | 11. Key stakeholder consultations |
| 6. Economic impact | 12. Governance. |

Specific terms of reference were drafted for each component. Work was carried out under contract by independent consultants for 10 of the components. Two of the components, Safety and Security, were completed by in-house technical experts.

The LAAs were given an opportunity to comment on the terms of reference and the draft reports. For those reports containing airport-specific confidential information, the individual LAAs were provided with draft reports from which all airport-specific information from other Authorities had been removed. Reports were finalized in the light of all comments received from the LAAs and certain final reports were presented to the LAA management.

Key stakeholder associations (ATAC, CAC, IATA) were also provided with executive summaries of the completed reports on an ongoing basis.

4.0 REPORT ORGANIZATION

The remainder of this paper is divided into three sections. Section 5.0 draws together the policy issues that arose in the course of the individual studies into a consolidated set of key policy issues. These key policy issues are separately discussed in detail in Sections 5.1 through 5.10. Section 6.0 outlines the next steps in the LAA Lease Review Project.

The appendix provides a summary of the findings for each of the 12 LAA Review work components. The individual subsections contain summaries of the study objectives, methodology, overall and specific conclusions, and consultants' recommendations, as well as an identification of any policy issues that emerged from the study. It is to be emphasized that any opinions expressed in the individual studies conducted by external consultants reflect the views of the authors, and not necessarily those of Transport Canada.

5.0 KEY POLICY ISSUES

Sections 5.1 through 5.10 identify a number of policy issues that emerged from the various work components. Table 5.0 consolidates these issues into a set of key policy issues, and references the relevant work components.

Additional issues could be identified in the course of the upcoming consultations with key stakeholders, and by other government departments during inter-departmental consultations.

Table 5.0
Key Policy Issues

Policy Issue	Referenced Work Component
Explicit and comprehensive airports framework	<ul style="list-style-type: none"> • Governance • Key stakeholder consultations
Checks and balances in governance framework	<ul style="list-style-type: none"> • Governance • Key stakeholder consultations
Representation of user interests	<ul style="list-style-type: none"> • Pricing practices • Governance • Key stakeholder consultations
Economic oversight (includes strong market power, and lack of recourse)	<ul style="list-style-type: none"> • Facility planning and capacity development • Pricing practices • Governance • Crown rents and LAA financial viability
Rent and Crown Return (including adequacy of return to the Crown, and complexity of rent formula)	<ul style="list-style-type: none"> • Crown rents and LAA financial viability • Pricing practices • Key stakeholder consultations
Airport Improvement Fee	<ul style="list-style-type: none"> • Pricing practices • Governance • Public survey
Subsidiaries	<ul style="list-style-type: none"> • Crown rents and LAA financial viability • Pricing practices • Governance • Key stakeholder consultations • Public survey
Transparency	<ul style="list-style-type: none"> • Pricing practices • Governance • Key stakeholder consultations • Public survey
Federal Income Tax	<ul style="list-style-type: none"> • Governance
Ground lease (including complexity of lease, lack of landlord monitoring, and lack of practical remedies)	<ul style="list-style-type: none"> • Environmental stewardship • Asset maintenance • Crown rents and LAA financial viability • Key stakeholder consultations

5.1 EXPLICIT AND COMPREHENSIVE AIRPORTS FRAMEWORK

5.1.1 Issue Description

The transfer of airports to the LAAs was carried out in a policy and legislative framework that was primarily focused on transfer objectives. While there were high level statements of continuing federal government responsibility for the safety and efficiency of the airport system, there was no comprehensive statement of federal roles, responsibilities and accountabilities. Nor does there appear to have been a comprehensive examination of federal statutes and regulations to determine the existing scope of federal authority.

Moreover, the objectives for the LAAs were expressed in broad terms, leaving many issues open to the interpretation of the newly formed entities, without clear guidance from the federal government as to its expectations.

The Key Stakeholder Consultations component indicated that stakeholders are looking to the federal government to clarify its ongoing roles and relationship with the parties. They feel that the management structure should continue its development within a more comprehensive policy framework, which builds on the lessons learned from the first five years.

The LAAs themselves have concerns that the federal government is seeking to interpret the transfer policy to permit a more active role in airport matters, including greater financial participation in the success of the airports (financial objectives of the federal government are discussed in section 5.5). They indicate that these concerns are likely to continue until there is a clearer airports policy stating exactly what the government wants to achieve, rather than merely empowering the LAAs to operate the airports.

The consensus of all groups interviewed in the Key Stakeholder Consultations is that, at the time of the transfers, all parties acknowledged that the policy framework would evolve, and that those aspects of the policy which were not clear at the outset would be clarified over time.

5.1.2 Issue Discussion

- The continuing roles and responsibilities of the federal government remain those prescribed by legislation and international agreements. The key piece of legislation is the *Aeronautics Act*. Section 4.2 of that Act addresses the Minister of Transport's responsibilities respecting aeronautics:

"The Minister is responsible for the development and regulation of aeronautics and the supervision of all matters connected with aeronautics.

- The key words are "development", "regulation" and "supervision". The word "development" gives rise to a role as a policy-maker, "regulation" to a role as a regulator, and "supervision" to some kind of oversight role.
- In managing federal assets by way of a lease, the federal government has also taken on the role of a landlord. This role is addressed through the ground lease (discussed in sections 5.5 and 5.10). Yet, the lease does not clearly enunciate specific responsibilities that flow from these roles.
- A Future Framework for the Management of Airports in Canada (April 1987) stated that "Transport Canada would remain responsible for ensuring a safe and efficient airport system...", but provides no further elaboration. While the National Airports Policy 1994 is more comprehensive in terms of the federal government's role in airport ownership and operation, it does not provide any clarification with respect to the federal government's roles and responsibilities in other areas.
- The *Aeronautics Act* and regulations pursuant to that Act (e.g., the *Canadian Aviation Regulations*) establish the safety and security regulatory framework within which the LAAs operate.
- There does not appear to be any legislative, regulatory or residual powers by which the government could take action to address the efficiency of the system.
- The *Airport Transfer (Miscellaneous Matters) Act* was enacted in 1992. It dealt largely with a number of technical issues, which were consequentially required in order to enable the transfers (e.g., pension arrangements for transferred employees, continuation of collective agreements and arbitration awards). It did address two matters related to the ongoing environment for airport authorities: application of a part of the *Official Languages Act* and the provision of an explicit exemption from the *Income Tax Act* in respect of revenues earned from "an airport business" (the matter of income tax is discussed in section 5.9).
- More recent initiatives by Transport Canada in respect of commercialized providers of transportation infrastructure have been accompanied by specific legislation: the *Civil Air Navigation Services Commercialization Act* (1996) for NAV CANADA, and the *Canada Marine Act* (1998) for the Canada Port Authorities and the St. Lawrence Seaway Management Corporation.
- Internationally, it would appear that countries that have embarked on a program of airport commercialization or privatization have enacted specific airports legislation in order to provide governments with residual powers. In the United Kingdom, the *Airports Act* (1986), inter alia, provided the Civil Aviation Authority with the power to regulate the charging practices of commercialized/privatized airports. New Zealand has the *Airports Authority Act*, which has been in effect since 1986 and has undergone many amendments to reflect the transfer of control of that country's airports to for-profit entities. In Australia, the *Airports Act* (1996) provides a detailed

framework for the long-term leasing of major Australian airports.⁴

- A key area for clarification is the ongoing federal responsibilities in respect of the overall national system of airports. For example, the airlines have expressed concern that the cumulative effect of all airport development projects across the country conceivably could reach the point where there could be a serious negative financial impact on their industry. They question what the federal responsibilities are in this regard. As another example, all of the LAAs have expressed interest in purchasing their airports. While the National Airports Policy, which postdates the LAA transfers, makes it clear that the federal government will retain ownership of airports of national significance, the subsequent sale of the national civil air navigation system to NAV CANADA has brought the issue back into play in the minds of some stakeholders.

- The objectives, roles and responsibilities of the federal government remain those set out in legislation and international bilateral agreements. The *Canada Transportation Act* in its National Transportation Policy statement (section 5) states:

"It is hereby declared that a safe, economic, efficient and adequate network of viable and effective transportation services accessible to persons with disabilities and that makes the best use of all available modes of transportation at the lowest total cost is essential to serve the transportation needs of shippers and travellers, including persons with disabilities, and to maintain the economic well-being of Canada and its regions..."

This declaration forms the basis for the regulation of carriers and modes of transportation but it creates no obligations with respect to the provision of infrastructure not owned by them, in this particular case, airports. Hence this Act only articulates a broad contextual objective as it relates to those aspects of transportation which are not subsequently addressed specifically in the Act.

- Canada's international commitments with respect to airports are those related to its obligations in its bilateral air services agreements and membership in the International Civil Aviation Organization.
- While the objectives of the transfer initiative were clear, there was little detail on the ongoing expectations for the LAAs. The LAAs in Vancouver and Montréal were incorporated under Part II of the Canada Corporations Act which was last revised in the 1960s. Part II of the Act deals with corporations without share capital. While the non-share capital nature of the LAAs' corporate structure places them squarely in the realm of Part II, the commercial nature of these entities does not seem to fit particularly well with the types of organizations specifically contemplated by the Act. Part II was established for organizations of "a national, patriotic, religious, philanthropic, charitable, scientific, artistic, social, professional or sporting character, or the like objects". Moreover, Part II of the Act does not address the governance structure of the organizations created thereunder.

⁴ International comparisons warrant considerable care. As circumstances can vary so significantly among states, comparisons should always be viewed in the broadest possible context.

- The LAAs in Calgary and Edmonton were formed pursuant to Alberta's *Regional Airports Authorities Act*. This Act, which was enacted specifically to address the formation of airport authorities, contains a purpose clause and specific airport requirements.
- There would seem to be a number of issues on which the LAAs and key stakeholders are seeking clarification in terms of expectations. Some of these issues are:
 - Are the LAAs expected to seek to maximize their revenues, or are they expected to be less aggressive in their pursuit of revenues, within the requirements of long-term financial viability, for the broader public interest? This issue has implications for the financial return to the Crown (section 5.5);
 - What are the expectations in respect of the scope of LAA activities? Is an LAA expected to dedicate itself to the operation of its airport(s), with ancillary activities pursued solely or primarily for the benefit of the LAA (e.g., to generate ancillary profits to drive down charges on LAA users), or is there an expectation that the LAAs could take advantage of the skills that follow from operating a major airport, to engage in ancillary activities with the potential to provide non-airport related benefits to their region (The issue of ancillary activities through subsidiaries is separately discussed in section 5.7)?;
 - What are the expectations for the LAAs in terms of efficiencies?; and
 - Where are the LAAs expected to operate on a spectrum of private and public sector organizations? The LAAs seem to have taken different interpretations, with implications for matters such as the disclosure of information.
- The use of both federal and provincial legislation as the fundamental corporate legislation for the LAAs has been identified as a complicating factor in efforts to clarify federal and LAA roles for the future.
- The presence of directors nominated by the federal government has been identified as an issue. The initial LAA model did not include any nominations by the federal government to the Boards of Directors. The Canadian Airport Authority model, which was developed as part of the National Airports Policy, contains a requirement for up to two federal nominations to the Board.⁵ Three of the four LAAs have revised their Board structure to accommodate two directors nominated by the federal government.

5.1.3 Options

There would appear to be at least three basic options in respect of an explicit and comprehensive airports framework:

- the status quo;
- a policy statement by the federal government on the extent of its own roles and responsibilities and on its expectations for the LAAs within the limits of existing federal authority; and

⁵ The federal government could nominate three directors if the authority were in receipt of a federal subsidy.

- specific airports legislation. Such legislation would provide the authority (e.g., regulation-making authority) to take action to carry out the federal government's roles and to ensure that the LAAs operated in accordance with expectations.

The main advantages and disadvantages of each option are presented in Table 5.1.

Table 5.1
Options re Explicit and Comprehensive Airports Framework

Options	Advantages	Disadvantages
Status quo	<ul style="list-style-type: none"> • high level statement of responsibilities exists (e.g. <i>Aeronautics Act</i>). While detailed roles, responsibilities and expectations may not be explicitly stated, there appears to be a relatively high degree of common understanding 	<ul style="list-style-type: none"> • notwithstanding a relatively high degree of common understanding, specific areas of uncertainty exist
Policy statement	<ul style="list-style-type: none"> • clear statements of responsibilities and expectations would reduce/remove uncertainty for all parties • would provide uniform policy framework for all National Airport System airports 	<ul style="list-style-type: none"> • federal government would not be empowered, at this time, to carry out certain responsibilities, or to ensure that LAA performance is in line with any specified expectations
Specific airports legislation	<ul style="list-style-type: none"> • clear statements of responsibilities and expectations would reduce/remove uncertainty for all parties • mechanisms would be available to carry out responsibilities and to deal with future unexpected developments • would provide uniform policy framework for all National Airport System airports 	<ul style="list-style-type: none"> • reduction in LAA autonomy and flexibility could remove some of the benefits of the model • broad authority for the federal government to make regulations may introduce some uncertainties for LAAs and the financial community

5.2 CHECKS AND BALANCES IN GOVERNANCE FRAMEWORK

5.2.1 Issue Description

The LAA model was based on the premise that there would be no need for formal regulatory/oversight processes, if:

- an appropriate form of corporate entity were to be adopted;
- an appropriate governance framework (including transparency) were to be established; and
- certain informal influences were effective.

These factors were seen as providing a system of checks and balances at that time.

It now appears that a number of these checks and balances have not materialized as expected. While the actual performance of the LAAs does not appear to have been materially affected by deficiencies in the checks and balances, the concern is that such deficiencies may result in an inability to address problems should they arise.

Further, the system of checks and balances could not have addressed certain developments not fully anticipated at the time of the design of the LAA model and governance framework.

5.2.2 Issue Discussion

- The key anticipated checks and balances in the governance framework for the LAAs appear to have been that:
 - the non-share capital corporate structure of the LAAs, and the accompanying prohibition against the distribution of any profits, would remove the incentive to generate excess profits, and hence act as a moderating influence on prices;
 - accountabilities to local governments and business groups appointing/nominating directors to the Board would serve as a check against inappropriate behaviour;
 - other elements of the LAA's Letters Patent/Articles of Incorporation and corporate bylaws, which were initially approved by Transport Canada, would provide safeguards for the public interest (as would Alberta's *Regional Airports Authorities Act* and associated regulations in the case of Calgary and Edmonton);
 - continued government ownership of the assets would give the federal government a lever through the ground lease;
 - meaningful consultations with stakeholders would ensure that the views of all affected parties would be considered in the decision-making process;
 - financial institutions providing capital funding to the LAAs would serve as a source of discipline on investments; and
 - the *Competition Act* would have some applicability to core LAA activities.

It would appear that a number of these checks and balances may not be playing the role originally envisaged for them.

- It is now acknowledged that the non-share capital form of corporate structure does not guarantee, by itself, either non-monopolistic pricing or efficiency of operations. The federal government does not appear to have explicitly defined responsibilities in the areas of airport pricing and efficiency, nor does it appear to have the means available to address problems that might develop in these areas (federal roles and responsibilities discussed in section 5.1).
- Accountabilities to nominating³ bodies may be less direct than initially envisaged. The concept of fiduciary responsibility of directors results in a fairly limited direct accountability back to nominating bodies. A director is not the "representative" on the LAA Board of the body that nominated him/her. While a director may represent a nominating body, in the sense that he/she may bring to the Board table perspectives and sensitivities similar to those of the nominating body, a director must separate himself/herself from the interests of that body and act in the best interests of the LAA. The interests of the LAA and a particular party may diverge significantly on certain issues. Accountabilities appear to be limited to the flow of non-confidential information and the rights of renomination and revocation of directors possessed by the nominating body. In all LAAs, directors may be renominated (two LAAs have two-term limits). However, only two of the LAAs (Calgary and Edmonton) provide their nominating bodies with authority to remove their director(s).
- One LAA provides an interesting accountability feature, which allows the local government of the major city served by the LAA (one of the nominating bodies) to request a special public meeting, at any time, to discuss specific issues.
- The ground lease contains a number of elements of a governance nature, but the lack of practical, moderate remedies for breaches of the lease appears to detract from its value as one of the checks and balances (discussed in section 5.10)
- Meaningful consultations with users and other stakeholders do not appear to have developed at all LAAs to the same degree (representation of user interests is separately discussed in section 5.3).
- Financial institutions have not had a disciplining role, to the extent envisaged. The influence of the financial community does not appear to have been put to the test, to this point⁴. To date, capital projects requiring funding have generally had strong justification and enjoyed widespread support among users. While monitoring by the financial community may have had some influence on LAA behaviour, the main impact appears to have been in influencing the method of generating revenue to repay lenders (insistence on substantial up front funding may have had an influence on the selection of Airport Improvement Fees over increases in traditional user charges).

³ Directors are nominated for the two LAAs incorporated under the *Canada Corporations Act* (Vancouver and Montreal), and officially appointed by the respective Boards. Directors in Calgary and Edmonton are appointed directly by external bodies. For simplicity, the term nominated will be used for the remainder of this paper.

⁴ There is some indication that the financial community may have expressed misgivings about a project at one of the LAAs.

Given the apparent comfort level of the financial community with the LAAs (i.e., due to strong market power and their track record to date), it appears unlikely that the financial community would place significant restrictions on funding, except in the most extreme of circumstances. It seems likely that the potential for a disciplining influence from the financial community would vary inversely with the market power of the LAA. In other words, the degree of discipline would be less where the need may be greatest.

- The *Competition Act* has only marginal applicability to the LAAs. It also appears that the degree of competition faced by the LAAs may be less than originally contemplated (the extent of LAA market power is discussed in section 5.4).
- Certain developments would not likely have been fully anticipated in the design of the original governance structure. While Airport Improvement Fees (AIFs) were contemplated in the design of the LAA model, it is not certain that the current degree of reliance on AIFs would have been anticipated (AIFs are specifically addressed in section 5.6).
- There may also be informal influences on the behaviour of LAAs that may not have been fully appreciated at the time of the model design. First, the behaviour of the LAAs is likely to be influenced by a desire to be regarded as industry leaders and models. Airports do not want to act in a way that causes them to earn a "bad name" in the international community. They do not want to be regarded as either a high cost airport or as an airport that is inconsistent with the internationally accepted code of conduct established by the International Civil Aviation Organization⁵. This is especially true when the airport has aspirations of being a major player on the international level (e.g., consulting and management services). Second, individual directors of the LAAs typically live in the communities served by the airport(s). There appears to be a certain pressure that comes from not wanting to live in a community and be associated with an activity that is held in disfavour by that community. This applies on the personal level, as well as the professional level (e.g., possible impact on the professional activities of an accountant, engineer or lawyer who serves as a director of an LAA with a negative image).
- The status of the LAAs with respect to the payment of federal income tax may also have a role to play in the system of checks and balances (discussed in section 5.9).

5.2.3 Options

The issue of checks and balances is, in effect, a series of sub-issues, each one relating to an identified gap in the originally anticipated checks and balances. These sub-issues taken individually include:

- the form of corporate entity;
- accountability to nominating bodies;
- ground lease; and

⁵ While there is an obligation, through the ground lease, for the LAA to observe multilateral agreements such as the Chicago Convention and bilateral air transport agreements, that obligation does not extend to non-binding charging principles of the International Civil Aviation Organization.

- relationship between LAAs and users.

Taken together, these sub-issues raise the issue of economic oversight.

The ground lease, the relationship between LAAs and users, and economic oversight are not discussed further in this section. Options for these sub-issues and issues are separately discussed in section 5.10, 5.3 and 5.4, respectively.

The form of corporate entity and the accountability to appointing body sub-issues are discussed below.

In respect of the form of corporate entity, there appear to be only two fundamental options:

- the status quo; and
- a for-profit form of corporate entity.

There are variations within these groups. Both organizational forms may be accompanied by other changes in the checks and balances. The main advantages and disadvantages of these options are set out in Table 5.2.1.

Table 5.2.1
Options re Basic Corporate Form of Airport Authority

Options	Advantages	Disadvantages
Status quo (i.e., not-for-profit)	<ul style="list-style-type: none">• constraint against distribution of profits expected to have a moderating influence on exercise of market power	<ul style="list-style-type: none">• by itself, does not guarantee non-monopolistic pricing or efficiency in operations
For-profit corporate entity	<ul style="list-style-type: none">• presence of shareholders might provide incentive for cost efficiencies	<ul style="list-style-type: none">• major philosophical change• out-of-step with corporate structure for other transportation alternative service delivery models in Canada• significant formalized economic regulation/oversight would be required as offset to profit motive

On the matter of accountabilities to nominating entities, Table 5.2.2 identifies the following five options and presents the main advantages and disadvantages of each:

- the status quo;
- right to remove a director nominated by a nominating body. Presently, this right exists at only two LAAs;

- requirement for LAA to hold a public meeting to discuss a specific issue if requested by one or more nominating bodies. As noted previously, one LAA has a feature whereby the major city that it serves can require the LAA to hold such a meeting. An option might be to allow nominating bodies representing some predetermined percentage of externally nominated directors to require the LAA to hold a special public meeting;
- requirement for all LAAs to adopt fully the Public Accountability Principles for Canadian Airport Authorities; and
- increased transparency. Options addressing transparency are separately reviewed in section 5.8.

These options are not all mutually exclusive. The second, third, fourth and fifth options could be implemented separately or in combination. The status quo, however, stands by itself.

Table 5.2.2
Options re Accountability to Nominating Entities

Options	Advantages	Disadvantages
Status quo	<ul style="list-style-type: none"> • nominating bodies seem satisfied 	<ul style="list-style-type: none"> • checks and balances are not as extensive as initially contemplated
Right to remove directors by external nominating bodies	<ul style="list-style-type: none"> • may increase accountability 	<ul style="list-style-type: none"> • potential to create instability on Board, if director is removed for taking position, which although unpopular with nominating body, may be in best interests of LAA
Right to request special public meeting	<ul style="list-style-type: none"> • may increase public profile of key issues and improve accountability 	<ul style="list-style-type: none"> • potential for overuse
Full adoption of Public Accountability Principles for Canadian Airport Authorities	<ul style="list-style-type: none"> • consistency for all airports in National Airports System 	<ul style="list-style-type: none"> • none apparent
Transparency	<ul style="list-style-type: none"> • see Table 5.7.1 for main advantages and disadvantages of various transparency options 	<ul style="list-style-type: none"> • see Table 5.7.1 for main advantages and disadvantages of various transparency options

An analysis of options has not been presented for the marginal applicability of the *Competition Act*. Apart from the status quo, the only specific option would appear to be amendments to the Act. Such amendments are not considered feasible, because the nature of the amendments would represent a fundamental change to the underlying philosophy of the Act.

5.3 REPRESENTATION OF USER INTERESTS

5.3.1 Issue Description

One of the expected checks and balances of the LAA governance model was the existence of meaningful consultations with stakeholders, which would ensure that the views of all affected parties would be considered in the decision-making process. The experience from the first five years of LAA operations is that meaningful consultations with users and other stakeholders do not appear to have developed, to the same degree, at all LAAs.

The issue of representation of user interests starts with the need to define users. In the case of the LAAs, the primary users are the airlines and the travelling public/passengers.

The airlines agree that the LAAs have been more responsive to industry operational needs than was the case under federal government operation of the airports. They state that the LAAs are typically good at consulting on day-to-day operational matters. The airlines perceive that they have little or no influence over LAA decisions with respect to capital expenditures or the setting of fees and charges⁶. Concerns have also been expressed about inadequate disclosure by the LAAs of information, which the airlines require to determine the justification for airport charges and to ensure that there is not an element of cross-subsidization in respect of subsidiaries. The airlines feel that the LAAs have adopted a "wide and shallow" interpretation of their constituency, meaning that everyone in the public at large is a stakeholder, without a recognition of the special needs of their primary customers. In the Key Stakeholder Consultations, airlines and other stakeholders with commercial interests on the airport commented that the LAAs do not regard them as the primary customers of the airport.

The travelling public present special challenges from the standpoint of representation of interests.

The LAAs are significantly different in terms of the representation of user interests than Transport Canada's more recent initiatives in the commercialization of major transportation infrastructure.

5.3.2 Issue Discussion

- When the LAA model was being designed, there was concern that the nomination of one or more directors to the Board by individual airlines, or an association of airlines, would have created a conflict-of-interest situation (or at least the perception of a conflict of interest).
- An active member of an airline or an airline association would be in a conflict-of-interest position. As a director, such an individual would be constantly torn between his/her fiduciary responsibility to the LAA and responsibility to his/her employer. While it is possible for any director to find himself/herself in a potential

⁶ An exception is the agreement between ATAC and one LAA in respect of the Airport Improvement Fee.

conflict of interest situation from time to time, an active member of an airline or airline association would face this type of situation on a regular basis.

- More recent initiatives by Transport Canada have not demonstrated the same concern about nomination of Directors by users. In the case of NAV CANADA, five of the ten external appointments on the Board of Directors are made by national user associations⁷. For Canada Port Authorities, a majority of directors are to be appointed by the Minister in consultation with users⁸. Directors are required to have generally acknowledged and accepted stature within the transportation industry or business community. Appointees identified through consultation with users must also have the relevant knowledge and extensive experience related to the management of a business, to the operation of a port, or to maritime trade. The Board of the St. Lawrence Seaway Management Corporation consists of eight directors, five of whom are appointed by users. The directors who are chosen by the users are, in fact, not members of the various user groups but rather representatives who have the skills and knowledge that are suitable for the position – thus limiting the potential for conflict of interest.
- The Supplementary Principles for the Creation and Operation of Local Airport Authorities and the Public Accountability Principles for Canadian Airport Authorities specifically preclude certain individuals from becoming a director (elected officials and government employees). Airline employees, present or past, are not mentioned.
- Airline nominations to the Boards of airports are not common at commercialized airports internationally as governments often have a controlling interest⁹.
- The LAAs are strongly opposed to airline nominations to their Boards.
- The airlines believe that measures are necessary to provide them with more input to LAA decisions. While the airlines speak positively about the multiple director appointments made by user associations to the NAV CANADA Board (and the good results that they see following from such a situation), they have not actively promoted the opportunity to make director nominations to the LAA Boards. Recently, however, the Air Transport Association of Canada has expressed some interest.¹⁰ The International Air Transport Association seems to prefer that the emphasis be placed on other measures to improve user input.
- The LAA model recognizes the importance of having the right skills and backgrounds on the Board of Directors. The ground lease (and the Alberta legislation) state that,

⁷ So far, four of the directors are nominated by the Air Transport Association of Canada (ATAC).

⁸ The Board is to have between 7 and 11 directors. Between 4 and 8 directors are to be appointed by the Minister in consultation with users.

⁹ As noted previously, a degree of caution is warranted in making international comparisons. Overall context is always important. In this case, there may be other safeguards for airline interests (e.g., government ownership, economic regulation, formal contractual arrangements with airlines).

¹⁰ In the Key Stakeholder Consultations, the airline stakeholders at one LAA commented that there should be a requirement for airline representation on the LAA Board.

to the extent that it is practicable, Boards should collectively have persons with skills and backgrounds in a variety of disciplines. Among the desired backgrounds are ones in "air transportation" and "aviation". These skills are identified as desirable, rather than mandatory. Some of the LAAs either have, or have had, such skills on the Board.

- Passengers are not organized or otherwise able to act collectively and strategically with regard to airport investment and pricing actions. Accordingly, there is no means available at this time for the LAAs to consult in a formal way with the travelling public, as they are able to do with the airlines. It is not clear that an organization could be formed to represent the interests of passengers in this way. In the United States, for example, there is an Airline Passenger Association, but it does not appear to play much of a role in consultations on technical airport matters.
- While an effective forum for consultations with passengers seems unlikely, this does not mean that the views of the travelling public are not obtained by the LAAs. First, there are customer surveys, which the LAAs are presently using. Secondly, there is a substantial overlap between the interests of airlines and passengers. As a result, the interests of passengers are being represented, to some extent, by airlines. However, the interests of the airlines and passengers may diverge on certain issues. One such issue would appear to be the Airport Improvement Fees collected directly from passengers, without any involvement by the airlines. In this case, airlines and passengers are likely to have quite different views on the method of collection. In addition, the airlines may react differently to proposals for increased airport charges, depending upon whether such charges are to be collected directly from the passengers or through more conventional airport user charges (e.g., landing fees). Accordingly, it would seem that airline interests are an imperfect proxy for the interests of the travelling public.
- In the United States, there is a more formal regulation for Passenger Facility Charges (the name given to Airport Improvement Fees in that country) than is applicable to landing fees and other airport fees (Airport Improvement Fees are discussed in section 5.6).
- The LAA model does not impose any formal requirements for consultation with airlines or passengers. Airports subject to the Public Accountability Principles for Canadian Airport Authorities are required to provide not less than 60 days advance notice through local media of planned increases in airport user charges. Such notice is to include an explanation of the justification for such increases.
- There is no formal avenue of recourse for airport users. Recourse is discussed more fully in section 5.4.

5.3.3 Options

Table 5.3 identifies a number of options in respect of the representation of user interests:

- the status quo;
- voluntary consultation guidelines (also discussed as part of an economic oversight option in section 5.4.3). One element of such guidelines could be the opportunity for users to make presentations directly to the LAA Board of Directors on specified matters;
- mandatory consultation requirements, which would be the same guidelines as in the previous option, with the addition of an enforcement mechanism (also discussed as part of an economic oversight option in section 5.4.3);
- requirement for LAA Boards, at LAA discretion, to include either:
 - a person with previous background in air transportation from the perspective of users; or
 - a person from among a list of nominees provided by a formal airline association or a group of local airport users. An active member of the industry would be ineligible for reasons of potential conflict of interest; and
- identification of a formal airline association or a group of users as a nominating body.

Not all of these options are mutually exclusive. In addition, variations on these options are also possible.

None of the options in Table 5.3 provide for a practical forum for consultation with the travelling public. In each option, there is also a disadvantage that airline interests may not coincide with the interests of the travelling public. Gaps in respect of the representation of the travelling public may require separate measures to supplement the options examined in Table 5.3.

Table 5.3
Options re Representation of User Interests

Options	Advantages	Disadvantages
Status Quo	<ul style="list-style-type: none"> during first five years, there do not appear to have been major instances of LAAs acting contrary to the views of the majority of users (there have been complaints about LAA transparency) 	<ul style="list-style-type: none"> one of the key checks and balances would remain weak out-of-step with more recent initiatives in Canada airline perspectives do not represent interests of the travelling public
Voluntary Consultation Guidelines	<ul style="list-style-type: none"> clear statement of performance standards would strengthen key component of self-regulation require no legislative or lease amendment 	<ul style="list-style-type: none"> guidelines conducive to addressing matters of form, but not substance (i.e., meaningfulness of consultations) no formal direct means to enforce no guarantee of user perspective being present in Board discussions and decisions following consultations airline perspectives do not represent interests of the travelling public
Mandatory Consultation Requirements	<ul style="list-style-type: none"> clear statement of performance standards would strengthen key component of self-regulation more in line with requirements in NAV CANADA and Canada Port Authority initiatives 	<ul style="list-style-type: none"> requires enforcement vehicle (legislation or amended lease) guarantees form, but not substance (i.e., how can meaningful consultations be enforced) no guarantee of user perspective being present in Board discussions and decisions airline perspectives do not represent interests of the travelling public
<p>Mandatory requirement for Board to include either:</p> <p>(a) a person with a background in air transportation or</p> <p>(b) a person from among a list of nominees provided by a formal user association (e.g., ATAC) or group of local users (active member of industry ineligible for reasons of conflict of interest).</p> <p>Choice of option could be left to LAA.</p>	<ul style="list-style-type: none"> strengthen self-regulation checks and balances would bring a user perspective to Board discussions and decisions more user perspective on Board, and/or input to Board member selection, consistent with NAV CANADA, Canada Port Authority and Seaway initiatives 	<ul style="list-style-type: none"> inventory of such persons may be limited requires, at least, amendment to lease, and maybe changes in by-laws and provincial legislation airline perspectives do not represent interests of the travelling public
Identification of a formal user association as an appointing body (active member of industry ineligible for reasons of conflict of interest)	<ul style="list-style-type: none"> strengthen self-regulation checks and balances would bring a user perspective to Board discussions and decisions more user input to Board member selection consistent with NAV CANADA, Canada Port Authority and Seaway initiatives 	<ul style="list-style-type: none"> would require amendment to all corporate by-laws (Alberta legislation might require further amendment because of resulting Board size) airline perspectives do not represent interests of the travelling public

5.4 ECONOMIC OVERSIGHT

5.4.1 Issue Description

Major airports, by nature, have a significant degree of market power. In Canada, commercial entities with market power on the scale of the LAAs are typically subject to some form of regulation, and means of recourse for users, in respect of investment and/or pricing practices. The LAAs operate within a light form of self-regulation, without any formal avenue of recourse available to their users. By contrast, Transport Canada's more recent initiatives to establish new management structures for operators of key transportation infrastructure (i.e., NAV CANADA, Canada Port Authorities, and the St. Lawrence Seaway Management Corporation) have involved more formal self-regulatory mechanisms, all with some avenue of appeal for users. Internationally, states generally have been unwilling to allow airports to operate without some form of regulatory framework.

The two major airline associations – the Air Transport Association of Canada and the International Air Transport Association – have advocated enhancements to the present self-regulatory model. The Air Transport Association of Canada has recommended the development of principles on airport pricing, similar to those established in legislation for NAV CANADA. Such principles would deal with cost transparency, fairness in charges and an appeal mechanism. The International Air Transport Association is concerned about the dynamics of the relationship between the LAAs and the airlines. They believe that a more formalized and structured approach to consultations is required. They are particularly concerned about a lack of transparency (e.g., insufficient information to determine reasonableness of charges). The international carriers also support the establishment of an appeal mechanism.

5.4.2 Discussion

- The measure of market power is the degree to which an entity can raise prices and sustain those higher levels. The LAAs possess substantial market power in respect of a large majority of their activities.
- The LAAs accounted for 45% of the passenger traffic in Canada in 1997. It is acknowledged that the LAAs are subject to varying degrees of competition in segments of their activities (e.g., competition with other Canadian airports and American airports for overseas traffic). However, the most significant component of an airport's business is its origin and destination (O&D) traffic, over which it holds a virtual monopoly. O&D traffic accounted for between 65% and 84% of the passengers at the LAAs in 1997. In addition, the LAAs have a strong hold over elements of their connecting passenger traffic (e.g., Vancouver's role as a point of connection for passengers travelling from southern Canada to points in the Yukon).
- An LAA is free to make its own investment decisions, and to establish its own charges, without any need for external review or approval, or exposure to appeal within its not-for-profit status. While some stakeholders appear to regard the present

arrangements as providing no form of economic oversight, there is a light form of self-regulation in place. The main vehicle of self-regulation is the governance framework within which the LAA operates. In establishing this framework, the basic premise appears to have been that this governance structure would provide the necessary safeguards against the significant market power of the LAAs, making it unnecessary to set up formal processes. A key element in the governance framework was a system of checks and balances (discussed in section 5.2)

- The experience in the first five years suggests that the LAAs have not taken investment or pricing actions that could be characterized, at this time, as abuse of market power. However, there have been some signs of behaviour that represent a breakdown in key elements of a self-regulatory model. These breakdowns occur in the areas of transparency and consultation. The most significant illustration of such behaviour is the failure of the LAAs to provide airlines or foreign governments (U.S.) with the cost data necessary to allow a determination of the reasonableness of the charges that they pay (the issue of transparency is discussed more fully in section 5.8).
- LAA stakeholders are primarily concerned about the potential for problems in the future. Stakeholder concerns may be due, at least in part, to a realization that the range of tools available to safeguard the public interest may not be as extensive as originally believed. Specifically, a number of the elements of the governance framework may not be playing the role originally envisaged for them (discussed in section 5.2). In addition, there would appear to have been certain developments that would likely not have played a part in the design of the original framework (discussed in general terms in section 5.2 and, in more specific terms, in sections 5.6 and 5.7).
- When the LAA model was created, the selection of a light form of self-regulation would appear to have been influenced by a concern that formal economic oversight processes could seriously impair the financeability of the LAAs. This same concern does not appear to exist today. The LAAs have now established an operational and financial track record with which the financial community is comfortable. The highly positive experience of another non-share capital corporation (i.e., NAV CANADA) in obtaining financing also suggests that certain options for enhanced economic oversight would be unlikely to impair the financial viability of the LAAs.
- The Canadian experience generally is that commercial entities with market power on the scale of the LAAs are not allowed to operate without some form of regulation on investment and/or pricing practices. The form of regulation varies widely, from traditional rate setting regulation to light-handed models of self-regulation.
- Transport Canada's most recent initiatives in respect of the governance of providers of key transportation infrastructure reflect self-regulatory models, with varying degrees of recourse for users in the event of a breakdown in self-regulation:
 - the *Civil Air Navigation Services Commercialization Act* (1996) establishes a self-regulatory model for NAV CANADA, based on mandatory consultation, transparency, a set of charging principles, and a mechanism in which appeals

on pricing decisions can be made to the Canadian Transportation Agency. The Agency has the power to roll back increased fees which do not respect the established pricing principles, and to order refunds for users;

- the *Canada Marine Act* (1998) establishes a requirement for consultation, a prohibition against unjust discrimination among users, and an opportunity for any interested person to file a complaint with the Canadian Transportation Agency. The Agency is required to consider the complaint, report its findings to the port authority, and the port authority is expected to "govern itself accordingly"; and
 - the *Canada Marine Act* also established certain transparency requirements for the St. Lawrence Seaway Management Corporation and the Canadian Port Authorities. It prohibits against unjust discrimination in fees among users and provides an opportunity for users to file a complaint with the Canadian Transportation Agency.
- The appeal mechanisms in respect of NAV CANADA, the Canada Port Authorities, and the St. Lawrence Seaway Management Corporation address charging matters, but not the level of investments made by the entities.
 - A survey of four developed aviation countries (the United States, the United Kingdom, Australia and New Zealand) results in the following observations:
 - All four countries have some form of formal economic oversight of airports. The United States and New Zealand have adopted self-regulatory models in respect of airport charges (although the United States uses a more traditional form of third-party regulation for Passenger Facility Charges. The American approach on Passenger Facility Charges is outlined in section 5.6). The United Kingdom and Australia employ formula-style regulation (i.e., establishment of Consumer Price Index minus some predetermined percentage, as a maximum increase on airport charges);
 - All four countries rely on legislation, regulations or other formal instruments as a basis for economic oversight;
 - Three Commonwealth countries have specific airports enabling legislation;
 - All four countries have established legislative or regulatory requirements for transparency/disclosure of information;
 - At least two countries (United States and New Zealand) have explicit requirements in terms of consultation; and
 - All four countries provide an avenue of recourse/appeal to users.

5.4.3 Options

There would appear to be at least four basic options for economic oversight:

- the status quo;
- a moderately enhanced self-regulatory model, in which guidelines are specified in respect of such matters as consultation, opportunities to make presentations directly to Boards on specified matters, disclosure/transparency of information including subsidiaries, and pricing principles for aeronautical charges and AIFs;

- a substantially enhanced self-regulatory model, with formal requirements for consultation, opportunities to make presentations directly to Boards on specified matters, disclosure/transparency of information including subsidiaries, and pricing principles for aeronautical charges and AIFs – plus a streamlined appeal mechanism like the one established in respect of NAV CANADA; and
- an interventionist form of regulation, which could include the traditional form of rate setting regulation in which there is a third-party review and approval of key investment and/or pricing decisions (e.g., CRTC process for local telephone rates), or the formula style of regulation found in Australia and the United Kingdom (a cap on fee increases, according to a formula, typically a rate of inflation minus some prescribed percentage).

Table 5.4 sets out the four basic options and summarizes the main advantages and disadvantages of each. Hybrids and variations on these options are possible. For example, there could be an option falling between the moderately enhanced self-regulatory model with guidelines but no appeal mechanism, and the substantially enhanced self-regulatory model with mandatory requirements and an appeal mechanism.

The assessment of the options presented in Table 5.4 does not distinguish between matters of pricing versus levels of investment. For the most part, the options could apply to both. It should be noted, however, that the current practices for other non-share capital providers of infrastructure are essentially directed at matters of pricing. The existing appeal mechanisms in respect of NAV CANADA and Canada Port Authorities do not address level of investment issues¹¹.

As the governance framework plays such a key role in the current form of economic oversight, options in respect of the representation of user interests and other aspects of the governance framework (discussed in sections 5.3 and 5.2, respectively) will also be of relevance to economic oversight.

¹¹ Capital expenditures for the Seaway continue to be made by the federal government. Canada Port Authorities are subject to certain conditions in respect of borrowings.

Table 5.4
Options re Economic Oversight

Options	Advantages	Disadvantages
Status Quo	<ul style="list-style-type: none"> current model has performed well, with some deficiencies (e.g., transparency), but no major problems at the LAAs. Most concerns deal with potential for future problems 	<ul style="list-style-type: none"> no clear standards for acceptable/expected practices (consultation, disclosure and pricing) no formal means to deal with problems, when/if they arise out-of-step with more recent initiatives in Canada, and with international practice
Moderately enhanced self-regulation (i.e., guidelines in respect of consultation, opportunity to make presentations directly to Boards on specified matters, disclosure of information/transparency including subsidiaries, pricing practices including AIFs)	<ul style="list-style-type: none"> consistent with intended spirit of self-regulation clear statements of performance standards strengthen self-regulation no need for legislative or lease amendment 	<ul style="list-style-type: none"> no formal means to deal with problems, when/if they arise
Substantially enhanced self-regulation (i.e., requirements in respect of consultation, opportunity to make presentations directly to Boards on specified matters, disclosure of information/transparency, and pricing practices including AIFs) and a streamlined appeal mechanism (such as exists in the case of NAV CANADA)	<ul style="list-style-type: none"> significantly strengthens self-regulation (i.e., binding recourse vehicle) more in line with recent initiatives in Canada and with international practice appeal mechanism unlikely to affect LAA financeability 	<ul style="list-style-type: none"> new or amended legislation required to authorize appeal mechanism costs to all parties associated with recourse vehicle (on the other hand, such costs may provide incentive to parties to avoid appeals)
More interventionist forms of regulation examples: <ul style="list-style-type: none"> traditional review and approval by third party; and formula style regulation, as found in Australia and the UK (limit on fee increases to Consumer Price Index minus x%). 	<ul style="list-style-type: none"> high degree of protection to stakeholders precedents in international experience 	<ul style="list-style-type: none"> out of step with other Canadian initiatives (i.e., NAV CANADA, CPAs) difficult to predict effect on LAA financeability, given lack of Canadian experience with such mechanisms in the transportation infrastructure business costly and time-consuming processes required

5.5 RENT FORMULA AND CROWN RETURN

5.5.1 Issue Description

This issue focuses on the reasonableness of the rent from two perspectives: those who pay the rent, and the Crown which receives it. For this purpose, those who pay are interpreted broadly to also include users, whose charges are impacted by the amount of the rent paid by the LAAs. The discussion on the reasonableness of the rent begins with the apparent different understandings of the government's original "no worse off" financial objective.

A related issue is the complexity of the formula for determining the amount of the rent.

The issue of Rent and Crown Return evokes strong views from the LAAs and the airlines:

- the LAAs believe that the policy framework for the determination of rents is unclear, the resulting rents are too high, and the formula is too complex. In respect of the policy framework, they feel that the government has changed its financial objective from one of being "no worse off" to one of being "better off";
- the Air Transport Association of Canada states that the lease payments exceed what can be justified on a commercial basis. They recommend that the government reappraise its rental policy and set it according to commercial principles, starting with the elimination of "participation" rent¹²; and
- the International Air Transport Association criticizes the rent as being a "hidden tax". They express concerns about "revenue diversion" to other modes of transportation and other government priorities.

Section 5.5.2 will discuss Rent Formula and Crown Return in two parts:

- the financial objectives of the government, and the reasonableness of the actual and projected return to the Crown; and
- the complexity of the rental formula.

5.5.2 Issue Discussion

5.5.2.1 Financial Objectives and Reasonableness of Return

- A Future Framework For the Management of Airports in Canada (April 1987) stated that the "federal government would expect to obtain reasonable compensation for any facility transferred". Compensation "should consider historical investments as well as future earning potential". This reflected the fact that airports are federal assets developed and paid for by the general taxpayer which have subsequently been

¹² Based on speaking notes of Vice President of Finance delivered to Canadian Airports Council/Airports Council International Airports Conference in Ottawa on December 10, 1998.

transferred to non-governmental entities.

- This approach was confirmed in the Supplementary Principles for the Creation and Operation of Local Airport Authorities (June 1989), which stated "Valuation of the airport to be transferred to the LAA will be on the basis of "fair market value", with appropriate consideration to the airport's future earning potential". Negotiations proceeded with the LAAs on this basis.
- A rental structure was developed which included up to six different categories of rent.¹³ Two of these categories had "base" and "participation" components¹⁴:
 - the "base" component was designed to produce a return to the Crown comparable to what it could have reasonably expected to earn had it continued to operate the airport. In this way, the "base" rent reflected a "no worse off" minimum objective; and
 - the "participation" component was intended to allow the Crown to share in value-added initiatives undertaken by the new airport operator. The "participation" component provided an opportunity for the Crown to be "better off" financially.
- Taken together, the "base" component and the "participation" component demonstrate that the federal government intended to be at least "no worse off", and potentially "better off". The federal government sought only to be "better off", however, if the LAA were to achieve better results than the federal government.
- The basic philosophy behind the determination of rent has been retained for Canadian Airport Authorities, but the formula has been simplified. The "base" and "participation" components have been retained, but the distinction among the various revenue categories has been eliminated.
- The rental structure for the Canadian Airport Authorities also differs from the LAA structure, in that the former considers all revenues of the Authority whether generated on the Demised Premises or elsewhere. LAA rents are based only on revenues earned on the Demised Premises.
- In 1997, amendments were made to the lease formulae for three of the LAAs. While one LAA retained the basic LAA rental structure, two LAAs switched to a Canadian Airport Authority-style rental formula. The slightly revised formula for one LAA applies from 1996 through to the end of the term of the lease. The revised formulae

¹³ There is a seventh category of rent called Additional Rent, which is essentially a residual category to handle adjustments and penalties.

¹⁴ A single formula exists for the remaining categories. However, with the exception of the Other Revenues category, which could contain revenues of both a "base" and "participation" nature, the remaining categories resemble either "base" or "participation" revenues. The rent associated with existing ground rentals seems to share the main characteristics of a "base" rent, whereas rent from Airport Improvement Fees (called Passenger Facility Charges in lease) and Developed real estate appear to be more in the nature of "participation" rents.

for the other two LAAs are applicable to the years 1996 through 2005.

- KPMG's report on Crown Rents and LAA Financial Viability concludes that using a compensatory pricing approach, over the first five years of the leases, the Crown is better off financially at one LAA, neutral at one and worse off at two LAAs. Over the full 60-year term of the lease, KPMG concluded that the Crown would be worse off at two LAAs and better off at two LAAs. When a residual pricing approach is utilized, the Crown is better off at all four LAAs.
- The LAAs were also provided with an opportunity to provide their own sensitivity scenarios. Three LAAs provided KPMG with alternative scenarios.
- Another way of looking at the reasonableness of the rents being earned by Transport Canada is to calculate a rate of return in a conventional commercial manner, taking into account the monopoly or near-monopoly character of the core of the airport business. This matter was explored by KPMG in its report on Crown Rents and LAA Financial Viability.
- KPMG calculated/estimated a rate of return to the Crown using two separate approaches, which differed on the basis of the methodology for the quantification of the Crown's investment (the rent was the return in both approaches). One methodology used the net book value of assets, and the other used a market value proxy based on selected sales of major airports internationally.
- The reasonableness of the rate of return is assessed in relation to benchmarks based on the rates of return for Canadian regulated utilities.
- The results of the KPMG analysis would appear to be inconclusive. Based on the net book value approach, the return to the Crown was either within the benchmark range, or well above it, for all of the LAAs. By contrast, based on the market value proxy approach, the Crown return was below the lower point of the benchmark range for each LAA.
- Beyond the practical difficulties associated with the measurement of the Crown's investment, there appear to be a number of issues which would also have to be addressed before a return on investment calculation would serve as an acceptable yardstick of the reasonableness of the rental rate. For example, given that Canadian taxpayers borrowed money to fund airport investments through the years and, in many cases, were not able to recover those costs from users, the net book value almost certainly understates the taxpayers' investment in airports. In many cases, that understatement would be substantial. More fundamentally, return on investment was not the agreed principle for the lease negotiations.

5.5.2.2 Complexity of the Rental Formula

- The LAA rental formulae, with their different rental categories and varying methods and rates of rental calculation, create an administrative burden for both the LAAs and

Transport Canada. The existence of different rental payment rates may also introduce concerns about the categorization of certain revenues, which could increase the review and audit effort required by Transport Canada. In its report on Crown Rents and LAA Financial Viability, KPMG observed that there are issues in the assignment of revenues to various categories that could affect the rent payable.

5.5.3.1 Options – Financial Objectives and Reasonableness of Return

There would appear to be three main options in respect of the federal government's financial objectives:

- the status quo (i.e., as a minimum, the federal government be "no worse off" financially than it would have been had it continued to operate the airport(s), and potentially "better off" if the LAA is able to do better than the federal government. There is no limit to how much the federal government would share in the value-added initiatives of the LAA);
- "no worse off" as a minimum, and potentially better off, but there would be some kind of a limit on how much better off the federal government could be. That limit could be expressed in a variety of ways (e.g., maximum rate of return expressed on some predetermined methodology); and
- "no worse off", but not better off. In short, this would represent elimination of "participation" rent, as recommended by the Air Transport Association of Canada.

Table 5.5.1 summarizes the main advantages and disadvantages of these options.

Table 5.5.1
Options re Financial Objectives

Option	Advantages	Disadvantages
Status Quo (i.e., "no worse off" as a minimum, and potentially "better off")	<ul style="list-style-type: none"> • maximum benefit for taxpayers 	<ul style="list-style-type: none"> • no limit on return to the Crown
"No worse off" as a minimum, and potentially "better off", with an explicit limit	<ul style="list-style-type: none"> • taxpayers assured reasonable return • provides a justification for level of rents 	<ul style="list-style-type: none"> • return to taxpayers could be lower than presently forecast • practical difficulties in measuring limit
"No worse off", but <u>not</u> better off	<ul style="list-style-type: none"> • likely to reduce costs of airport services to users 	<ul style="list-style-type: none"> • lowers expected return to taxpayers

5.5.3.2 Options – Complexity of Rental Formula

In addition to the initial LAA formula and the simplified Canadian Airport Authority formula, other rental formulae could be considered, including:

- flat amount per passenger, perhaps increasing over time (e.g., with inflation); and
- percentage of total airport revenues.

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Table 5.5.2 summarizes the main advantages and disadvantages of the four options.

In evaluating rental formula options, a number of criteria may be relevant: flexibility to deal with ups and downs in the business cycle, incentives for airport efficiency, administrative burden, equity among airports, and public perception of equity among airports.

It is assumed that each option can achieve the desired level of return to the Crown.

Table 5.5.2
Options re Rental Formula

Rental Option	Advantages	Disadvantages
LAA formula	<ul style="list-style-type: none"> • "base" and "participation" components provide flexibility to deal with all phases of the business cycle (i.e., rents would generally be higher during more favourable economic conditions, and generally lower in less favourable conditions) • provides incentive to airport operator to reduce costs 	<ul style="list-style-type: none"> • different rental categories and rates could affect the rent payable and do require additional effort on the part of airports (calculation) and Transport Canada (review and audit).
CAA formula	<ul style="list-style-type: none"> • "base" and "participation" components provide flexibility to deal with all phases of the business cycle • provides incentive to airport operator to reduce costs • less administration than LAA formula 	<ul style="list-style-type: none"> • significant administrative effort still required
Flat amount per passenger (could increase over time)	<ul style="list-style-type: none"> • variability of rent with number of passengers provides flexibility to deal with good and bad times • incentive to reduce costs • administratively simple 	<ul style="list-style-type: none"> • as the rates per passenger would vary among airports, there could be difficulties with public perceptions of equity (e.g., rate could be higher for airport X than for airport Y, because of the higher proportion of long-haul international traffic at the former) • pressure from CAAs to make changes across the system
Fixed percentage of revenues	<ul style="list-style-type: none"> • variability of rent with revenues provides some flexibility to deal with all phases of business cycle • incentive to reduce costs • likely to require least amount of administrative effort (only slightly less than passenger option) and provide earliest availability of final figures • likely to be the best option from the standpoint of equity among airports and public perceptions of equity among airports (i.e., percentage could be the same for all airports) 	<ul style="list-style-type: none"> • revenue recognition remains an issue for rent determination purposes

5.6 AIRPORT IMPROVEMENT FEES

5.6.1 Issue Description

Airport Improvement Fees (AIFs) have become a significant source of revenue for the LAAs, surpassing each of the major aeronautical charges, landing fees and general terminal fees, by a significant margin for at least one LAA. While AIFs were contemplated prior to the transfer of the airports, it is not clear that AIFs were expected take on as significant a role as they now play in the funding of the LAAs. By their nature, AIFs present special issues that do not exist in respect of the major aeronautical charges which historically have been the mainstay of airport revenues. The federal government has not articulated any kind of policy on AIFs.

Concerns have been expressed by some users that the LAAs could use the AIF as a source of funding for activities other than capital expansion projects, including airport operating expenses and subsidiary ventures.

Preliminary results from the Public Survey indicated a considerable level of traveller and community resident acceptance of AIFs. Almost three-quarters of travellers and residents surveyed feel that the use of an AIF to improve or modernize facilities is somewhat or very appropriate. Roughly the same proportion believes that the price being charged at the time of the survey represented a fair price¹⁵. The current method of AIF collection is acceptable to travellers, but they would prefer the AIF to be collected at the time of ticket purchase and listed separately on the ticket. Only about one-quarter of the travellers surveyed find it unfair to pay for benefits accruing to future travellers.

5.6.2 Issue Discussion

- AIFs are fees imposed on passengers, primarily for the purpose of generating funds for capital improvements at the airport. All of the LAAs have implemented AIFs. At Vancouver, Edmonton and Dorval, the AIFs are collected directly from passengers at the airport, prior to departure. At Calgary, the AIF is collected by airlines and travel agents at the time of ticket purchase. There is no AIF at Mirabel.
- Several factors appear to have contributed to the decision to introduce such fees, rather than increase existing charges such as landing fees and general terminal fees:
 - Airlines prefer the AIF option, because the fee does not become part of their cost structure and, with the exception of one LAA, they are not involved in the collection of the fee (airlines are compensated for collection of the AIF for that one LAA through ATAC);
 - AIFs are attractive to airport operators, because the burden of consultations is generally less than in the case of increases in existing user charges. Consultations show that the interests of airlines and passengers are similar with respect to increases in traditional airport fees, landing fees and general

¹⁵ The AIF has doubled at one of the LAAs subsequent to the survey.

terminal fees. These interests seem to diverge in respect of the AIF. Airlines have historically been required to collect federally imposed fees/taxes paid directly by passengers (e.g., former Air Transportation Tax). There is no practical forum for consultations directly with passengers to compensate for this divergence; and

- The financial community preferred the AIF option and imposed certain covenants for the funding of new construction from operating cashflows. The revenue requirements following from such covenants would have resulted in very large increases in existing charges, which would likely have been strongly resisted by the airlines.
- These fees have become significant sources of revenue for the LAAs, accounting for between 18% and 32%¹⁶ of total airport revenues in 1998.
- In the United States, a combination of formula and government regulation is employed in respect of Passenger Facility Charges (PFCs), the name given to AIFs in that country. The self-regulatory mechanism in place for more traditional forms of aeronautical charges was not considered appropriate for PFCs:
 - the amount of a PFC is set by formula. Federal regulations specify that a PFC may be set at either \$1, \$2 or \$3 per enplaned passenger (the U.S. Department of Transportation has proposed an increase in the maximum fee to \$5);
 - the PFC Office of the Federal Aviation Administration must approve the introduction of a PFC. Before granting authority to impose a PFC, the PFC Office reviews the extent of local consultations, the use to which the revenues will be put, and the duration of the PFC, with a focus on the justification for the project and the views of airlines. Once approved, PFC revenues may only be used for project purposes stated in the application. In addition, federal formula-based grants, for which the airport is otherwise eligible, are reduced by 50% of PFC revenues; and
 - no round-trip ticket may be subject to more than four PFCs.
- The initial establishment of AIFs has been associated with the funding of a major capital program at each LAA. Nevertheless, with the exception of one LAA at which there is an agreement with the airlines on the AIF, it is not certain that AIF revenues are dedicated to the funding of the particular capital program.
- The explicit linkage to capital improvements at the above-referenced LAA is part of an agreement with the Air Transport Association of Canada, which essentially involves a commitment from the airlines to collect an AIF, but only after a prescribed consultation process has been completed. A number of other conditions are attached to the collection of the AIF by the airlines:
 - revenues shall only be used to fund a program of major capital projects, including associated financing costs, which are related to the primary

¹⁶ A study by the U.S. General Accounting Office showed that Passenger Facility Charges accounted for 18% of the funding sources for the 71 largest airports in the United States in 1996.

- functions of the airport (there is an explicit prohibition against the use of AIF revenues to pay for operating and maintenance costs);
 - the period of construction must be for a minimum of five years and a maximum of 10 years;
 - the total estimated costs of the program must be at least 50% of the annual revenue of the airport, excluding AIF revenues, in the first year of the program;
 - the amount of the fee must be either \$5, \$8 or \$10, and is to be adjusted for inflation every five years;
 - the fee must be discontinued when AIF-funded projects have been completed and the associated debt retired.
- It should be noted, however, that these constraints apply only as long as the airlines are collecting the AIF. The LAA could avoid such constraints by collecting the AIF directly from passengers, as is the case at the other LAAs.
 - AIFs can result in additional administration costs when a new collection method has to be established, regardless of whether the AIF is collected directly from the passenger or collected by the airlines.
 - While Transport Canada has not established an explicit requirement for the LAAs to limit the use of AIF revenues to capital projects, the lease formula now in effect at two of the LAAs provides financial disincentives (i.e., higher rents) against the generation of AIF revenues in excess of eligible capital expenditures.
 - AIFs are also being introduced by Canadian Airport Authorities. Financial needs differ significantly among airports. For some of the smaller Canadian Airport Authorities, the AIF may play a key role in ensuring the ongoing viability of the airport (i.e., could be required to cover operating and maintenance costs).
 - The absence of a stated relationship between AIFs and particular costs is another illustration of the problems in transparency discussed in section 5.8.
 - The use of AIF funds for airside projects means that certain users, who would benefit from improved facilities (i.e., commercial cargo operators, non-commercial aircraft operators), would not be helping to pay for those facilities. Even where funds are used for passenger-related facilities, there may also be equity issues related to the exemption for connecting passengers, who may contribute to the need for additional facilities. Where AIFs are used to produce a substantial amount of upfront financing of facilities, there is an issue of intergenerational equity (i.e., how much should today's users pay for facilities that will benefit users in the future?).

5.6.3 Options

Five basic options in respect of Airport Improvement Fees have been identified in Table 5.6. These options are quite similar to the four basic options for Economic Oversight.

- the status quo;
- guidelines in respect of AIFs, including consultation thereon, the level, the duration, the use of the revenues, the manner of collection, and the degree of upfront funding;
- requirements set out in new legislation/regulations or in amendments to the ground lease, dealing with the same issues as in the previous option. The requirement would be accompanied by some practical remedy for non-compliance;
- a requirement for the airlines and the LAA to reach a formal agreement on an AIF before one is introduced or increased. Given the lack of opportunities for passengers to express their views, it seems likely that such an option would involve certain prescribed elements (i.e., to avoid an agreement that might be suitable to both the airlines and the LAA, but might contain elements that would go against the interests of individual travellers). Another factor to be considered is the strong market power that large airlines may possess at particular airports. There is also a need to ensure that the interests of one or more large airlines do not constrain the LAAs in pursuing development projects which are in the best interests of the airport authority and the travelling public at large; and
- requirement for federal government approval of all AIFs, similar to arrangements in the United States.

Table 5.6
Options re Airport Improvement Fees (AIFs)

Options	Advantages	Disadvantages
Status quo	<ul style="list-style-type: none"> • AIFs have played a key role in the financial success of the LAAs • AIFs appear to have a fair level of acceptance among stakeholders 	<ul style="list-style-type: none"> • the nature of AIFs (i.e., a charge imposed on passengers, with whom there is no practical way to consult) removes one of the key components of self-regulation (i.e., consultation) • lack of transparency (i.e., relationship between AIF revenues and specific costs)
Guidelines on AIFs (e.g., consultation, collection methods, use of revenues, duration, level, degree of upfront funding)	<ul style="list-style-type: none"> • clear statement of performance standards would strengthen self-regulation • no legislative or lease amendment required 	<ul style="list-style-type: none"> • no formal means to enforce
Requirements for AIFs (e.g., consultation, collection methods, use of revenues, duration, amount, degree of upfront funding)	<ul style="list-style-type: none"> • clear statement of performance standards would strengthen self-regulation • means to enforce compliance 	<ul style="list-style-type: none"> • requires legislative action or reopening of lease
Requirement for LAA to reach agreement with airlines	<ul style="list-style-type: none"> • an agreement between airlines and an LAA is practical (agreements are in effect at Calgary, Winnipeg and Kelowna) • keeps federal government out of enforcement 	<ul style="list-style-type: none"> • potential for airport development to be constrained by airline self-interests • care must be taken not to impose restrictions that would impair ability of smaller airports to achieve and maintain viability • requires reopening of lease or legislative action
Requirement for federal gov't approval of AIFs (as in the United States)	<ul style="list-style-type: none"> • maximum protection for stakeholders • precedent exists in North America 	<ul style="list-style-type: none"> • no longer self-regulation • requires new government administrative process • federal government effectively involved in pricing issues

5.7 SUBSIDIARIES

5.7.1 Issue Description

Three of the LAAs have established for-profit subsidiaries to engage in a variety of commercial activities in Canada and/or abroad. While the policy framework allows the LAAs to become involved in ancillary activities, it is not clear that the current scope of such activities would have been anticipated in the design of the LAA model and governance structure. No explicit policy framework was established in respect of ancillary activities.

Ancillary activities through subsidiaries raise such issues as: the risk profile of subsidiaries, the potential for revenue diversion, repatriation of profits, financial disclosure and transparency of information, the governance of subsidiaries, and the potential for unfair advantages to subsidiaries.

Airlines have expressed concerns about the risks associated with subsidiaries, as financial losses could fall back on airport users in the form of higher charges. They see subsidiaries as having the potential to distract management attention and to divert airport funds. They are also concerned that there is no assurance that any subsidiary profits will flow back to the parent LAA for the benefit of its stakeholders. The airlines have expressed a strong desire to obtain adequate information on subsidiaries, in order to ensure that there is no cross-subsidization.

In the Public Survey, community residents and travellers surveyed were split on whether LAAs should pursue other business activities. Of those who support such activities, over 6 in 10 agree with the pursuit of both activities on the airport and a broader range of activities. A strong majority, however, were opposed to the use of airport funds off the airport. Only about 2 in 10 residents surveyed would support the use of AIF revenues to subsidize for-profit subsidiaries. Support from travellers is slightly lower.

5.7.2 Issue Discussion

- The *Canada Corporations Act* provides broad authority for non-share capital corporations to engage in ancillary activities¹⁷. Alberta's *Regional Airports Authorities Act* also allows the establishment and operation of subsidiaries. The purpose clause of the Alberta Act may have the effect of narrowing the scope of subsidiary activities (i.e., reference to "general benefit of the public of the region").
- The Supplementary Principles for the Creation and Operation of Local Airport Authorities (1988) state that an LAA is "intended to manage and operate a local airport system and associated business enterprises". They also provide that an "... LAA will be free to undertake non-aviation related activities that are compatible with the broad socio-economic interests of the LAA's adjacent communities and the province".

¹⁷ Section 16(1) of *Canada Corporations Act*

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- The LAAs presently have a total of 13 active subsidiaries. One LAA has 10 subsidiaries, another has two subsidiaries, and a third LAA has one subsidiary.
- These subsidiaries operate both domestic and international airport and non-airport related businesses in the following areas:
 - airport management and operational services. Presently, six airports in Canada and at least four airports abroad are operated by LAA subsidiaries;
 - national and international airport marketing and consulting services. Services have been provided to tourism authorities and entities outside the air mode;
 - financing and construction of airport facilities; and
 - new airport-related business ventures, including equity investments made by LAA subsidiaries in airports in Eastern Europe, South America, and the South Pacific. Investments of this kind may be necessary, in some cases, to access contracts for airport management services.
- The current financial status of the for-profit LAA subsidiaries, and the financial arrangements between the LAAs and their subsidiaries, are difficult to determine due to fragmented and incomplete financial disclosure and transparency. However, it would appear that, based on limited 1997 financial information, subsidiaries in total appear to have generated around \$10 million in revenues, hold over \$20 million in total assets, and to have recorded a net loss of under \$500,000. The subsidiaries would appear to have approximately \$17 million in non-interest bearing loans with no specific terms of repayment outstanding to the not-for-profit parent LAA. It is not known whether any of the subsidiaries have loans from other parties that might contain some form of guarantee by the LAAs.
- Circumstances appear to be conducive to the creation of additional subsidiaries in the future. Tax incentives, financial flexibility, the lease structure and lack of subsidiary restrictions may all be factors. The initial LAA lease is written such that the Crown is permitted to collect rents from airport developments and revenues made on the airport site only. LAA off-airport business ventures are not subject to Crown rent. The newer Canadian Airport Authority lease, on the other hand, stipulates that the Crown is permitted to collect rents from airport developments and revenues worldwide. In the case of LAAs, the movement of parts of their non-core airport businesses off-site and the creation of subsidiaries have allowed them to shelter certain revenues from the Crown and to develop financial flexibilities which are not permitted within the CAA structure. These subsidiaries are "for-profit" and subject to income tax. To-date, few subsidiaries have paid taxes, due to the accumulated losses or tax planning strategies aimed at reducing taxable income.
- Other not-for-profit providers of transportation infrastructure are subject to varying degrees of restrictions in respect of ancillary activities. NAV CANADA is free to engage in such activities, however, the profits from such activities must be applied against NAV CANADA's costs in determining the financial requirements which provide the upper limit on charges for civil air navigation services. The Canada Port Authorities are intended to be focused on port operations. Only activities necessary

to support port operations are to be undertaken (although certain existing activities are grandfathered). Port subsidiaries are only permitted to undertake activities that the federal government approves through an Order-In-Council. The port parent is not permitted to provide loans to a subsidiary or to indemnify a subsidiary. Subsidiaries are not to receive commercial advantages through the port parent.

- Internationally, it is common for major European airports to operate one or more subsidiaries. The one distinguishing feature is that the national governments (and other levels of government) typically have an equity stake in the airport, providing safeguards for the public interest. For example, Amsterdam Airport Schiphol has a large number of subsidiaries. Its shareholders are the national government (76%), the City of Amsterdam (22%) and the City of Rotterdam (2%). The British Airports Authority (BAA) operates a number of subsidiaries. In this case, there is no government shareholding (apart from one "golden share"). An element of control over subsidiary activities exists, however, by way of the CPI minus X% cap on aeronautical revenues imposed by the Civil Aviation Authority, following a review by the Monopolies and Mergers Commission. This cap would appear to effectively prevent the BAA from recovering any subsidiary losses from aeronautical users.
- By contrast, the U.S. and Australia, have enacted legislation to restrict airport subsidiaries. In the U.S., the *Federal Aviation Act (FAA)* prohibits airport subsidiaries from being established and does not permit airport authority revenues to be diverted into subsidiary activities. In Australia, where major airports are leased to for-profit airport companies for 50 years, the *Airports Act 1996* prohibits activities that are not incidental to the operation and development of the airport.
- Each of the types of business activities undertaken by subsidiaries has a different level of financial risk. Domestically, LAA financial risk appears to be lower in activities involving airport consulting and marketing and generally higher when subsidiaries are providing direct financing for companies locating their businesses on the airport site. The financial risk appears to be low when one domestic airport authority manages and operates another Canadian airport on a fee for service basis. Airport consulting/management services can be of substantial benefit to smaller airports, particularly those airports operated locally for the first time under NAP.
- When airport management and consulting services are provided outside the country, there is a general benefit to Canada from the export of high-value Canadian services. However, when Canadian LAA subsidiaries become involved internationally, there can be greater financial risks. In the case of equity participation in international airports, there are greater risks due to the significant financial commitments required and the particular country's economic and political situation. Currency and inflation fluctuations, as well as, credit risks represent ongoing risks, though these can be hedged. There are also other risks related to foreign projects tied to economic conditions. The LAAs indicate that, if Canadian airport subsidiaries are to compete successfully in the international marketplace for foreign airport management and operational contracts, equity participation (usually in the range of 10 to 20 percent) is becoming a required element of most agreements.

- The issue of financial risks would be further complicated if the Canadian parent airport authority were to indemnify the loan for a subsidiary's equity participation in foreign airports. In this instance, the financial risk to LAA stakeholders would be greater as the parent company would assume full financial responsibility for the subsidiary's loan and, in the case of default, would be required to pay the outstanding portion of the loan. This situation could potentially lead to an increase in Airport Improvement Fees (AIFs), landing fees and/or general terminal fees at Canadian airports with subsidiary activities. One LAA has stated that it has structured its subsidiaries in a way that the liability to the parent LAA is limited.
- With the establishment of airport authority subsidiaries, there appears to be an increased possibility for the diversion of revenues off airport through vehicles such as working capital loans, interest-free loans and other forms of financial security. For example, as previously noted, there already are approximately 17 million dollars in non-interest bearing loans with no specific terms of repayment. These loans have been mainly in the form of working capital, but a portion of these loans/subsidiary profits have been used for equity participation in foreign airports. These loans also contain no specific requirements for the payment of interest or the repayment of principal and may provide an unfair advantage to the subsidiaries vis-a-vis any competitive businesses.
- Associated with revenue diversion is the issue of repatriation of subsidiary profits. LAA users argue that, if they are to bear risks associated with potential subsidiary losses, they should benefit from profits generated in such activities. There is also an issue about the repayment of loans provided by parent LAAs. There are already indications that profits earned by a subsidiary have been used to provide funding to another subsidiary.
- Revenue diversion would be further complicated if any of the subsidiaries were to have an element of foreign ownership.
- A common message emanating from key stakeholders throughout the LAA Lease Review has been the lack of financial transparency and disclosure of LAAs and their subsidiaries. There would appear to be several dimensions to the transparency issue in respect of subsidiaries. Certainly, there is some information available. Consolidated financial statements for the LAAs and Annual Reports provide some information. The information is aggregated, however, and would not appear to provide much transparency into second and third level subsidiaries.
- There may also be an issue in respect of the governance of subsidiaries. The main issue concerns the overlapping of directors of the LAAs and subsidiaries. At one LAA, the subsidiary directly owned by the LAA has a four-person Board consisting of the LAA Chairperson, two other directors and the CEO of the LAA (also a member of LAA Board). The LAA Chairperson is also the Chairperson of the subsidiary. This subsidiary has subsidiaries of its own. There are no common directors between the first-line subsidiary and the second-line subsidiaries. At another LAA, the

subsidiaries have three-member Boards, all of whom are members of the LAA Board. There does not appear to be a prohibition against such practices, per se¹⁸. Common directors would appear to provide both potential advantages and disadvantages.

- On the positive side, decisions in the subsidiaries can be made with complete understanding of the interests of the parent. As directors of for-profit corporations, the fiduciary responsibility of the subsidiary directors is to act in the best interests of their corporations. The best interests of a for-profit corporation are normally equated with enhancing shareholder value. In this case, the shareholder is the LAA. It could be argued that the directors of the LAA are in the best position to determine the best interests of the LAA.
- On the negative side, there may be a question as to whether the Board of the parent would exercise as much scrutiny vis-à-vis the subsidiaries, when the Board of the subsidiaries is made up of their LAA Board colleagues, as it would if there was less overlap between parent and subsidiary Boards. The fact that the Chairperson of the subsidiary is the LAA Chairperson might also have an effect on the level of scrutiny. Nevertheless, whatever the overlap between the Boards, directors are still required to perform reasonable due diligence as a result of their fiduciary responsibilities.
- There is an additional governance issue resulting from the fact that some subsidiaries report directly to the Board, by-passing LAA management.

5.7.3 Options

Four main options are identified in Table 5.7 in respect of subsidiaries:

- the status quo;
- guidelines on subsidiary practices could address the scope of subsidiary activities, the nature of parent/subsidiary transactions, interface between parent and subsidiary Boards, the distribution of subsidiary profits, and the disclosure of subsidiary information;
- mandatory requirements for subsidiary practices, in either an amended ground lease, legislation/regulations, or the LAA Letters Patent/Articles of Incorporation; and
- prohibition against subsidiary activities.

¹⁸ Both Directors' Duties, prepared by Osler, Hoskin & Harcourt and the *Regional Airports Authorities Regulation* (section 21) speak to certain requirements in respect of common directors for affiliated companies, indicating that the practice is not prohibited per se.

Table 5.7
Options re Subsidiaries

Options	Advantages	Disadvantages
Status quo	<ul style="list-style-type: none"> allows LAAs to take full advantage of commercial opportunities, which provide benefits to other Canadians (e.g., provision of expertise to small airports, export of high-value services) 	<ul style="list-style-type: none"> problems have been identified re subsidiaries (e.g., transparency of information) ready means to address problems not available no oversight
Issue guidelines on subsidiary practices (e.g., scope of activities, nature of parent/subsidiary transactions, distribution of profits, disclosure of information)	<ul style="list-style-type: none"> allows LAAs to pursue opportunities, with a clear understanding of what is expected of them 	<ul style="list-style-type: none"> no enforcement mechanism in event of non-compliance
Establish mandatory requirements for subsidiary practices (e.g., scope of activities, nature of parent/subsidiary transactions, distribution of profits, disclosure of information)	<ul style="list-style-type: none"> allows LAAs to pursue opportunities, with a clear understanding of what is expected of them enforcement mechanism available 	<ul style="list-style-type: none"> requires changes in lease, Letters Patent/Articles of Incorporation, or legislative action
Prohibit subsidiary activities	<ul style="list-style-type: none"> removes risks to stakeholders 	<ul style="list-style-type: none"> would deprive LAAs and other Canadians of potential benefits (e.g., provision of expertise to small airports, export of high-value services)

5.8 TRANSPARENCY

5.8.1 Issue Description

One of the key elements of a well functioning self-regulatory model is transparency in information and decision-making. In addition, one of the Six Characteristics of Effective Governance developed by the Canadian Comprehensive Auditing Foundation is that governing bodies "... fulfill their accountability obligations to those whose interests they represent by reporting on their organization's effectiveness"¹⁹.

A number of the studies undertaken as part of the Lease Review Project have identified deficiencies in the transparency of the LAAs, the most significant of which pertain to the provision of cost data in support of user charges and data on ancillary activities through subsidiaries, as well as the financial interface between LAAs and their subsidiaries.

5.8.2 Issue Discussion

- Users require information on the costs of airport services to enable them to make a determination of the reasonableness of the charges they are required to pay.

¹⁹ These six characteristics are used in the Governance study as criteria for the identification of critical issues.

- When the LAAs took over operation of their airports, they retained the fee structure that had been applied by Transport Canada. That structure included two major aeronautical fees, landing fees and general terminal fees, which historically had been set by Transport Canada on a system-wide, residual basis²⁰. In other words, there was no direct relationship between a particular fee at an individual airport and the costs of specific facilities and services at that airport. It should be noted that, while Transport Canada did not have a detailed cost accounting system in place, indications were that most of the fees at the LAAs were at less than full cost recovery at the time of transfer. Many fees were in a substantial under-recovery position.
- In its Pricing Practices report, KPMG has indicated that the LAAs' total fee increases reflect the substantial expansions at all four airports, and improvements required as a result of: strong traffic growth, deferrals of improvements during the period proceeding the transfer, the cessation of free police services, and the elimination of the financial losses incurred by three of the four LAAs under Transport Canada operations. Additional revenue initiatives have mainly been in the form of new fees, the most significant of which is the Airport Improvement Fee (discussed in section 5.6). In addition to AIFs, the LAAs introduced new fees in the form of transborder pre-clearance fees, international turnaround fees, common-use facility fees for check-in counters and other facilities used jointly, and security fees. KPMG has reported that only one of the LAAs has undertaken comprehensive costing or cost allocation studies that could demonstrate the extent of cost recoveries at the airport or its major sub-systems²¹. Three of the LAAs have stated that they intend to conduct comprehensive costing studies in 1999.
- The airlines maintain that there is inadequate disclosure by the LAAs of information required to make a determination of the justification for current aeronautical charging levels.
- As discussed in section 5.7.2, there appear to be gaps in the information available in respect of subsidiaries. The airlines are particularly concerned that there is insufficient information available to them to ensure that there is no cross-subsidization of subsidiaries by core LAA activities.
- In the Key Stakeholder Consultations, the LAAs indicated a belief that they are making substantial efforts to ensure that airport customers and related stakeholders are well informed about airport operations and progress in meeting projected service levels and financial goals. Airlines maintain, however, that insufficient information is provided to fully understand the rationale for certain decisions.

²⁰ The two major aeronautical fees were determined by pooling the costs of the airports in the International System and offsetting, against those costs, all other revenues at those airports. The two fees were then set to recover a part of the "residual" unrecovered costs. The levels of the fees were determined by the target cost recovery percentage for the airport system as a whole.

²¹ The only studies were estimations of incremental costs for the purpose of calculating the four new fees noted above (e.g., international turn around fees). One LAA did a more detailed study for calculating new transborder preclearance and international turn around fees.

- As noted in section 5.4.2, the Air Transport Association of Canada has recommended the development of principles on airport pricing, similar to those established for NAV CANADA. These principles include a requirement for cost transparency. The *Civil Air Navigation Services Commercialization Act* requires that charges be established in accordance with a methodology that is explicit and published by NAV CANADA. Charges must not generate revenues in excess of financial requirements in relation to the provision of civil air navigation services. All profits earned from activities other than the provision of civil air navigation services must be taken into account in determining these financial requirements. NAV CANADA is also required to make available a document containing details on proposals to introduce or revise charges. This document must include a justification for the proposals in relation to the prescribed charging principles.
- The International Air Transport Association has also expressed concern about a lack of transparency. They have commented that requests for information are often seen by the LAAs as being an "intrusion".
- There appears to be less of an issue of transparency with respect to information provided to the nominating entities and the general public. The LAAs appear to make substantial efforts to keep both groups informed. The information needs of nominating entities and the general public are, however, quite different than the needs of users paying airport charges.
- To date, there has been no indication of concerns on the part of LAA nominating bodies with the transparency of information. There is a mandated requirement for an annual meeting of the LAA with nominating bodies. At least one LAA holds such meetings on a quarterly basis. In addition, although nominating bodies are not entitled to receive confidential information from a director that they nominate, they do have access to obtain information that is in the public domain. The LAAs have indicated that they place a special emphasis on meeting the needs of nominating bodies.
- The general public seems fairly satisfied with the information available to it. There are a variety of sources of information available to the public, including the annual general meeting, annual reports, web-sites and newsletters. The Public Survey revealed that, although only a small percentage of community residents appear to have availed themselves of the various opportunities to obtain airport information, overall, community residents feel that they are at least somewhat well informed about their airport(s). At three of the LAAs, at least two-thirds of the respondents indicated that they are either very well informed or somewhat well informed about the airport. However, only a little over one-third of the residents surveyed for the remaining LAA indicated that they were at least somewhat well informed. Community residents at the first three LAAs were roughly split on whether they wanted more information, while roughly 6 in 10 indicated a desire to receive more information at the remaining LAA (overall, only 5% of respondents said they wanted less information).

- In its report on Governance, Consulting and Audit Canada concluded that there are significant transparency problems. As a minimum, a need for transparency improvements was seen in respect of the justification for airport charges, principles to link charges to costs, consultation guidelines, performance indicators, five-year performance reviews, and corporate financial reporting.
- LAA attitudes towards disclosure are also influenced by their attitudes on where they sit on a spectrum of private and public sector entities. Entities seeing themselves more on the private sector end of the spectrum appear to have a tendency to see the requirements for disclosure in more limited terms.
- Internationally, of four countries surveyed (i.e., Australia, New Zealand, United Kingdom and United States), all have established legislative or regulatory requirements for transparency/disclosure of information. In addition, the United States and New Zealand have explicit requirements in terms of consultation. For example, in New Zealand airport companies are required to consult with every "substantial customer"²² before introducing or revising a charge, including a charge payable directly by passengers, or within 5 years of having introduced or revised a charge (i.e., apparently to deal with situations where over-recovery may result from traffic growth, without increases in charging unit rates). Airports over a specified financial threshold must not approve capital expenditures, which over a five-year period would be equal to or greater than 20% of the value of the airport assets at the beginning of the period, unless every substantial customer has been consulted on those expenditures. In addition, the legislation authorizes regulations in respect of the disclosure of certain types of information. The provision exists for financial penalties for non-compliance with such regulations (i.e., maximum fine of 200,000 NZ\$, plus a maximum of 10,000 NZ\$ for each continuing day of non-compliance).

5.8.3 Options

There would appear to be three basic options concerning transparency:

- status quo;
- explicit guidelines for improved transparency;
- mandatory requirements, set out in legislation/regulations or in an amended ground lease.

The main advantages and disadvantages of these options are presented in Table 5.8. Whether established as guidelines or as requirements, the following areas would appear to have relevance to the issue of transparency:

- justification for airport charges. This condition could include a requirement for an LAA to develop an explicit statement of a consistent methodology for the determination of charges and to make certain kinds of information available to users to demonstrate that the charges are in accordance with the methodology;

²² A "substantial customer" is defined as any person who paid more than 5% of the charges in respect of a particular activity.

- consultations (e.g., matters to be consulted on, minimum time frames);
- five-year performance reviews. Guidelines/requirements could address both content and process. From a content perspective, areas of required investigation could be specified (e.g., review of subsidiary activities, prescribed performance indicators). From a process standpoint, transparency would be improved if all stakeholders had access to the results of the review. At present, only nominating entities and Transport Canada have access to the results of the reviews at two of the LAAs;
- performance indicators. At least two of the LAAs have indicated that they are working to develop a set of performance indicators that could be helpful in giving greater transparency to the LAA's accomplishments in the area of cost efficiency. While differences among airports are likely to make inter-airport comparisons difficult, trends within a given airport should be meaningful;
- corporate financial reporting;
- requirement for, and contents of, web-site. All of the LAAs have their own web-sites. The contents vary among LAAs. At present, LAAs are required, as a condition of the ground lease, to make certain information available to any person who asks to see such information at the LAA's head office. Such information includes (additional items are included for LAAs subject to the Public Accountability Principles for Canadian Airport Authorities and the Alberta legislation):
 - current Airport Master Plan;
 - current annual expenditure plan for a five-year period;
 - most recent and previous annual financial statements and accompanying auditor's reports of "the Tenant and of each of its subsidiaries and of each corporation whose accounts are consolidated in the Tenant's financial statements";
 - five most recent annual reports; and
 - articles of incorporation and by-laws.This information could be made available through the web-site; and
- reporting on subsidiary activities and financial relationship with the LAA.

Table 5.8
Options re Transparency

Options	Advantages	Disadvantages
Status Quo	<ul style="list-style-type: none"> notwithstanding deficiencies in transparency, current model has performed well overall 	<ul style="list-style-type: none"> no clear standards for acceptable/expected practices no formal means to deal with transparency problems
Guidelines (in respect of justification for airport charges, consultation, performance indicators, five-year performance reviews, corporate financial reporting, requirement for and contents of web-site, reporting on subsidiary activities and financial relationship with LAA)	<ul style="list-style-type: none"> consistent with intended spirit of self-regulation clear statements of performance standards strengthen self-regulation 	<ul style="list-style-type: none"> no formal means to deal with problems, should they persist
Requirements (in respect of justification for airport charges, consultation, performance indicators, five-year performance reviews, corporate financial reporting, reporting on subsidiary activities and financial relationship with LAA)	<ul style="list-style-type: none"> ability to enforce, significantly strengthens self-regulation 	<ul style="list-style-type: none"> new or amended legislation, or amendment to ground lease, required

5.9 FEDERAL INCOME TAX

5.9.1 Issue Description

With the objective of assisting the financial viability of newly-formed LAAs, a legislated exemption from federal income tax was provided in the *Airport Transfer (Miscellaneous Matters) Act (1992)*. The Act states that an airport authority, which would include LAAs and Canadian Airport Authorities, would be exempt from federal income tax on income derived from an "airport business", provided that the corporation does not distribute any income or capital for the benefit of any member of the corporation and all, or substantially all, of the gross revenue of the corporation was earned from an airport business.

In 1992, LAAs were pioneers in alternative service delivery. There was no precedent for commercializing a government function into not-for-profit organizations. As there was very little historical information (no financial track record as a corporation) and the LAA model was unique, there was a lot of uncertainty as to whether LAAs would be financially viable. Confusion with regard to the tax status of the LAAs added to concerns about financeability. As a result, extra certainty in respect of taxation (through specific legislation) was deemed necessary.

5.9.2 Issue Discussion

- The *Income Tax Act* exempts not-for-profit organizations from taxation, provided that they act in accordance with their stated not-for-profit goals and mandate (prescribed in constating documents such as articles of incorporation/letters patent and by-laws).
- As discussed in previous sections, concerns about the financeability of the LAAs are no longer applicable. The LAAs have strong market power and are financially viable over the short, medium and long term. LAAs have established a positive financial track record and the financial community has developed a high degree of comfort with these entities.
- Since the creation of the LAAs, government policy and thinking has evolved on not-for-profit organizations. More recent transportation entities are a reflection of these new policies. Transport Canada has commercialized other transportation functions, and transferred these to non-share capital/not-for-profit organizations (e.g., NAV CANADA, Canada Port Authorities, etc). Neither NAV CANADA, the Canada Port Authorities, nor the St. Lawrence Seaway Management Corporation (SLSMC) have an explicit exemption from federal income tax. NAV CANADA has not been subject to income tax, based on interpretations by Revenue Canada. Canada Port Authorities and the SLSMC are not expected to be taxable, based on such interpretations.
- Explicit exemptions covered by a piece of legislation other than the *Income Tax Act* are generally not considered to represent good tax policy. In the case of the LAAs, the legislated exemption has the potential to influence their behaviour in the opposite direction of the stated not-for-profit mandate, by removing Revenue Canada's authority to check on the not-for-profit behaviour of the LAAs. In the absence of the legislated exemption, the determination of whether an LAA is operated in accordance with its not-for-profit purposes would be made by Revenue Canada.
- Removal of the legislated exemption would:
 - not alter the not-for-profit status of the LAAs. The LAAs would retain this status as long as they continued to act in accordance with their not-for-profit objectives;
 - allow the LAAs to make "profits", and still remain exempt from the payment of income tax, as long as such funds were reinvested in the not-for-profit organization. The LAAs could also build up capital reserves without incurring tax, provided that the reserves were used for capital purposes;
 - not restrict the pursuit of ancillary activities through subsidiaries. LAAs could have as many for-profit subsidiaries as they wanted. The tax status of the subsidiaries is not relevant to the tax status of the parent LAA. However, the nature of the transactions between the parent and the subsidiary would be relevant. The LAAs would have to pay attention to this arrangement to ensure the continuation of their tax-exempt status, given the non-arms' length relationship between the not-for-profit parents and the for-profit subsidiaries;

- treat the LAAs the same as all other not-for-profit providers of transportation infrastructure; and
- give Revenue Canada the check and balance role over airports, a role that it now has in respect of all other not-for-profit corporations in Canada.

5.9.3 Options

Table 5.9.1 examines the main advantages and disadvantages of two options in respect of federal income tax:

- the status quo (continued explicit exemption); and
- removal of explicit exemption.

Table 5.9
Options re Explicit Exemption from Federal Income Tax

Options	Advantages	Disadvantages
Status quo (i.e., continued explicit exemption)	<ul style="list-style-type: none"> • legislated certainty of tax exemption 	<ul style="list-style-type: none"> • potential for unintended effect on LAA behaviour • original rationale no longer applicable (i.e., not required for financeability) • inconsistent with treatment of other not-for-profit providers of transportation infrastructure • element of system of checks and balances is missing (no role for Revenue Canada)
Elimination of explicit exemption (i.e., recurrent interpretation by Revenue Canada)	<ul style="list-style-type: none"> • no change in taxable status of LAAs • consistent with treatment of other not-for-profit providers of transportation infrastructure • would provide an additional element to system of checks and balances (i.e., ongoing incentive to act in a not-for-profit manner) 	<ul style="list-style-type: none"> • none apparent

5.10 GROUND LEASE

5.10.1 Issue Description

The ground lease defines the contractual arrangements between the LAA and Transport Canada for the lease of the Demised Premises which consist of the airport lands, buildings, machinery and equipment at the time of the transfer.

The ground lease establishes all aspects of the commercial landlord/tenant relationship. While the ground lease is primarily a commercial agreement, it is not exclusively so. It also addresses a number of matters of a governance nature.

The ground lease is a complex document, which extends to over 300 pages. The LAAs have criticized the ground lease as being complex, thereby creating a substantial administrative burden. Much of the criticism relates to the rental formula which is discussed separately in section 5.5.

Finally, the lack of moderate enforcement levers available to Transport Canada in the ground lease is an important issue as the only formal enforcement levers are notices of non-compliance and/or default.

5.10.2 Issue Discussion

- A standard ground lease was used for each LAA. The only differences are in respect of the specific rental formulae, any provisions to deal with airport-specific circumstances (e.g., bridges and dykes at Vancouver International Airport), and a relatively small number of minor variations in wording²³.
- While the ground lease is primarily a commercial agreement, it also addresses a number of matters of a governance nature in Article 9, Corporate Matters, including:
 - desired skills for Board members;
 - requirement for conflict-of-interest rules for Board members;
 - requirement for Ministerial approval to change instruments of incorporation in respect of not-for-profit status, composition of Board, and process for appointment to Board;
 - requirement for annual public meeting and specification of certain characteristics for such meetings;
 - requirement for an independent performance review every five years, to be conducted by an independent expert retained by the LAA; and
 - specification of material to be made available to any person at the LAA's head office.

²³ Certain other differences of a governance nature are to be found in the amended ground leases for Calgary and Edmonton as a result of their partial adoption of the Public Accountability Principles for Canadian Airport Authorities.

- Certain requirements of a commercial nature may also contribute to governance. For example, requirements for the LAA to manage, operate and maintain the airport "in an up-to-date and reputable manner befitting a First Class Facility and a Major International Airport" serve to safeguard the Minister's interests both as a landlord and as the protector of the public interest in respect of the provision of an adequate national transportation system.
- Transport Canada actively monitors and enforces the rental provisions of the lease. The lever for enforcement is financial, and comes in the form of interest payable on overdue or insufficient rental payments.
- The Department has expended less effort in the monitoring of the non-rental provisions of the lease. Consultants conducting the studies on Environmental Stewardship and Asset Maintenance both observed that Transport Canada was not monitoring the terms of the ground lease in these areas, as should a prudent landlord. Another example is to be found in respect of follow up to the submission of the five-year Performance Reviews. Two of the four LAAs were over a year late in submitting their reviews to Transport Canada. Departmental follow-up on this non-compliance was not vigorous.
- Apart from the financial levers available in respect of rent, the only formal enforcement lever²⁴ available to the Department is termination of the lease arising from an event of default. The ground lease establishes the conditions under which an LAA would be considered to be in default of the terms of the lease. For example, an LAA which failed to observe any of the covenants, conditions or provisions of the ground lease, and which did not resume compliance within a prescribed period after receiving a Notice of Non-Performance, would be in default of the lease.
- The ground lease sets out a process, which starts with a breach of the lease and ends with the termination of the lease, if the breach is not remedied. This process was designed, not with a view to cancellation of the lease, but rather with a view to creating incentives and opportunities for the LAA to remedy the problem. For example, when an event of default has occurred, a Notice of Non-Performance is to be delivered to the LAA, with a copy to the LAA's lenders. This step was intended to bring the influence of the financial community to bear on resolution of the problem. The expectation is that a lender in receipt of such a notice would apply immediate pressure on the LAA for resolution of the matter. The lease also allows Transport Canada to fix the problem, at the expense of the LAA.
- While the process following from an event of default does provide some incentives and opportunities for breaches of the ground lease to be remedied, the significance of the process may be a deterrent to Transport Canada's monitoring and enforcement of less significant conditions of the lease. Transport Canada has never issued a Notice

²⁴ Certain provisions of the lease might be considered to be in the nature of a remedy, but would not constitute an enforcement lever. For example, the lease imposes an obligation on the LAA to pay taxes. In the event that the LAA does not comply, the lease gives Transport Canada the right to pay the taxes and recover those costs, plus interest, from the LAA as Additional Rent.

of Non-Performance.

- The ground lease appears to have certain drawbacks as an instrument of governance. In the event of required changes, modifications are difficult to implement because they require agreement from the LAAs. Thus, from a practical perspective, the lease is a contractually cumbersome document that requires significant buy in and effort before it can be altered.

5.10.3 Options

This section will present, and briefly examine, options in respect of remedies or enforcement levers in the ground lease. There appear to be three main options:

- the status quo;
- current ground lease, with more active monitoring and enforcement; and
- introduction of practical intermediate enforcement levers and remedies, accompanied by increased monitoring activities by Transport Canada.

Some form of financial penalty could be considered as an enforcement lever. The financial penalties (i.e., interest) that follow from overdue and insufficient rental payments would appear to be achieving their purpose. The amount of penalties for non-rental breaches of the lease could be structured to be commensurate with the severity of the breach. Penalties could be structured as an amount per occurrence, plus an amount per day for continuing non-compliance. Penalties could be paid as Additional Rent, an existing category of rent. It is acknowledged that there is a difference between the use of financial penalties for breaches of the rental provisions and breaches of non-rental provisions. In the case of the former, the penalty provides a financial solution to a financial problem. In the case of the latter, the problem would generally not be financial. It is also recognized that any financial penalty ultimately falls back on the users that pay the airport's charges.

As noted in section 5.8.2, there is an international precedent for the use of financial penalties as a lever for compliance or an enforcement mechanism for non-compliance. For example, legislation in New Zealand provides for the establishment of regulations to impose financial penalties for non-compliance in respect of disclosure of certain information.

Table 5.10 presents the above-mentioned three options and notes the main advantages and disadvantages of each.

Table 5.10
Options re Enforcement Levers and Remedies in Ground Lease

Options	Advantages	Disadvantages
Status quo	<ul style="list-style-type: none"> • breaches of lease not material, so far • process associated with an event of default provides some incentives and opportunities for breaches to be remedied 	<ul style="list-style-type: none"> • only enforcement levers are notices of non-compliance and/or default • severity of lever may serve as deterrent to monitoring and enforcement of less significant breaches • certain intermediate breaches may occur as a result of the lack of monitoring and intermediate remedies
Current ground lease with more active monitoring and enforcement	<ul style="list-style-type: none"> • takes advantage of existing provisions in lease 	<ul style="list-style-type: none"> • there may still be reluctance to commence default process for less significant breaches
Introduction of practical intermediate levers and remedies (e.g., financial penalties)	<ul style="list-style-type: none"> • existence of practical remedies provides incentive for greater compliance with lease, and the means to enforce in event of non-compliance 	<ul style="list-style-type: none"> • few options have been identified to-date

6.0 NEXT STEPS

The final stage of the consultation process with LAAs and key stakeholders involves discussions on a consolidation of the high level policy issues that Transport Canada sees as emerging from the Lease Review Project. The present paper has been drafted for the purpose of serving as the starting point for such "wrap-up" consultations. In this regard, it seeks to identify the main high level issues, provide a discussion on each issue, identify basic options, and assess the principal advantages and disadvantages of such options.

While stakeholders have the opportunity to comment on any aspect of the Lease Review Project, this next stage of consultations will attempt to focus attention on the following questions:

- have all the key issues been identified, and have they been properly expressed;
- has a reasonable range of options been identified; and
- have the identified options been appropriately assessed.