

Chapter 10

Transport Canada

Airport Transfers: National Airports System

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Transport Canada

Airport Transfers: National Airports System

Main Points

10.1 Our audit examined how Transport Canada handled the transfers of Canada's largest and busiest airports between 1992 and 1999. These airports make up Canada's National Airports System. Under the transfer agreements, Transport Canada retains ownership of the airports but leases out their management, operation and development to bodies known as airport authorities. Our audit concentrated on the financial and oversight aspects of airport transfers in the National Airports System (NAS), not on security and safety.

10.2 We found many significant weaknesses in management practices. Among our most important observations are the following:

- Before it started the lease negotiations for each airport transferred in the second round, and any renegotiations, Transport Canada did not determine the fair market value of the airport assets and business opportunities it was transferring. Such information is fundamental to both negotiating and renegotiating leases and, in our view, its absence represents a clear departure from sound management practice. The quality of information for making decisions on such things as rent is significantly impaired as a result.
- The Department has renegotiated four leases, at a cost to the government of about \$474 million in forgone rent (\$342 million net present value). The renegotiated deals do not adhere to some of the government's key directions. Further, Transport Canada cannot demonstrate how the deals for all of the transferred airports are equitable, uniform, consistent and fair, one with the other, as the government directed.
- As a result of renegotiations, the government has, in effect, agreed to a reduction of future revenues of the Crown and to the funding of significant capital projects. The information presented to Parliament on forgone rent and the funding of capital projects was fragmented, incomplete and, in some years, non-existent.
- From 1992 to 1999, the government continued to provide financial support to most of the transferred airports. It provided to the airport authorities a total of \$360 million, including \$118 million in rental credits at Lester B. Pearson International Airport toward a number of renovation projects. The government received a net total of \$593 million in rent from airport authorities in this period.
- As assessed by its consultants, the Department's preliminary financial results indicated that five years after transferring the first four airports in 1992, the government's most likely financial position varied significantly after each transfer — from better off to worse off. Although the analysis had been completed — as part of three separate studies with a total cost of \$680,000 — a year before our audit ended, we found that Treasury Board and Cabinet had not yet seen the results. The Department has yet to conduct any such analysis for any of the other transferred NAS airports.
- We are concerned that eight years into the transfer process, Transport Canada has yet to clearly define its role as landlord and overseer of the National Airports System. Its handling of key emerging issues such as those related to airport improvement fees, subsidiaries and sole-source contracting has generally been inadequate and, until 1997, was virtually non-existent. Treasury Board and/or Cabinet have received little information on these issues, and some of what they have received has been incomplete and inaccurate.

Background and other observations

10.3 Airports in the National Airports System have been transferred in two rounds. In 1992, Transport Canada leased out the management and administration of four major airports — at Montreal (Dorval and Mirabel), Vancouver, Calgary and Edmonton — to four “local airport authorities”. The second round began in 1996 with the transfer of Toronto’s Lester B. Pearson International Airport. Since then, 12 other airports, including those at Ottawa, Victoria, Winnipeg and Moncton, have been transferred to “Canadian airport authorities”. At the end of our audit, the last four NAS airports — Gander International, Québec/Jean-Lesage International, Fredericton and Prince George — remained to be transferred.

10.4 Although Transport Canada began transferring airports in the late 1980s and has been leasing out airports since 1992, only in 1994 was the National Airports Policy issued. The government saw transfers as a means of funding expansion in the vital National Airports System, making airports more competitive and viable and giving communities the flexibility to use them as tools for economic development. At the same time, Transport Canada would be able to oversee the entire System.

10.5 Transport Canada notes that a number of aspects of the transfer initiative have been positive and that airport authorities have made some strategic choices that have also represented difficult operational decisions. These included, for example, the expansion of passenger facilities, liberalization of operating policies and relocation of scheduled traffic from one airport to another.

The Department’s responses to our recommendations are included in this chapter. While the Department agrees with the majority of the recommendations and indicates the steps that it is taking or intends to take to address them, it takes a different position on a number of issues as reflected in its response following paragraph 10.106.

Introduction

10.6 Since 1992, Transport Canada has been transferring the management and operation of Canada's largest and busiest airports to airport authorities — not-for-profit organizations created specifically to run and develop the airports that make up the National Airports System (NAS). They are meant to represent the interests of the municipalities served by the airports and the interests of other stakeholders such as boards of trade, chambers of commerce and other local socio-economic groups (see Exhibit 10.1).

10.7 Each of the 26 airports in the NAS either handles more than 200,000 passengers every year for at least three consecutive years or serves a provincial or territorial capital (see Exhibit 10.2). Collectively, the NAS airports handle more than 90 percent of air passenger traffic in Canada. The government considers them to be the airports most essential to Canada's air transportation.

10.8 Transferring its responsibility for operating NAS airports and divesting its ownership of more than 100 other airports to local governments or community

organizations is the last step in the government's withdrawal from air transportation operations. In 1988 it privatized Air Canada, and in 1996 it sold its civil air navigation system to NAV CANADA. However, Transport Canada's mandate to regulate the safety and security of air transportation has not changed. It must still ensure that transferred airports operate in a safe and secure manner.

Transfer model for airports in the National Airports System is unique

10.9 In transferring the NAS airports, the federal government enters into long-term lease arrangements with airport authorities but retains ownership of the airports. The term of the leases is 60 years, with an option to renew for an additional 20 years.

10.10 The NAS airports transferred so far represent billions of dollars in airport revenues and other business opportunities such as hotels, restaurants and retail concessions. Airport authorities can also create subsidiaries with the ability to generate even more revenue from "off-airport" business activities. NAS airports have their own regional economic realities and are at different stages of

The airports in the National Airports System transferred so far represent billions of dollars in airport revenues and other business opportunities such as hotels, restaurants and retail concessions.

The first round of airport transfers were those to local airport authorities (LAAs) in 1992. The second round of airport transfers, to Canadian airport authorities (CAAs), was intended to follow the 1994 National Airports Policy and the Public Accountability Principles. Both LAAs and CAAs are constituted, for the most part, under the *Canada Corporations Act* and pursuant to by-laws approved by the Minister of Transport. An airport authority is intended to be a not-for-profit business entity created under federal/provincial legislation, as required, to manage and operate a local airport system and associated business enterprises. Local municipalities and various groups nominate members to the boards of directors of LAAs and CAAs. Virtually all authorities include two or three federal government representatives, who do not report to the federal government.

Airport authorities are responsible for all airport operations and for capital projects such as expanding terminal buildings and improving runways. Among other things, they are also responsible for providing emergency services, developing airport lands for various uses (for example, hotels and other commercial activity) and for renting space used for shops, restaurants and the many other businesses that serve the travelling public.

Airport authorities — LAAs and CAAs — are largely monopolies and enjoy a captive market. They can, without regulation, set fees (for example, landing fees) to fund capital works and operations at airports, make any type of investment, and accumulate large reserves, tax-free. Thus, many large airports in the NAS have been given a financial position that enables them to carry out very large projects in a short period of time.

Exhibit 10.1

About Airport Authorities

Source: Transport Canada

Airport authorities pay Transport Canada nothing up front for either the use of the airports or the rights to attendant business opportunities — which include the power to set their own user fees.

growth and expansion. Airport authorities pay Transport Canada nothing up front for either the use of the airports or the rights to attendant business opportunities — which include the power to set their own user fees. Instead, the intent is that the government will receive its due consideration in rent payments over the 60-year term of each lease.

As owner/landlord the government is entitled to receive rent

10.11 As owner/landlord of transferred airports in the National Airports System, the government is entitled to receive rent from each airport authority for the use of land and airport facilities. In 1999, the government netted over \$170 million in rent. This was more than a quarter of the

cumulative \$593 million net total it had received since the transfer process began in 1992. We note that most NAS transfers were made in the last three years, and the government has renegotiated rent reductions in some of them, bringing in less revenue as a result (see paragraph 10.55).

Two rounds of transfers to date

10.12 The NAS airports have been transferred in two rounds. The first began in 1992, when Transport Canada leased out the management and administration of four major airports — at Montreal (Dorval and Mirabel are considered one airport), Vancouver, Calgary and Edmonton — to four local airport authorities (LAAs). The second round began in 1996 with the transfer of Toronto’s Lester B. Pearson

Exhibit 10.2

Canada’s National Airports System



The National Airports Systems (NAS) consists of 26 airports that, collectively, handle over 90 percent of the air passenger traffic in this country. Included in the NAS are airports serving the national, provincial and territorial capitals as well as airports that handle at least 200,000 passengers every year for at least three consecutive years.

Source: Transport Canada, February 2000

International Airport to a Canadian airport authority (CAA). The change from LAA to CAA reflects the government's introduction of the National Airports Policy in 1994 (see Exhibit 10.3). The Policy defined Canada's National Airports System for the first time. The NAS included the four airports leased in 1992, and the federal government noted that it would lease out all remaining NAS airports along the same lines. However, all new airport authorities (CAAs) would be expected to follow Public Accountability Principles and adhere to a new standard formula for calculating rent payable to the government.

In February 2000, four airports remained to be transferred

10.13 Although the National Airports Policy anticipated that all 26 NAS airports would be transferred by 31 March 2000 (see Exhibit 10.4), in February 2000 there were still four to be transferred (at Quebec, Fredericton, Gander and Prince George). According to Transport Canada, there are several reasons why the four airports remain. The Department notes that in one case, until recently there was no local interest in taking over the airport. It further notes that because these are smaller airports, their long-term financial viability is a concern. In 1998, the government directed Transport Canada to make the four airports self-sustaining by March 2003 and has extended their transfer deadline accordingly.

Focus of the audit

10.14 We last audited airport transfers in 1993, and reported the very preliminary results of the first round of transfers. Now, seven years later, we are able to provide additional information on the results of the first round as well as on NAS transfers in general (to February 2000).

10.15 Our overall objective for the audit was to examine Transport Canada's management and administration of airport transfers since the first round in 1992,

including any renegotiations. We also took a preliminary look at its performance in overseeing the financial viability and integrity of the National Airports System and discharging its responsibilities as landlord of the airport facilities. We did not review the safety and security aspects of airport operations.

10.16 We focussed our audit on eight of the largest airports: those at Victoria, Vancouver, Edmonton, Calgary, Toronto, Ottawa, Montreal (Dorval and Mirabel) and Moncton. All are part of the National Airports System, representing 85 percent of its traffic in 1998 and just about all of Transport Canada's lease revenues. We looked at Transport Canada's adherence to government directions and to key financial principles established for the transfers. We also looked at its new role as landlord of the transferred facilities and overseer of the National Airports System and at how it was dealing with emerging issues of governance and accountability. In doing so, we considered the transfer arrangements and any renegotiated arrangements for each airport.

10.17 More details about the audit objective and scope (including the areas we did not examine) are in **About the Audit** at the end of this chapter.

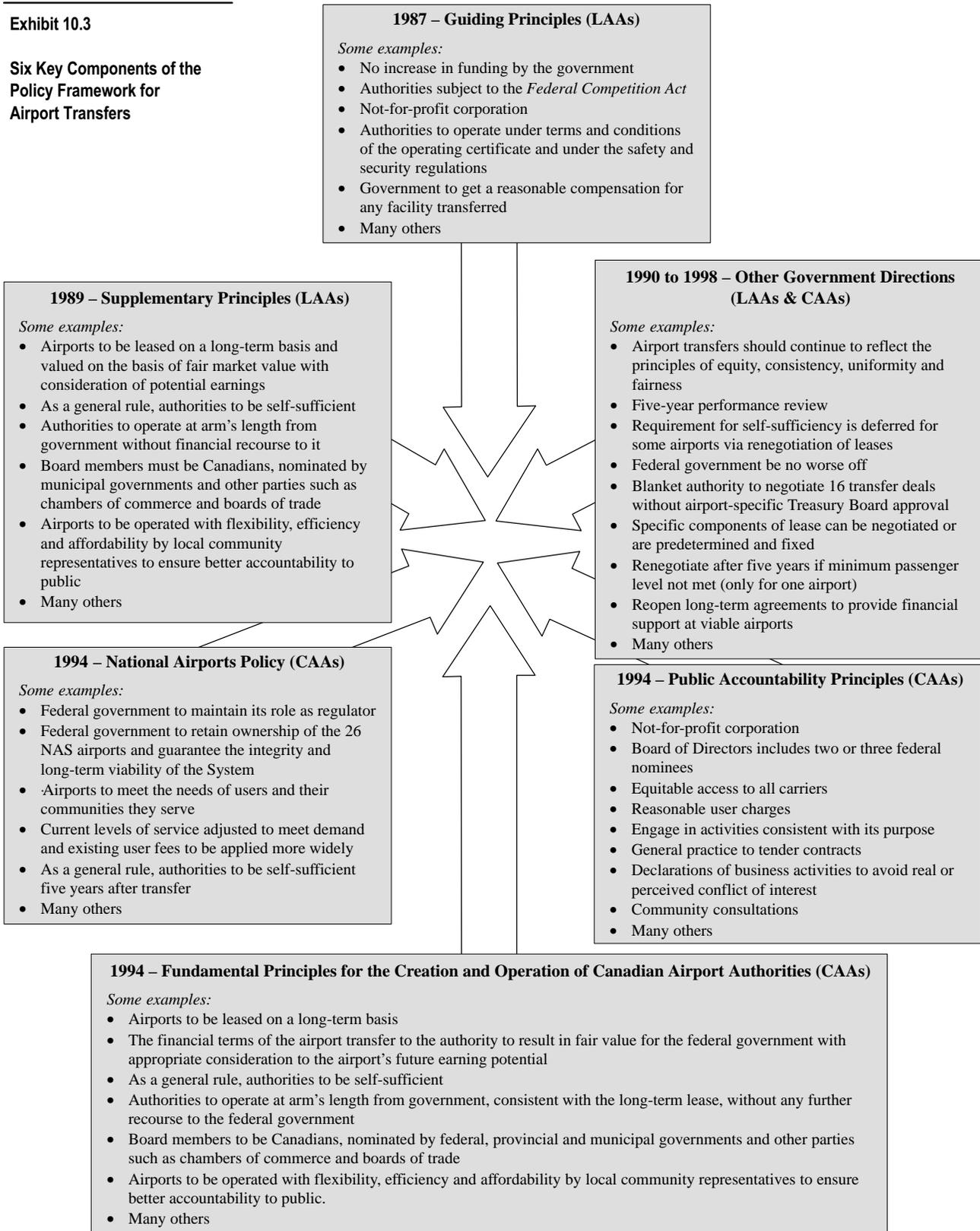
Observations and Recommendations

10.18 The observations and recommendations that follow are not intended to suggest that the government terminate the transfer initiative or take back the airports it has already transferred. However, the need to address observed shortcomings is a pressing one. Leases run for 60 years; some have already been renegotiated, and the government has given a qualified undertaking to renegotiate with at least three more airport authorities under certain conditions. Transport Canada is also being pressured by more authorities to enter into renegotiations. Proper systems and

The government has given a qualified undertaking to renegotiate with at least three more airport authorities under certain conditions.

Exhibit 10.3

Six Key Components of the Policy Framework for Airport Transfers



practices ought to be in place to complete both the last four NAS transfers and any future renegotiations and to ensure that Transport Canada fulfils all of its responsibilities for oversight and governance after transfer.

Policy Aspects of the National Airports System

A comprehensive national policy on airports did not exist until 1994

10.19 Although Transport Canada began the process of transferring airports in the late 1980s and has been leasing out airports since 1992, only in 1994 did it indicate a need for a National Airports Policy. At the time, no statutory, regulatory or policy framework clearly defined Transport Canada's role in operating airports. According to the Department, the absence of a clearly defined policy in this area had led it to make ad hoc decisions.

10.20 Transport Canada also noted that in making ad hoc decisions, it had for over 60 years assumed more and more responsibility for airports. It assumed this responsibility in a patchwork way because there was neither a clearly defined role nor a coherent vision of an airport system to guide these decisions.

10.21 In July 1994, however, the government's National Airports Policy defined Canada's National Airports System for the first time. This Policy was part of the National Air Transportation Strategy, which set out a framework for the government to withdraw from the operation of airports and the air navigation system.

Policy framework for transfers has six components

10.22 The policy framework for airport transfers is a complex one that has evolved over time. It has six components: the National Airports Policy, four sets of

principles, and a number of specific government directions issued between 1990 and 1998 for either individual airports or groups of airports (see Exhibit 10.3). In February 2000, the six components of the framework were:

- eight guiding principles (introduced in 1987);

Exhibit 10.4

Status of NAS Airport Transfers at February 2000

Airports transferred to	Airport	Date of Transfer
Local airport authorities (LAAs)	Calgary International	July 1992
	Mirabel and Dorval (Montreal)	August 1992
	Edmonton International	August 1992
	Vancouver International	July 1992
Canadian airport authorities (CAAs)	Lester B. Pearson International	December 1996
	Winnipeg International	January 1997
	Ottawa International	February 1997
	Victoria International	April 1997
	Greater Moncton	September 1997
	Thunder Bay	September 1997
	London International	August 1998
	St. John's International	December 1998
	Saskatoon International	January 1999
	Charlottetown	March 1999
	Regina	May 1999
Saint John	June 1999	
Halifax International	February 2000	
Territories	Yellowknife	July 1995
	Whitehorse	October 1996
	Iqaluit	July 1995 ¹
Airports not yet transferred	Gander International	
	Jean-Lesage International	
	Fredericton Prince George	
Municipal Airports	Kelowna International ²	

Notes: 1 This airport, located in the capital of the Territory of Nunavut, became a NAS airport as of March 1999.

2 The Kelowna International Airport is part of the NAS because it handles more than 200,000 passengers every year for at least three consecutive years. A long-term lease agreement was signed with the City of Kelowna in 1946.

Source: Transport Canada

The National Airports Policy called for Transport Canada to continue to own airports in the System to guarantee the integrity and long-term viability of the System.

- 36 supplementary principles (1989);
- the National Airports Policy (1994);
- 36 Fundamental Principles for the Creation and Operation of Canadian Airport Authorities (1994);
- Public Accountability Principles (1994); and
- other government directions (1990 to 1998).

10.23 The guiding and supplementary principles. Cabinet approved a set of eight guiding principles in 1987 to guide the establishment of airport authorities and the transfer negotiations. These were followed in 1989 by 36 supplementary principles intended to give Transport Canada more direction on negotiating the first round of transfers. According to Transport Canada, the Fundamental Principles for the Creation and Operation of Canadian Airport Authorities and the Public Accountability Principles superseded the 1987 guiding principles and the 1989 supplementary principles. Nonetheless, it appears that both sets of principles (the 1987 guiding principles and the 1989 supplementary principles) still exist and apply in full to one LAA (Montreal). We asked Transport Canada what principles apply to the other three LAAs, given that renegotiations occurred after the issuance of the National Airports Policy. It informed us that to the extent that the legal documents amending the leases replaced the 1987 and 1989 principles with the 1994 principles, or are in addition to the 1987 and 1989 principles, the 1994 principles were applied to renegotiated leases. As a result, some of the 1987 and 1989 principles continue to apply to LAAs who did not agree to replace them with the 1994 principles.

10.24 The guiding and the supplementary principles articulated a

number of expectations — that, for example:

- the government’s overall funding requirement for airports would not increase in the long term as a result of transfers;
- the valuation of the airports to be transferred would be on the basis of their fair market value, with proper consideration of their earning potential;
- airport authorities would be financially viable; and
- airport authorities would operate at arm’s length from government and without financial recourse to it.

10.25 These principles also covered a number of non-financial items, such as:

- the transfer of airports to not-for-profit entities;
- a minimum two-year job guarantee for indeterminate Transport Canada employees affected by transfer; and
- a requirement for adherence to Transport Canada safety and security standards and regulations.

10.26 The 1994 National Airports Policy. In addition to defining the National Airports System, the National Airports Policy clearly confirmed the government’s intention to withdraw from the business of operating airports. It called for individual airports in the National Airports System to be self-sufficient within five years. The policy also called for Transport Canada to continue to own transferred NAS airports and to guarantee the integrity and long-term viability of the System. In addition, the policy directed that rent revenues from NAS airports would help fund capital requirements of airports outside the System.

10.27 Fundamental Principles for the Creation and Operation of Canadian Airport Authorities. The Fundamental Principles issued in 1994 for CAAs are virtually identical to the 1989

supplementary principles that apply to LAAs, with a few exceptions. Those deal largely with refinements to a number of the financial aspects of the supplementary principles, as elaborated in paragraph 10.28. The Fundamental Principles also updated the context of the transfer initiative by noting two key events that occurred after the 1989 supplementary principles were issued — the 1992 *Airport Transfer (Miscellaneous Matters) Act* and the National Airports System, established in the National Airports Policy of 1994.

10.28 Of the financial refinements made in the Fundamental Principles, perhaps the most notable was the requirement that financial terms negotiated with authorities “result in fair value for the federal government with appropriate consideration to the airports’ future earning potential.” In contrast, the 1989 supplementary principles explicitly require that the valuation of the airport to be transferred be on the basis of fair market value, with appropriate consideration to the airport’s future earning potential. In our view, the requirement in the Fundamental Principles to get fair value in an airport’s transfer does not preclude the need to determine, before the start of negotiations, the airport’s value, on the basis of fair market value as a benchmark for analysis and decision making.

10.29 Public Accountability Principles. With the National Airports Policy, the government released a fourth set of principles — Public Accountability Principles — that transfers in the second round were to follow. These principles were meant to broaden the accountability of airport authorities. Among other things, they provided for the federal government to nominate (as opposed to appoint) two or three members to each airport authority’s board of directors. The principles also cover conflict-of-interest requirements, community consultations and the general practice of obtaining competitive public tenders for contracts.

10.30 Other government directions from 1990 to 1998. Government directions such as approvals and decisions on individual transfer deals included some key refinements and exceptions to the transfer principles; they still apply today. For example, in December 1996 the government gave Transport Canada blanket authority to negotiate transfer deals for the remaining 16 airports without having to obtain specific approval for each one. In granting the blanket authority, it gave a number of directions on how Transport Canada was to apply the broad transfer principles issued previously. Many of the directions were very specific — indicating, for example, which components of the rent formula could be negotiated with airport authorities and which could not. Others allowed some exceptions to the transfer principles for the particular circumstances of specific deals. In granting the blanket authority, the government reiterated the requirement for Transport Canada to continue to ensure that all airport transfers reflect the principles of equity, consistency, uniformity, and fairness, one with the other.

Transport Canada needs to formally codify its application of the transfer framework

10.31 We wanted to track for Parliament how Transport Canada had applied the 1987, 1989 and 1994 transfer principles, as well as the subsequent refinements and exceptions to them, as it negotiated and renegotiated each transfer deal. But we were unable to do so because of the problems discussed further below. Documenting how transfer principles are applied in the negotiation process is important; airport transfers have been ongoing for eight years, during which the government has issued hundreds of directions on them. We expected that Transport Canada would have a mechanism — a “codified framework” — to provide such a documented record over the long transfer process. A codified

The government directed Transport Canada to ensure that all airport transfers reflect the principles of equity, consistency, uniformity, and fairness, one with the other.

The loss of corporate memory in an environment where there is no codified “application” framework or roadmap is worrisome.

framework is not merely a set of principles and directions for negotiating transfers. Rather, it is an annotated trail or record that details how differences in the application of principles to specific transfer deals and renegotiations can be reconciled with, among other principles, “fairness, one with the other”.

10.32 Such a codified framework would also document, for example, how certain key refinements or exceptions to transfer principles were applied in specific deals. This would include the blanket authority that in 1996 gave Transport Canada some flexibility to deviate from practices followed in previous deals on certain financial terms, and allowed the Department to negotiate on its own some elements of the formula that the government would otherwise have considered individually. According to the Department, some of these exceptions were necessary to reflect its role as guarantor of the viability of the National Airports System.

10.33 A codified framework would have tracked the way the Department applied the specific directions for each transfer deal in the context of the broad transfer principles — directions to, for example:

- provide financial support to some NAS airports beyond the original deadline of 31 March 2000 set by the National Airports Policy;
- provide a safety net by agreeing to renegotiate a lease after five years if the airport does not handle a minimum number of passengers each year; and
- reopen long-term lease agreements soon after transfer to provide financial support for capital projects at viable airports, under specific conditions.

We are concerned that the Department does not have such a framework of fundamental information that it ought to have. It would not only provide historical context but also, in our view, help ensure

that a corporate memory survived over the 60-year period of the leases and could be drawn on for any future negotiations and renegotiations or any policy review.

10.34 Transport Canada has seen a significant turnover among the employees involved in airport transfers, as a result of changes in its mandate that occurred over the years as it was transferring the airports. The loss of corporate memory in an environment where there is no codified “application” framework or roadmap is, in our view, worrisome.

10.35 We note that while Transport Canada would be responsible for any policy review, given the large number of players involved in the National Airports System it would be important that the Department be able to provide other stakeholders with a clear picture of the current policy regime, against which any proposed policy changes could be assessed. A codified application framework would help to promote such a picture.

10.36 We think the absence of a formal, codified application framework also increases the risk of fragmented, inconsistent and disconnected decision making by the Department when negotiating and renegotiating transfer agreements. The section *Managing and Administering Airport Transfers* elaborates further (see paragraphs 10.58 to 10.106).

Transport Canada’s five-year review still under way

10.37 In 1992, the Treasury Board directed the Department to carry out a comprehensive evaluation of transfers after five years, to determine their financial impact on the Department and to recommend an appropriate policy framework for future years. The Treasury Board reiterated that direction in 1997. Transport Canada planned the five-year review to focus only on the first round of transfers, those to the four local airport authorities. Although it was to have been

completed in June 1998, the review exercise (which has cost almost \$2 million) had not been finalized at the end of our audit in February 2000.

10.38 The preliminary results of the review have pointed to a number of concerns in the areas of transparency, airport charging principles (or user fees) and governance. The review has noted the need to make the management of airport authorities more transparent, accountable and consistent across the National Airports System. The review also noted some positive aspects of transfers, as elaborated in paragraphs 10.44 and 10.45. The Department believes that the review will help it adjust and improve policy to ensure that the government has the right policy instruments to protect the public interest.

10.39 At the end of our audit in February 2000, Transport Canada had yet to inform decision makers of any significant matter that may have surfaced during the review. During that time, Transport Canada continued to transfer NAS airports and had almost completed the second round at the end of our audit. Accordingly, any changes in the transfer agreements that the government may want to make as a result of the review may be more difficult and likely more costly, given that the large majority of transfer deals have already been negotiated. Any desired changes will have to be renegotiated with airport authorities, possibly at a cost to the Crown, as the renegotiations of three of the first-round transfers have shown.

10.40 During our audit, there was a considerable level of activity and effort by the Department to complete its five-year review. We understand that subsequent to our audit, the Department had compiled information and analysis and was summarizing its position and recommendations or courses of action for consideration by Treasury Board and/or Cabinet. This is intended for use in

updating and formalizing the government's position on the National Airports Policy by the end of December 2000.

10.41 The Department had not finalized its position and recommendations from the five-year review at the conclusion of our audit. We did not examine the mandate or methodology used or audit the analyses undertaken by the Department as part of its review. However, we are encouraged by the increased interest in finalizing the review, as evidenced by the recent actions of the Department.

10.42 Transport Canada should codify into a comprehensive transfer application framework all exceptions and refinements made to transfer principles over time. It should include in the framework the way it applied the 1987, 1989 and/or 1994 transfer principles, as well as the exceptions and refinements, in each of the transfer deals. It should use that framework in completing the transfer of remaining airports in the National Airports System, in any policy review or evaluation of the results of the second round of transfers, and in any future renegotiations.

Department's response: Transport Canada recognizes the benefits of having a comprehensive transfer application framework. The Department will consolidate its existing policies, decisions, guidelines and framework, and will continue to use it to guide future decisions and reviews.

10.43 Transport Canada should, on an urgent basis, complete the five-year review first requested by the government in 1992 and report the results to decision makers and stakeholders.

Department's response: As noted by the Office of the Auditor General, there was a considerable level of activity and effort by the Department at the time of the audit. The five-year review has been completed

The preliminary results of the Department's five-year review have pointed to a number of concerns in the areas of transparency, airport charging principles (or user fees) and governance.

Transport Canada notes that a number of aspects of the transfer initiative have been positive and that airport authorities have made some strategic choices that have also represented difficult decisions on operations.

and the preliminary results were provided to decision makers in May 2000. The Department plans to seek direction from decision makers during Fall 2000.

The five-year review examined the airport divestitures policy; the performance of the local airport authorities; matters of public interest such as safety and security, financial viability, and governance; and assessed performance against the 1987 and 1989 principles along with the other major elements.

Financial and Operational Aspects of the National Airports System

10.44 Transport Canada notes that a number of aspects of the transfer initiative have been positive and that airport authorities have made some strategic choices that have also represented difficult decisions on operations.

10.45 As a case in point, the Department cites the decision of the Edmonton Regional Airport Authority to transfer scheduled traffic from the Municipal Airport to the Edmonton International Airport. Another was the decision by Aéroports de Montréal to liberalize its operating policies so carriers

could choose which airport would be used for international traffic; once they had that option, the carriers chose to relocate international traffic from Mirabel to Dorval.

10.46 According to Transport Canada, although some actions by airport authorities aroused significant local opposition, each authority believed that it was doing what was necessary to ensure the long-term viability of the airport, enhance its competitiveness and respond to the interests of the community at large. These had been factors in the government's rationale for transferring NAS airports in the first place. Another reason had been to trigger much-needed capital projects.

Capital works at transferred airports are impressive

10.47 Since the transfer process began in 1992, most of Canada's airports have undergone major physical improvements (see Exhibit 10.6). In deciding on the timing and nature of capital projects, levels of service and other areas, airport authorities have had a flexibility that was unavailable to Transport Canada (see Exhibit 10.5). As a result, they have been able to expand passenger facilities and

Exhibit 10.5

The Rationale for NAS Airport Transfers

The government's decision to get out of the airport business in the late 1980s was predicated on three realities.

First, only a few of the largest airports were operating at a profit or at least breaking even, and most airports had large and growing deficits, which represented a significant financial drain on the federal government.

Second, the significant funding to carry out much-needed expansions and upgrades to Canada's airports was not available, and undercapacity was becoming a problem. The government was not charging airport improvement fees.

Third, Transport Canada's approach to operating airports was national in focus, rather than local. Government ownership and control of airports thus meant that, in general, federal airports may not always have been operated in a way that reflected the specific economic needs and priorities of regions and local municipalities.

Transferring the management and operation of airports to airport authorities was intended to enable airports to operate as self-sustaining businesses that would contribute to developing local economies. This approach to operating airports was not always possible when the government managed them because various legal, policy and other constraints hindered its ability to both take advantage of the commercial potential of its airports and introduce efficiencies.

Source: Transport Canada

undertake various capital projects such as hotels, bridges, roads, parks and trails.

10.48 According to Transport Canada, these projects have benefited the regions and communities that the airports serve. The Department also noted that the timing and nature of the projects would have been significantly different had it continued to operate the airports. It informed us that reductions to operating and capital budgets for the past number of years would have resulted in deferring capital projects and extending the life of aging facilities and equipment.

10.49 Traditionally, sources of revenue for airports have included landing fees and revenues from concessions, land leases and development. Since the transfers, airport authorities have been able to raise their own financing through borrowing. This has enabled them to make significant capital improvements. They have also had an opportunity to recover costs by levying airport improvement fees, a tax-like fee, on travellers. Levying airport improvement fees is something the government has not done at the four NAS airports it still operates.

Changing conditions can affect airports financially

10.50 The ability to recover airport costs varies significantly from one airport to the next, depending on size. There are large differences in the number of passengers that airports handle (see Exhibit 10.7). Three airports, Calgary, Pearson and Vancouver, handle 62 percent of passenger traffic in the entire country; Pearson alone handles 33 percent. In 1998, Pearson ranked 24th in the world for aircraft movements and Vancouver was 31st.

10.51 Given the wide differences in passenger volumes, some airports can do better than others at sheltering themselves from potential losses of revenue when economic conditions and air traffic patterns change. Sensitivity to economic downturns and aviation industry restructuring is a key characteristic of the National Airports System, with implications for the financial viability of a number of airports.

10.52 Current traffic at NAS airports is at an unprecedented peak, as Exhibit 10.8 shows. Since the first round of transfers in 1992, the airport industry has generally experienced a boom. Passenger traffic has

Given the wide differences in passenger volumes, some airports can do better than others at sheltering themselves from potential losses of revenue when economic conditions and air traffic patterns change.

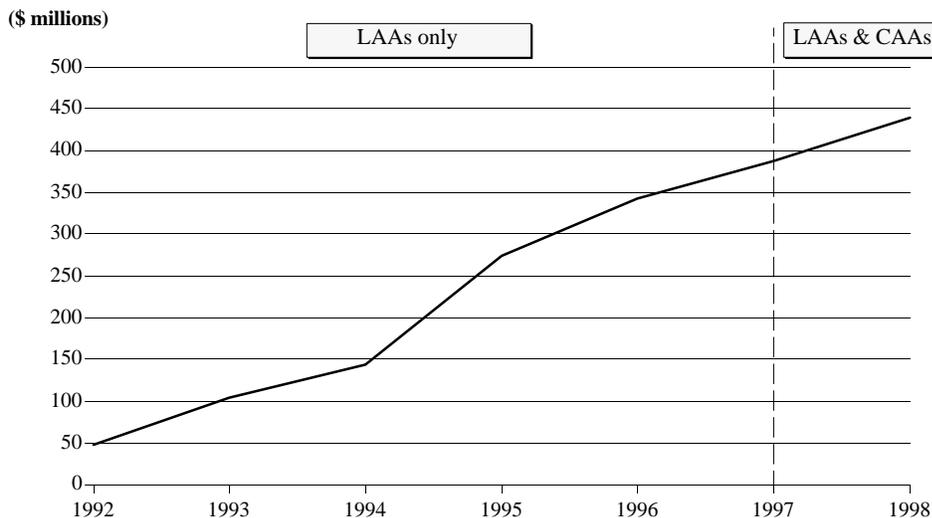


Exhibit 10.6
Capital Works at Eight Airport Authorities – From Date of Individual Transfers to 1998

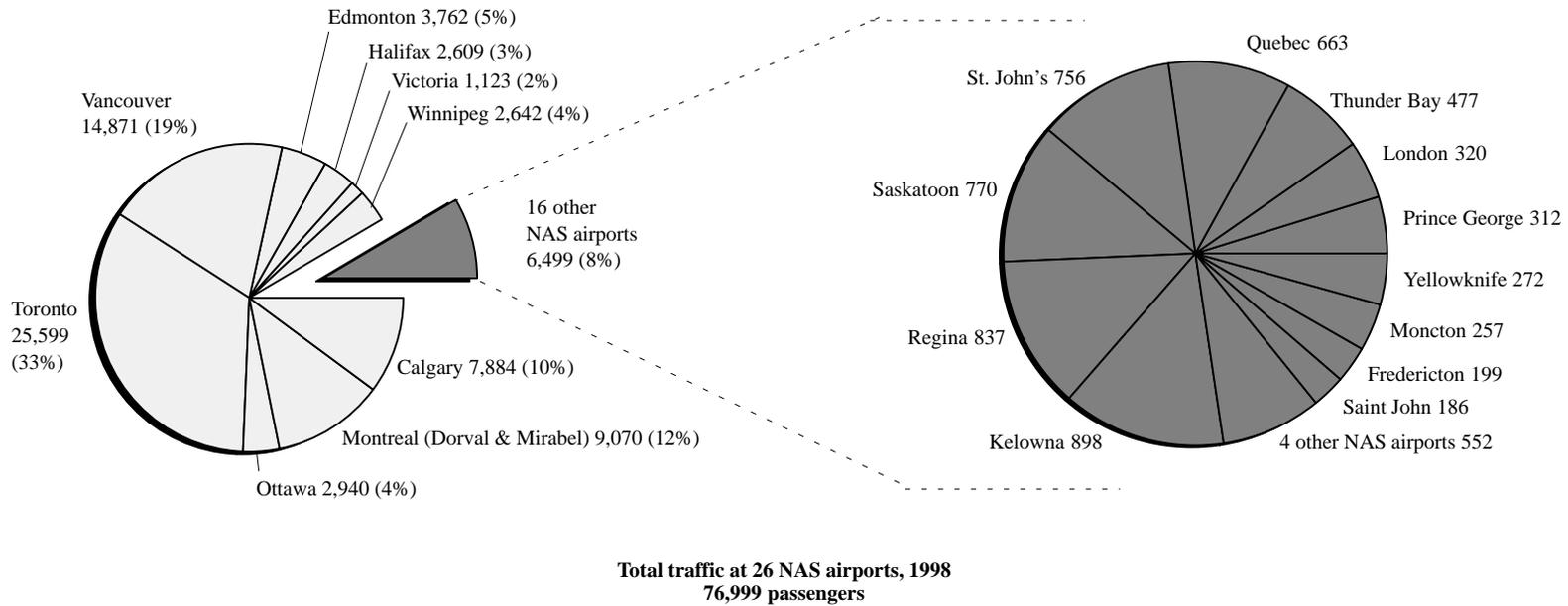
(current dollars)

Source: Annual report for each airport authority (current year cost of assets less prior year cost of assets)

Exhibit 10.7

1998 Passenger Traffic at NAS Airports

(in thousands)



Source: Transport Canada

grown, and airport revenues with it. Airport authorities have consistently increased their revenues from a variety of sources. For many authorities, one of these sources is airport improvement fees. They accounted for about 22 percent of their combined airport revenues in 1998 (see Exhibits 10.9 and 10.10).

Government financial support continues after transfer

10.53 As early as the first round of transfers, it was intended that airport authorities would finance all of their operating and capital requirements “without recourse to the federal government” over the term of the lease. To the extent that there would be any government funding in the early years of

transfer, its full recovery in subsequent years was expected. However, the government has made some exceptions. It indicated in the National Airports Policy of 1994 and in subsequent directions, for example, that it would give some financial support to smaller NAS airports for a few years, after which it would require all NAS airports to be self-sufficient. But there is no requirement in the policy that it recover the financial support provided in the early years. At the conclusion of our audit, the government had provided a cumulative total of \$44 million in financial support to those smaller CAA airports.

10.54 As well, the original leases to LAAs provided for some \$202 million in financial support by the government,

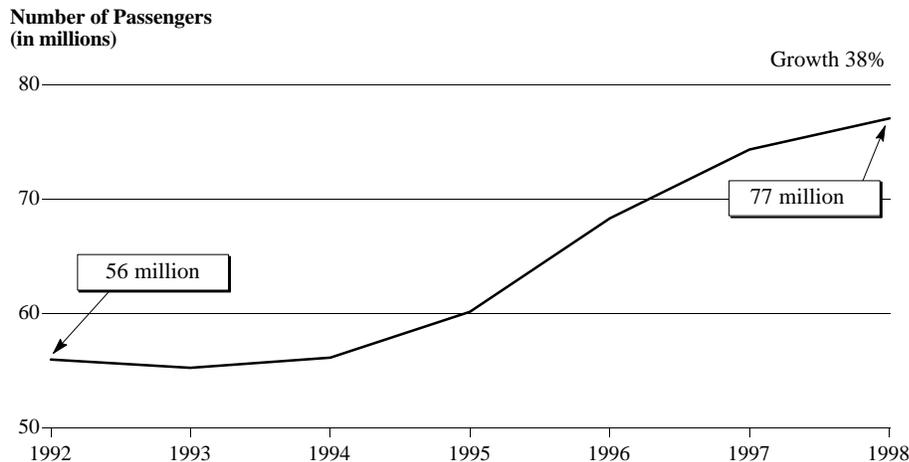


Exhibit 10.8

Passenger Traffic at 26 NAS Airports – 1992 to 1998

Source: Transport Canada

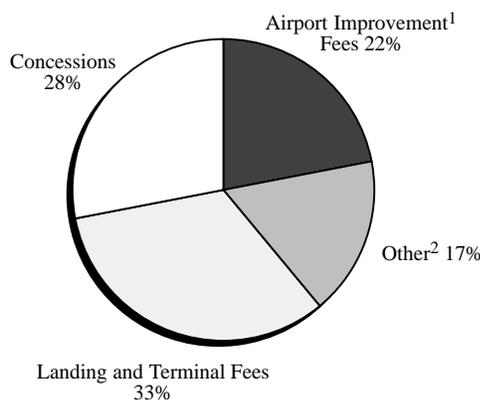


Exhibit 10.9

Source of Revenues Collected by Airport Authorities in 1998

Notes: 1. Represents 22% of 1998 gross revenues for airports charging fees.
2. Includes revenues such as, but not limited to, leased lands and parking fees.

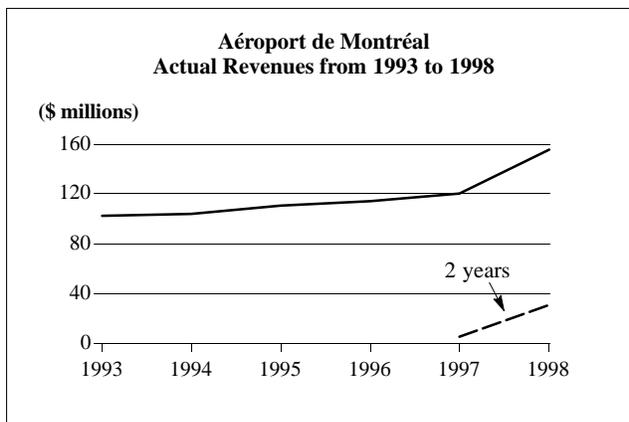
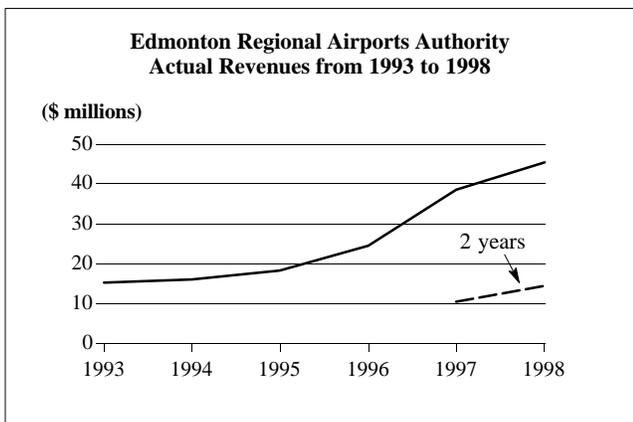
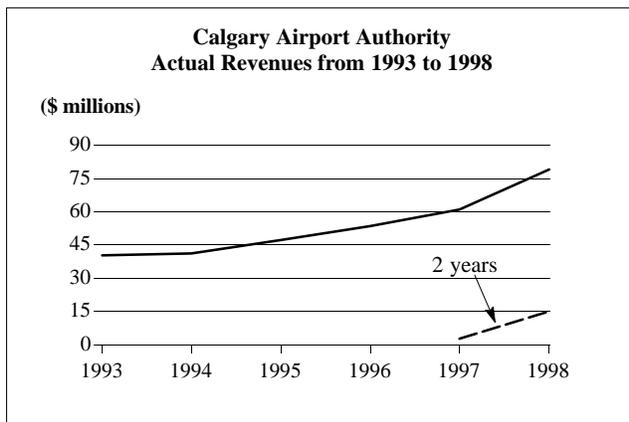
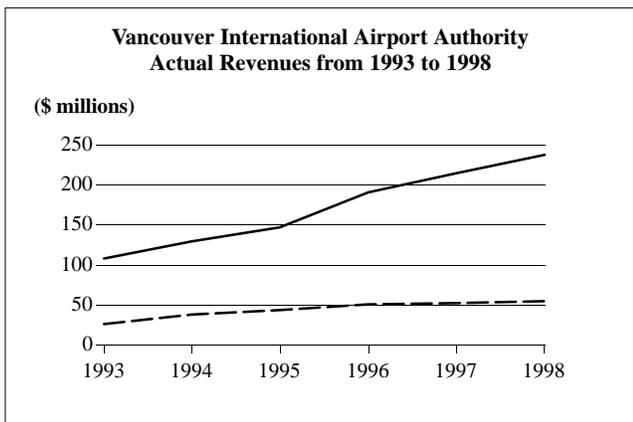
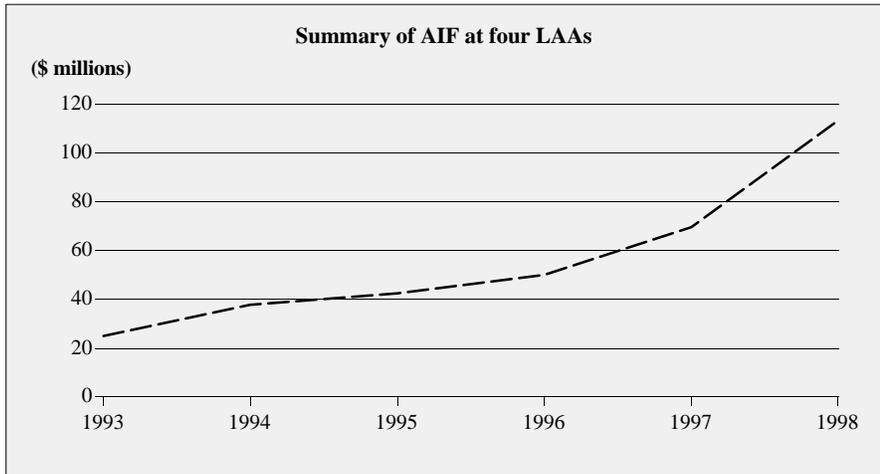
Source: Transport Canada

Exhibit 10.10

Comparison of Airport Improvement Fees and Actual Revenues for Local Airport Authorities – 1993 to 1998

(current dollars)

— Total Revenues
 - - - AIF



Note: Vancouver began collecting AIF in 1993; Calgary, Edmonton and Montreal began collecting AIF in 1997.

Source: Financial information in annual reports of the airport authorities

under certain conditions. According to Transport Canada, the lease formula was designed in such a way as to lessen the burden on the airport authority in the short term but provide higher returns to the government in the long term. Including the \$44 million in financial support to CAAs noted above, Transport Canada turned back or offset a total of some \$246 million from 1992 to 1999 to fund shortfalls in LAA and CAA airport revenues (see Exhibit 10.11). It also agreed to defer to a future date about \$44 million in rent, of which \$30 million is still outstanding and will come due with interest starting on 1 January 2002.

10.55 In addition, the government agreed in 1997 and 1998 to renegotiate its transfer deals with LAAs in Edmonton, Calgary and Vancouver — three of the airports transferred in the first round — and with the CAA in Toronto (the first transfer in the second round). According to the Department, these renegotiations resulted in an estimated \$474 million in forgone rent revenues (\$342 million net present value) — that is, \$210 million forgone by December 1999 and an estimated \$264 million more in the next six to seven years. Under the renegotiated agreements with the LAAs, the government can nominate two or three members to each board of directors; this brings the structure of LAA boards into line with those of CAAs. In the Toronto renegotiations, the government agreed to give the Greater Toronto Airports Authority a rent credit toward a number of capital works projects at the Pearson Airport.

10.56 Transport Canada is not the only federal source of financial support for the operations of transferred airports. Some airport authorities have also received subsidies from the Atlantic Canada Opportunities Agency and the Canada Infrastructure Works Program, among others. Indeed, the federal government continues to provide significant financial support to transferred airports. Our

analysis of Transport Canada's financial records (excluding the renegotiated deals with LAAs) reveals that from 1992 to 1999, the Department alone provided airport authorities with an average of about 37 cents in financial support for each dollar of total gross rent revenue (see Exhibits 10.11 and 10.12).

10.57 **Three airports account for almost all of Transport Canada's revenue from rent.** We found that three of the transferred airports — Calgary, Pearson and Vancouver — accounted for over 95 percent of Transport Canada's total revenues from rent in 1998, net of any financial support it provided that year. At four of the 10 other transferred airports, airport authorities paid no rent and, in fact, received net financial support from Transport Canada (Exhibit 10.13). Financial results for 1999 show a similar pattern — Calgary, Pearson and Vancouver were still the main revenue sources for the Department. In addition, the four that received net financial support in 1998 continued to do so in 1999, along with four more airports transferred that year (see Exhibit 10.11).

Managing and Administering Airport Transfers

10.58 We examined Transport Canada's performance in managing and administering selected airport transfers — in particular, whether it had followed sound management practices and complied with government directions. We selected four second-round transfers to CAAs (Toronto, Ottawa, Moncton and Victoria) and four renegotiations (Edmonton, Vancouver, Calgary, and Toronto). We looked at Transport Canada's compliance with some of the government's key financial directions and principles for transfer. For LAAs, the principles included the requirement to determine the fair market value of the airports to be transferred. For CAAs there was a requirement that the financial terms for the airport transfer result in fair value

From 1992 to 1999, Transport Canada turned back or offset a total of some \$246 million to fund shortfalls in revenues of transferred airports.

The Calgary, Pearson and Vancouver airports accounted for over 95 percent of Transport Canada's total revenues from rent in 1998.

Exhibit 10.11
**Airports Transferred to Airport Authorities –
 Transport Canada Received Rent and Provided Support – 1992 to 1999 (current dollars)**

Current Dollars (in thousands)	1992	1993	1994	1995	1996	1997	1998	1999	Total
Local Airport Authorities									
Aéroports de Montréal									
Gross rent revenue	7,576	20,028	18,945	21,119	23,563	20,045	22,839	23,598	157,713
Revenue shortfall	(9,044)	(23,727)	(23,543)	(19,951)	(21,566)	(21,327)	(22,311)	(21,040)	(162,509)
Negative rent*	(1,468)	(3,699)	(4,598)	(6,000)	(6,000)	(1,282)	–	–	(11,047)
Deferred rent	(2,500)	(6,000)	(6,000)	(6,000)	(6,000)	(3,500)	–	–	(30,000)
Vancouver International Airport Authority									
Gross rent revenue	19,759	27,726	36,695	41,390	47,664	51,933	57,081	59,728	341,976
(Deferred rent) / Reimbursed	–	–	(8,000)	–	8,000	–	–	–	0
Calgary Airport Authority									
Gross rent revenue	6,676	12,991	13,754	15,730	17,456	18,255	19,046	19,854	123,762
Revenue shortfall	(695)	(4,483)	(4,684)	(1,579)	–	–	–	–	(11,441)
Edmonton Regional Airports Authority									
Gross rent revenue	1,159	2,124	2,373	2,787	7	–	131	212	8,793
Revenue shortfall	(2,034)	(5,705)	(6,521)	(6,773)	(3,527)	(1,394)	(1,037)	(529)	(27,520)
Negative rent*	(875)	(3,581)	(4,148)	(3,986)	(3,520)	(1,394)	(906)	(317)	(18,727)
(Deferred rent) / Reimbursed	(625)	(1,429)	(1,503)	(2,254)	–	–	5,811	–	0
Canadian Airport Authorities									
Greater Toronto Airports Authority									
Gross rent revenue	–	–	–	–	1,522	106,033	108,460	117,902	333,917
Rent credit – Renegotiations	–	–	–	–	(1,522)	(103,485)	(12,621)	–	(117,628)
Ottawa Macdonald-Cartier International Airport Authority									
Gross rent revenue	–	–	–	–	–	3,977	5,282	5,967	15,226
Victoria Airport Authority									
Gross rent revenue	–	–	–	–	–	–	729	1,015	1,744
Negative rent*	–	–	–	–	–	(161)	–	–	(161)
Greater Moncton Airport Authority									
Negative rent*	–	–	–	–	–	(600)	(1,714)	(959)	(3,273)
Winnipeg Airport Authority									
Gross rent revenue	–	–	–	–	–	970	1,370	1,933	4,273
Thunder Bay International Airport Authority									
Negative rent*	–	–	–	–	–	(545)	(1,180)	(808)	(2,533)
Greater London International Airport Authority									
Negative rent*	–	–	–	–	–	–	(2,138)	(1,182)	(3,320)
St. John's International Airport Authority									
Negative rent*	–	–	–	–	–	–	(335)	(7,607)	(7,942)
Saskatoon Airport Authority									
Negative rent*	–	–	–	–	–	–	–	(9,652)	(9,652)
Charlottetown Airport Authority									
Negative rent*	–	–	–	–	–	–	–	(7,032)	(7,032)
Regina Airport Authority									
Negative rent*	–	–	–	–	–	–	–	(3,642)	(3,642)
Saint John Airport Inc.									
Negative rent*	–	–	–	–	–	–	–	(7,293)	(7,293)
SUMMARY									
Gross rent revenue	35,170	62,869	71,767	81,026	90,212	201,213	214,938	230,209	987,404
Less: Revenue shortfall supported by the Crown	(11,773)	(33,915)	(34,748)	(28,303)	(25,093)	(24,065)	(28,715)	(59,744)	(246,318)
Rent credit	–	–	–	–	(1,522)	(103,485)	(12,621)	–	(117,628)
Total federal support	(11,773)	(33,915)	(34,748)	(28,303)	(26,615)	(127,512)	(41,336)	(59,744)	(363,946)
Deferred rent repaid to (agreed by) the Crown	(3,125)	(7,429)	(15,503)	(8,254)	2,000	(3,500)	5,811	–	(30,000)
Net rent revenue received by the Crown	20,272	21,525	21,516	44,469	\$65,597	70,201	179,413	170,465	593,458
Portion total federal support over gross rent revenue	33.5%	53.9%	48.4%	34.9%	29.5%	63.4%	19.2%	26.0%	36.9%

*Negative rent equals payments by Transport Canada to the airport authorities.

Source: Transport Canada

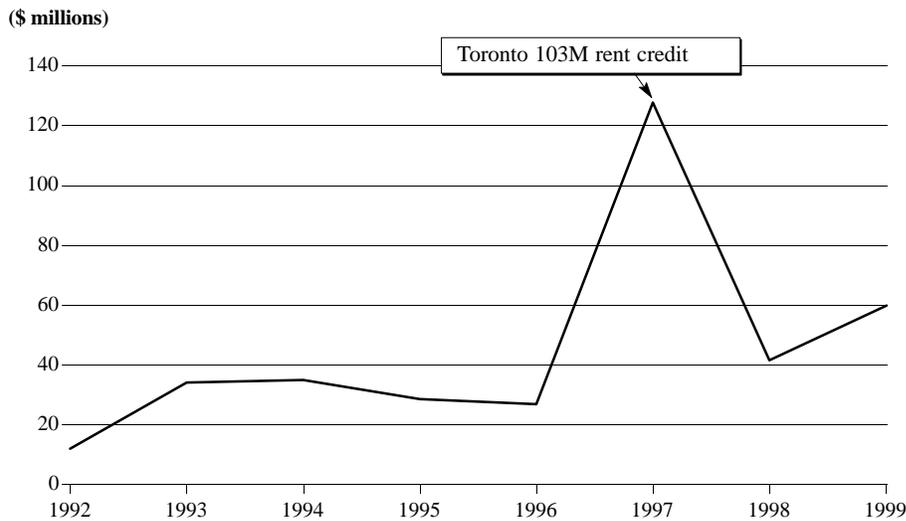


Exhibit 10.12

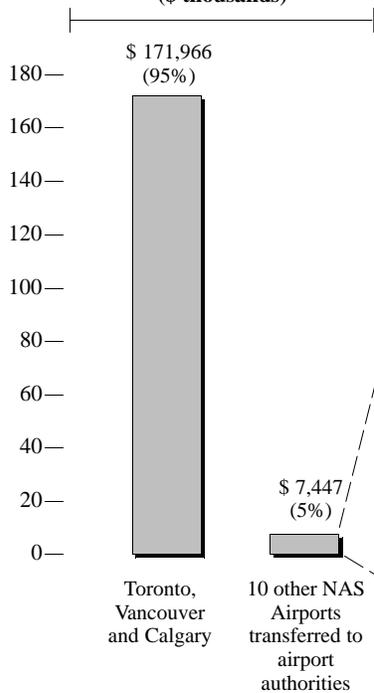
Federal Support* to Transferred Airports – Transport Canada 1992 to 1999

(current dollars)

* Represents either payments to authorities to offset or fund shortfalls in airport revenues and fund rental credits as per negotiated agreements.

Source: Transport Canada

Three airports of the National Airports System accounted for 95% of the 1998 net rent revenue* (\$ thousands)



Net Rent Revenue Received by Transport Canada in 1998 (including negative rent paid)

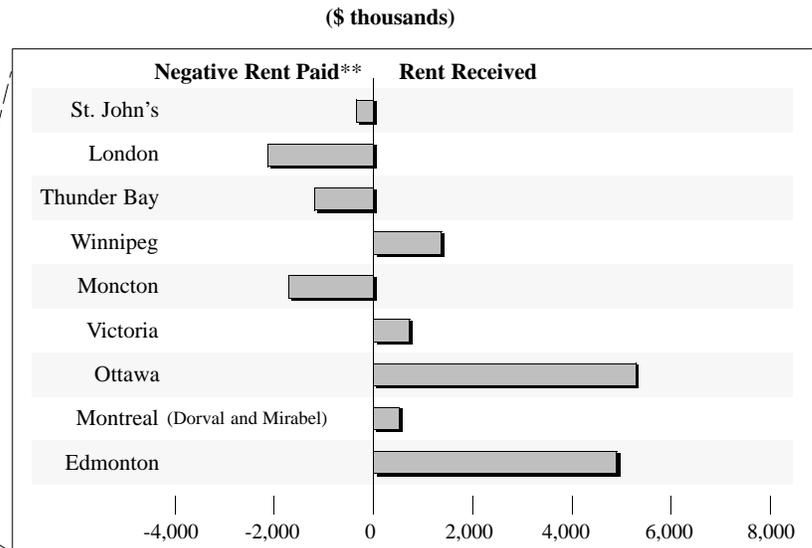


Exhibit 10.13

* Net rent revenue = gross rent revenue less revenue shortfall, rent credit and deferred rent.

** Negative rent equals payments by Transport Canada to the airport authorities.

Source: Transport Canada

We find it disturbing that Transport Canada decided not to determine the worth — the fair market value — of what it was transferring both before it entered into lease negotiations in the second round of airport transfers and before it began any renegotiations of existing leases.

for the government, with appropriate consideration to the airport's earning potential. There was also a requirement for both LAAs and CAAs that the government be no worse off financially after transfers than before. We also reviewed the Department's adherence to the direction that all of the transfer deals, including renegotiations, reflect the principles of equity, consistency, uniformity and fairness, one with the other.

Transport Canada did not assess fair market value

10.59 We found that Transport Canada had not determined the worth — the fair market value — of what it was transferring before it entered into lease negotiations with airport authorities in the second round of transfers as well as the renegotiations of existing leases.

10.60 Transport Canada noted that in 1989, before entering negotiations on each of the four airports destined to be transferred in the first round (Montreal, Vancouver, Calgary and Edmonton), it engaged a financial advisor to determine their fair market value prior to negotiations, under various scenarios. The value computed in 1990 by the financial advisor under the lease option for Montreal was \$453 million, for Vancouver \$310 million, for Calgary \$166 million and for Edmonton \$56 million.

10.61 However, the Department informed us that it was made aware by its financial advisor that any valuation would be meaningful only after the transfer framework had been determined. According to the Department, this occurred only after the human resource and legal frameworks had been finalized. The Department further noted that the above-mentioned values computed for the four LAAs quickly became irrelevant as the asset packages that would be transferred took shape.

10.62 We note that some of the key elements of the entity to be transferred

were clarified only in 1992, or later. Some of the clarifications are found in the *Airport Transfer (Miscellaneous Matters) Act*, such as the non-taxable status of airport authorities. Others are in the transfer arrangements negotiated with airport authorities, which, among other things, allowed airport authorities to levy user charges. Moreover, a decision was made not to regulate those charges.

10.63 We find it disturbing that Transport Canada decided not to determine the worth — the fair market value — of what it was transferring both before it entered into lease negotiations in the second round of airport transfers and before it began any renegotiations of existing leases — even though, by then, many of the previous limitations on determining the fair market value of airport business it was transferring were no longer present. Indeed, many unique elements of the entity to be transferred that were unknown in 1989 had been sufficiently defined by 1995 before the start of second-round transfers and any renegotiation, as evidenced by the transfer deals and supporting policy statements and legislative framework. The Department's position is that the conditions and circumstances that served as the basis for the advice from the Department's independent financial consultants for the first round transfers continued to exist for the second round transfers and renegotiations. For the reasons cited above, we do not consider the Department's position persuasive.

10.64 Moreover, the valuation of the airports still to be transferred could also draw on the operational and financial performance of those already transferred for such things as growth potential, profitability, and ability to raise financing and levy user charges. In our view, the Department's failure to obtain an independent determination of fair market value of the airports once the elements of transfer had been clearly defined, and once markets for funding airport

operations had been proved, represents a clear departure from sound management practice.

10.65 Transport Canada believes that it ended up getting a fair value through the negotiations and renegotiations. The Department notes that it provided the Minister, Treasury Board and/or Cabinet with a range of values in support of each transfer deal. However, this range of values deals specifically with a floor position so that the government can assess whether it would be no worse off (see paragraphs 10.76 and 10.77). The floor position does not represent a full range of possible values for fair return. Moreover, because the Department was negotiating each deal with only one party and outside a normal competitive environment, it could not inform decision makers how the offers made by airport authorities in the second round of transfers and any proposals for reduced rent would compare against a reasonable range of fair market value.

10.66 Transport Canada used the net book value of the airport assets at the time of transfer to establish a key element of the LAA formula. We further note that the net book value was also used as the benchmark for fair market value by Transport Canada when it requested approval from Treasury Board for the renegotiating of the rent at Vancouver, Edmonton and Calgary. Generally, book value is significantly different from fair market value. Unlike fair market value, book value does not reflect the real worth of a going concern with the potential to generate substantial revenue — rather, it is more a function of historical costs. (For example, in 1989 the valuation of the Montreal airport was placed at three times that of the Calgary airport. This occurred because the net book value of Montreal included two airports — Dorval and Mirabel — to be “cost recovered” from users, while Calgary had only one. The Lester B. Pearson International Airport is another example. According to the

Department, prior to its negotiating the transfer in 1995 the fair value of the Pearson airport’s airside and general terminal business would have been minimal, because the assets were almost fully amortized.)

10.67 Accordingly, using a return on the net book value as the sole benchmark is unlikely to provide a meaningful basis for assessing the fairness of rent. It is noteworthy that in its 1997 Fourth Report to the House of Commons, the Public Accounts Committee made a number of recommendations on the transfer of the air navigation system to a not-for-profit corporation. Among them was that for any planned divestiture, the government obtain formal valuations from independent advisors and that it do so after the nature and the value of the assets to be transferred had been clearly defined, and also that it use these valuations as a benchmark before the start of any negotiations.

10.68 Fair market value information relevant for decision making. In our view, before it started negotiating each transfer and before renegotiating existing airport deals, the Department ought to have determined a range of fair market value for each airport. In assessing the fair market value of an entity that is a going concern, has no share capital and finances itself entirely through debt, it is important to apply a test of “financeability” (see Exhibit 10.14). Financeability is a measure of the amount that investors

Unlike fair market value, book value does not reflect the real worth of a going concern with the potential to generate substantial revenue.

Exhibit 10.14

Definition of Financeability

In assessing an entity’s going-concern value, it is important to have the value tested in the financial markets. In this case, because the corporation was intended to be financed entirely through debt, the test of that market was to help determine the amounts investors were willing to risk in the venture. This test of the market, known as assessing the financeability of the entity, provides an additional indication of whether the assessed value is reasonable.

Source: Auditor General’s October 1997 Report, Chapter 19, Transport Canada – The Commercialization of the Air Navigation System.

The lack of information on fair market value in the business cases supporting the transfers has serious implications.

would be willing to risk in a business, and it is a good and practical indicator of fair market value. As such, financeability is an integral component of discounted cash flow methodology when determining the net present value of business worth.

10.69 The lack of information on fair market value in the business cases supporting the transfers has, in our view, two serious implications. First, it means that the Minister, Treasury Board and/or Cabinet were not given all the relevant facts — that is, a full range of the possible value of each airport to be transferred. Second, they were not given an appropriate benchmark against which to assess whether, for example, the rent amounts they were being asked to approve were fair and reasonable.

10.70 It is noteworthy that, still without having obtained essential information on their business worth, Transport Canada subsequently renegotiated rent reductions totalling an estimated \$289 million for three of the four NAS airports it had transferred in the first round.

10.71 After the renegotiations and as part of its five-year review of the first round of transfers, Transport Canada analyzed the fairness of the rents charged to the four LAAs. Looking at the Crown's rate of return and using a very conservative approach, the analysis showed that the rent at all four airports as and where renegotiated was well below

market value, and there was no evidence that the authorities could not have afforded the original rent. The Department has yet to undertake a similar study of the airports transferred in the second round.

10.72 Before entering into negotiations or renegotiations of airport transfer agreements, the government should obtain a formal valuation opinion from a qualified independent professional on the fair market value of what it is transferring and use that information to assess and develop a position on a fair rental charge.

Department's response: See response following paragraph 10.106.

Is the government better off?

10.73 In 1992, the government explicitly directed that Transport Canada ensure that it would be “no worse off” as a result of transferring the airports, from two perspectives. First, the government's financial position was to be no worse off overall after transfer than before, taking into account all of its responsibilities for all airports combined. This position would be measured on the basis of a net present value of the impact on the government's fiscal framework and the Department's reference levels (its budget). Second, the government was to be “no worse off” at each airport and, indeed, was to be better off financially over the term of the lease than if Transport Canada had continued to operate the airport. According to Transport Canada, being “no worse off” in this respect is a critical criterion in determining whether the government ought to proceed with a particular transfer proposal. (Exhibit 10.15 discusses the concept of “no worse off”.)

10.74 No worse off overall. In reference to “no worse off” from the first perspective, we wanted to review any analysis done by Transport Canada to assess whether the government was no worse off overall. We found that Transport Canada has yet to determine and update

Exhibit 10.15

Definition of “No Worse Off”

“No worse off” means that the net present value of the lease payments over the first 20 years of the lease must be equivalent to or higher than the net present value of the projected cash flow of the airport had Transport Canada continued to manage and operate it.” (No worse off position for individual airports.)

“The government's financial position after transfer was to be no worse than before the transfer, measured on the basis of a net present value of impact on the fiscal framework.” (No worse off position overall.)

Source: Transport Canada

with each transfer how airport transfers have cumulatively affected the government's fiscal framework. Nor has it updated its estimate of how the airport divestitures have affected its own budget (reference levels) on a cumulative basis since 1996.

10.75 Such an exercise would serve as a check to help ensure that federal funding for airports would not increase in the long term as a result of the transfers. Because these transfers have happened one at a time, timely analysis to assess whether the government is no worse off overall would have provided decision makers with a useful scorecard, in our view. It would have shown, for example, how transfers were affecting on a cumulative basis the government's and the Department's cash flow and overall financial position over the term of the leases. This information would have contributed to a full set of relevant facts for decision makers as they considered and decided on new transfer proposals and any renegotiations. We think Transport Canada ought to be providing Parliament with such information in its accountability reporting.

10.76 Ensuring that the government is no worse off with each airport transfer. In assessing airport authorities' offers in the second round of transfers to ensure that the government would be no worse off, we note that the Department changed key parameters for assessing whether the government would be no worse off as a result of transfers; further, we note that these have changed over time. For example, for LAA airport transfers the Department used a compensatory pricing policy (or full-cost-recovery assumption — that is, no provision was made for future expansion, major improvements or commercial projects because they were to be funded entirely from new revenue sources and not from departmental appropriations). But in the Pearson transfer, the first CAA airport, the Department assumed that it would have to

fund a significant portion of capital works for future expansion — and that the funds would come from the airport's revenues. As a result of its analysis, Transport Canada presented a business case to the Treasury Board showing that the government would be better off by \$271 million to \$829 million as a result of the Pearson transfer. The compensatory pricing assumption it had used in all previous transfers would have shown significantly different results. It would have left the government significantly "less better off" — if not worse off — and potentially by a few hundred million dollars. The Department developed two floor positions at around the same time, one with an express assumption that it would fund capital works and the other without. The difference between the floor positions was substantial, a difference ranging from more than \$621 million to more than one billion dollars over the term of the lease. In its five-year review a few years later, to measure the government's financial position after the transfer of the four LAAs the Department reverted to its previous assumption, a compensatory pricing policy. It noted that the compensatory pricing policy was not an assumption used in any of the transfers to CAAs.

10.77 In addition to assuming compensatory pricing, the Department informed us that it had changed other assumptions and parameters for assessing whether the government would be no worse off with individual transfers. These changes were made to take into account changes in economic policy, economic conditions, administrative policy and government directions during the eight years over which transfers occurred. The implications of these changes for its floor position in previously negotiated deals, and for renegotiations, were never fully assessed for fairness and equity or properly documented. Nor were the change in assumptions and parameters and the rationale for those changes clearly made known to the Minister, the Treasury

Transport Canada has yet to determine and update how airport transfers have cumulatively affected the government's fiscal framework and, on a cumulative basis since 1996, its own budget.

In assessing whether the government's position was no worse off with each airport transfer, the Department changed key parameters. The implications of the changes were never fully assessed for fairness and equity, or properly documented.

We find it extraordinary that the Department would agree to an arrangement that would leave it without access to some essential information on which its consultant's analysis and conclusions were based.

Board and the Cabinet as each new transfer proposal went forward. We consider that not providing decision makers with this contextual continuum was a serious weakness in the transfer process. We are concerned that it may have resulted in less favourable terms and conditions in some leases than in others.

10.78 For each of the four CAA transferred airports in our sample, we asked Transport Canada for its analysis of whether the government would be no worse off over the term of the lease (that is, its floor position) at the end of negotiations. We reviewed the available documentation but found that the methodology used was highly conceptual and based on historical, unaudited data. It was also replete with judgments and assumptions about what the Department would have done in the future (typically 18 to 20 years) in areas such as capital investments and operations, had it continued to operate the airports. The floor position was what one of Transport Canada's financial advisors called a "best guess" estimate. Given the highly hypothetical scenarios and methodology used to arrive at the floor position, we can provide no assurance as to whether the government was better off or worse off at the time of transfer. Moreover, we consider that a methodology based on many significant *ex post facto* (after-the-fact) assumptions of what Transport Canada might have done had it stayed in the airport business is inappropriate for determining its position at any given time after transfer. Such a determination will grow more difficult and abstract over time; and Transport Canada is already almost completely out of airport operations.

10.79 In 1999, a consultant hired by the Department completed an after-the-fact analysis of the government's financial position with individual transfers to the four local airport authorities in the first round, to determine whether it is no worse

off after transfer. The Department does not have much of the key documentation gathered by its consultants to support their analysis. It informed us that this was the result of a decision to maintain the confidentiality of the information that airport authorities provided to the Department's consultants.

10.80 We find it extraordinary that the Department would agree to any such arrangement that would leave it lacking access to information essential to understanding the basis and context for its consultant's analysis and conclusions — conclusions that could form the basis for the Department's recommendations to the Treasury Board and Cabinet. We note that under the transfer arrangements, the Department already had a general right to such information. The Department's new arrangement *vis-à-vis* the consultants' analysis and conclusions meant that Transport Canada did not have, for example, even the list and copies of consultants' reports and documents that the consultants had relied on in preparing the analysis. Key notes or transcripts of fact-finding interviews with airport authorities, airlines, the financial community and other federal departments were unavailable. We note that the Department could not provide us with documentation showing the evidence used to support key assumptions and projections in areas such as pricing, cost recovery and capital expenditures. Nor could it provide us with the computer files containing the modelling runs used to determine its financial position as a result of the first round of transfers.

10.81 We therefore are unable to verify and provide any assurance on the results of the analysis. That said, the analysis found that over the first five years after the transfers, the government was better off at one airport, marginally worse off at another, neutral with respect to a third airport (neither better off nor worse off) and significantly worse off at the fourth airport. Although the analysis had been

completed — as part of three separate studies with a total cost of \$680,000 — roughly a year before our audit ended in February 2000, we found that decision makers, including Treasury Board, had not yet seen the results.

10.82 Transport Canada has yet to conduct any such analysis of the other NAS airports in our sample (Toronto, Ottawa, Moncton and Victoria).

Transport Canada has not analyzed the overall financial impact of the airport transfers

10.83 In our view, the Department needs to develop a credible way to measure the overall financial impact of the airport transfers after transfer, in terms of benefits and costs. Its evaluation of the first round of NAS airport transfers has been under way for the past three years and has used many financial advisors. It is therefore disconcerting that Transport Canada has yet to establish a proper framework to evaluate and report on the overall financial impact of the airport transfers at any time after transfer over the life of the 60-year leases.

10.84 Transport Canada should periodically gather information on fair market value to use in assessing the appropriateness of the rents it has already negotiated, developing a reasonable benchmark, and evaluating any proposals from airport authorities to renegotiate their existing leases. It should use the results of such work to form the basis of new renegotiation proposals.

10.85 Before negotiating or renegotiating airport transfers, Transport Canada should establish a minimum amount as a floor position for assessing whether authorities' offers will leave the government no worse off. It should properly document all assumptions used in determining its floor position and any changes to them

over time, and should clearly communicate them to decision makers when seeking their approval for the transfer agreements or any renegotiated agreements.

Department's response: See response after paragraph 10.106.

10.86 When using external consultants to perform financial analyses related to airport transfers, Transport Canada should maintain appropriate documentation and records.

Department's response: Transport Canada will continue to maintain appropriate documentation and records, when using external consultants.

10.87 Transport Canada should develop an alternative to its current no-worse-off analysis to measure the overall financial impact of airport transfers at any time after transfer over the life of the 60-year leases, and report the results to decision makers and to Parliament on a timely basis.

Department's response: See response after paragraph 10.106.

Quality of information to decision makers needs significant improvement

10.88 Transport Canada is not allowed to negotiate any amendments to the LAA leases that affect financial arrangements without first obtaining approval from the Treasury Board. Our review of the Department's analysis to support the renegotiations of the leases at Vancouver, Calgary and Edmonton left us with significant concerns about the quality of information it provided to the Treasury Board.

10.89 **Renegotiations.** When it issued the National Airports Policy in 1994, the government announced that the second round of transfers to Canadian airport authorities (the CAAs) would use a new standard formula to calculate rents (see

It is disconcerting that Transport Canada has yet to establish a proper framework to evaluate and report on the overall financial impact of the airport transfers at any time after transfer over the life of the 60-year leases.

Exhibits 10.16a and 10.16b). Both the rent formula and the accountability principles to be applied were different from those applied in the first round of transfers to the LAAs. The Minister agreed to reopen those deals for negotiation in light of the new National Airports Policy and Public Accountability Principles. In 1995, Transport Canada began renegotiating the financial terms of the leases for three of the four LAA airports (Vancouver, Calgary and Edmonton) transferred in 1992.

10.90 In 1995, Transport Canada engaged a financial advisor to assess the financial implications of the new rent formula for LAA deals, before it was used

in transferring the remaining airports to Canadian airport authorities. Although we did not audit that assessment, we believe it was an important exercise to provide a perspective on the fairness of the new CAA rent formula compared with the formula originally used for LAAs. Later in 1995, when Transport Canada began renegotiating with the LAAs at Vancouver, Calgary and Edmonton, it knew its financial advisor’s view that applying the new formula to these local airport authorities would have minimal financial implications for them. Although we understand that reopening the first round of transfer deals could have some financial impact, we expected that

Exhibit 10.16a

Overview of the Lease Rental Formula – Local Airport Authorities (LAAs)

		LAA				
BASE RENT	Business Components	Base Revenues	–	Base Costs	=	Base Rent
	Airside/General Terminal (AGT)	Stated landing fees from airlines	–	Stated costs of operating the airport	=	Base AGT
	Concessions	Rental fees from boutiques	–	Stated costs of maintaining the rental spaces	=	Concession base rent
	Real estate (Base rent)	Rental fees from existing land leases at date of transfer	–	Not applicable	=	Real estate base rent
+						
PARTICIPATION RENT	Business Components	Actual Revenues	–	Stated Revenues	=	Participation Rent
	Airside/General Terminal (AGT)	Actual landing fees from airlines	–	Threshold landing fees from airlines	=	AGT participation rent
	Concessions	Actual rental fees from boutiques	–	States rental fees from boutiques	=	Concession participation rent
	Airport Improvement Fees (AIF)	Actual AIF revenues	–	Not applicable	=	AIF rent
	Real estate (Participation rent)	Rent based on fair market value	–	Not applicable	=	Real estate participation rent
	Other	Actual other revenues	–	Not applicable	=	Other revenues rent

Source: Transport Canada

Transport Canada would have valued each element it was renegotiating, measured the impact for fairness and equity with deals negotiated in the second round (the transfers to CAAs), and presented that information to Treasury Board and Cabinet. The renegotiated deals effectively reduced the revenue stream or rent payable to the Department by an estimated \$289 million total over the term of the three leases, with no clear indication, in our view, as to what benefits the Crown would receive from the substantial rent reductions that were renegotiated. The Department informed us that the benefits were “to relieve the following pressures that were driving renegotiations:

- accelerated growth and passenger traffic;
- consequential pressure to accelerate capital expansion;

- the perceived superiority of the CAA rent model; and

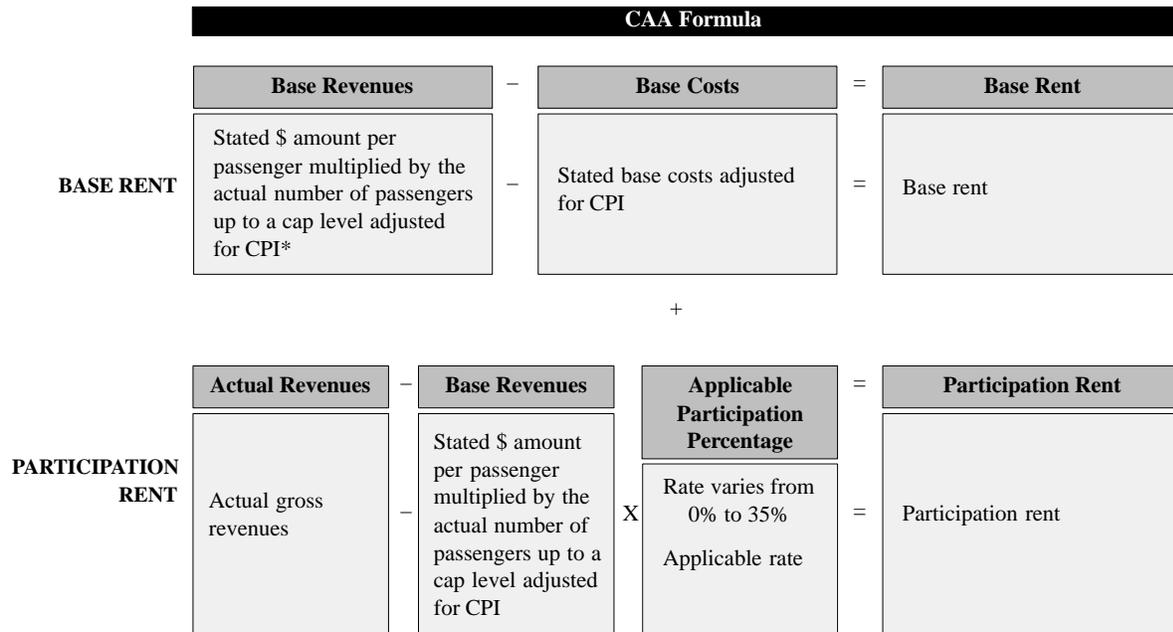
- a desire to install the Public Accountability Principles.”

The Department also indicated that it wanted to rectify an inequity between the LAA models and the CAA models with respect to charging rent on the AIF (airport improvement fee).

10.91 We note that one of the five benefits the Department had cited to us, the perceived superiority of the CAA rent model, was not made known to the Treasury Board and Cabinet. Moreover, the Department did not eliminate the inequities in the rent formula. In fact, the renegotiations created new inequities (see paragraph 10.95).

Exhibit 10.16b

Overview of the Lease Rental Formula – Canadian Airport Authorities (CAAs)



Note: Overall rent could be negative in years prior to self-sufficiency.

* Consumer Price Index

Source: Transport Canada

A key weakness in the renegotiation process was the absence of any independent review and challenge of the final agreements before they were signed. In fact, the deals were significantly different from what Treasury Board had authorized.

10.92 Information provided to the Treasury Board and Cabinet was inaccurate and incomplete. In December 1996, while renegotiations were under way, Transport Canada informed the Treasury Board that the LAAs at Calgary and Edmonton would adopt the new rent formula in full, and that Vancouver would adopt it in part. The Department also said that the revised rents would not materially affect its budget; it projected a \$7.5 million reduction in its budget over the first four years covered by the renegotiated agreements. But this did not represent the full costs of the renegotiations. Only later, when the Treasury Board Secretariat requested a business case to support the renegotiations, did the Department estimate that the rent reductions in the renegotiated deals would cost over \$124 million in the first five years. In February 1997, Treasury Board approved the amendments to the leases on the basis that the three airports had agreed to adopt the Public Accountability Principles. Renegotiations with airport authorities continued, and amended agreements were signed with Calgary in April 1997, Edmonton in December 1997 and Vancouver in June 1998.

10.93 A key weakness in the renegotiation process was the absence of any independent review and challenge of the final agreements before they were signed. In fact, the deals were significantly different from what the Treasury Board had authorized. We note that at the time the deals were finalized, Transport Canada did not advise the Treasury Board that in the final renegotiated agreements not one of the airports agreed to fully adopt the Public Accountability Principles, nor did it provide the reasons for their stance. These principles are central to ensuring a consistent accountability framework for all airports and the protection of the government's and taxpayers' interests. As illustrated in Exhibit 10.17, the renegotiated deals excluded certain key

aspects of the Public Accountability Principles, such as equitable access by all carriers, reasonable user charges, activities consistent with the airport authority purpose, the general practice of tendering contracts, and declarations of business activities to avoid real or perceived conflicts of interest. In our view, the Department ought to have informed Treasury Board and/or Cabinet of the concerns expressed by airport authorities that did not accept those Public Accountability Principles. For example, some airport authorities did not accept the principles relating to reasonable user charges and equitable access to all air carriers because, according to Transport Canada's records, they feared that including the principles in their letters patent could expose them to litigation on the reasonableness of the charges and equity of access. We believe that this kind of omission significantly impaired the quality of information made available to decision makers when they approved the renegotiations.

10.94 The fairness issue. One of the principles to guide the transfer of airports to CAAs was that all financial arrangements were to reflect the principles of equity, consistency, uniformity and fairness, one with the other. We acknowledge that certain differences exist among airports and that any financial arrangements must take these differences into account.

10.95 However, we were surprised to find that after renegotiation, the final agreements treated comparable airports differently (see Exhibit 10.18). For example, only Calgary's renegotiated lease included, in effect, a ceiling on its total rent (base rent and participation rent) for 10 years — Transport Canada having agreed to a passenger cap below the actual number of passengers at the time of renegotiations and having eliminated the clause requiring the payment of participation rent (see Exhibit 10.19). The renegotiated lease with Edmonton also

includes a clause unique to that airport, with a provision retroactive to 1996 extending forward 10 years to 2006. Under that clause, Transport Canada will continue to pay negative rent to fund shortfalls in airport revenues. Since 1996 the Department has paid \$6.4 million to the airport authority for this purpose. The clause also provides for a significantly higher subsidy to the Edmonton airport authority in the event of a downturn in the economy.

10.96 As a result of these renegotiations, Transport Canada has actually created three different rent formulas under essentially one model for CAAs. When we add the standard CAA formula for second-round transfers and the

original LAA formula that still applies to Montreal, the Department is really administering five different rent formulas.

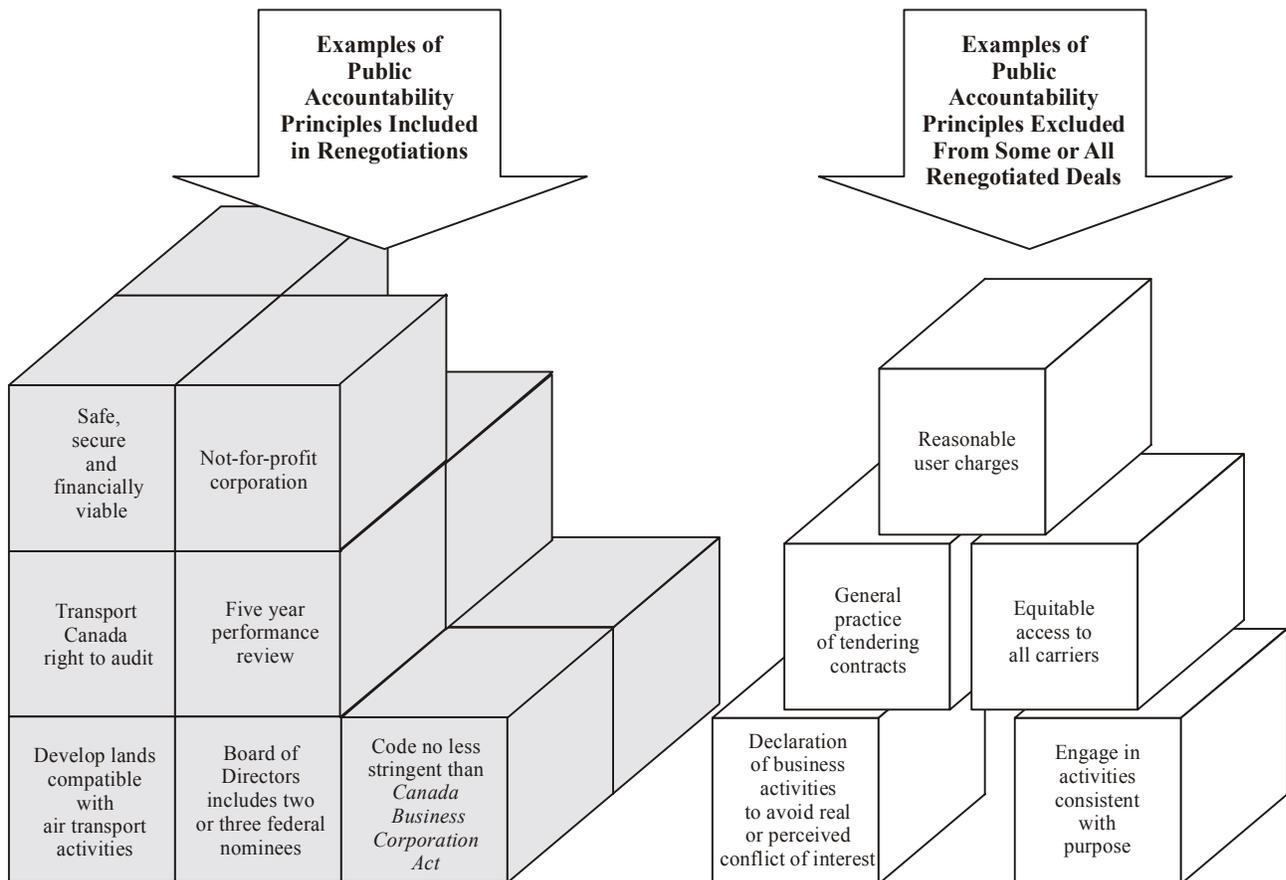
10.97 Transport Canada has not been able to demonstrate how transfer agreements as and where renegotiated based on different formulas can be equitable, uniform, consistent and fair, one with the other.

10.98 We were informed that the team that had negotiated the original LAA deals did not handle the renegotiations. It was the view of the Department that the lease renegotiations would be more appropriately handled by those officials who were responsible for lease management. We note that key financial elements/principles underlying the first

Transport Canada has not been able to demonstrate how transfer agreements as and where renegotiated based on different formulas can be equitable, uniform, consistent and fair, one with the other.

Exhibit 10.17

Examples of Public Accountability Principles Included/Excluded in Renegotiated First-Round Transfers



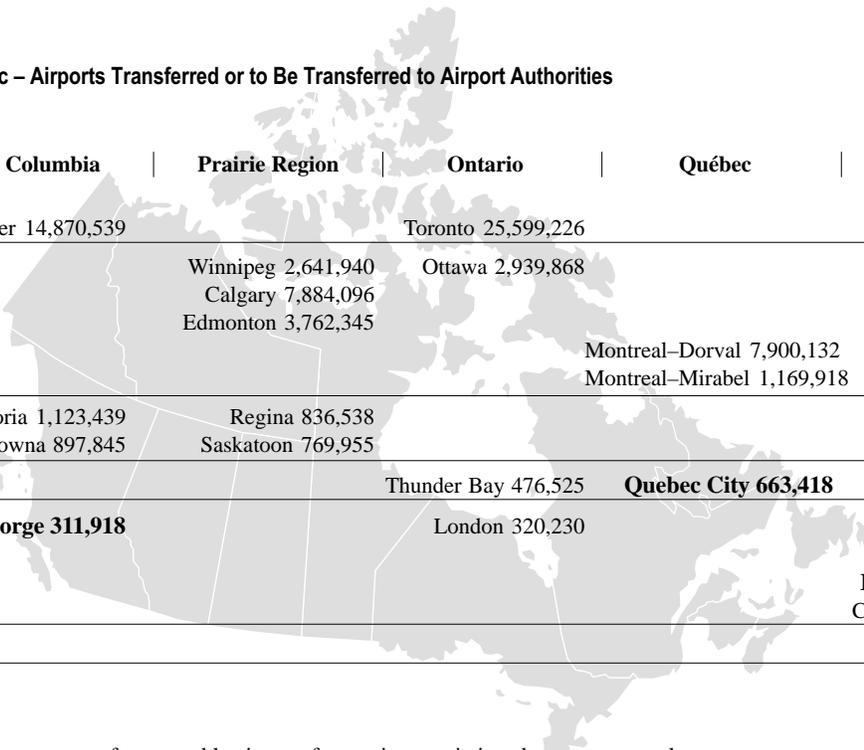
and second rounds of transfers were not applied consistently in the renegotiations. In fact, while the deals were being renegotiated, the Department’s chief negotiator (who had negotiated the original LAA deals and the first few CAA deals) had some concerns about the amendments and their possible effects on the transfer of the remaining airports. He informed senior management responsible for airport transfers that he was concerned about the rent inequities among airports. The Department noted that it had considered the views of the official, but it was unable to provide us with any supporting documentation or analysis.

10.99 As part of the fairness issue, we also assessed Transport Canada’s adherence to some of the key principles under the blanket authority it had received

in 1996. We looked at the financial elements that were to be predetermined before negotiations and fixed for the duration of the lease to see how the Department had applied them to the leases in our sample. Transport Canada was unable to demonstrate how the significant differences among airports in, for example, the base revenue per passenger and the base operating and capital cost amounts (three key components of the CAA rent formula) ensured equity and fairness among the transfer deals. These were items that the government had directed were to be predetermined and fixed, not negotiable. The Department confirmed that in its effort to adapt the LAA rent formula at Edmonton and Calgary to the CAA formula, it had negotiated the items. These financial elements have a direct impact, dollar for

Exhibit 10.18

**Comparable Airports
1998 Passenger Traffic – Airports Transferred or to Be Transferred to Airport Authorities**



Tier*	British Columbia	Prairie Region	Ontario	Québec	Atlantic
1	Vancouver 14,870,539		Toronto 25,599,226		
2		Winnipeg 2,641,940 Calgary 7,884,096 Edmonton 3,762,345	Ottawa 2,939,868	Montreal–Dorval 7,900,132 Montreal–Mirabel 1,169,918	Halifax 2,609,288
3	Victoria 1,123,439 Kelowna 897,845	Regina 836,538 Saskatoon 769,955			St. John’s 755,585
4			Thunder Bay 476,525	Quebec City 663,418	
5	Prince George 311,918		London 320,230		Moncton 257,205 Saint John 186,156 Fredericton 199,291 Charlottetown 156,107
6					Gander 104,016

*Transport Canada’s assessment of comparable airports for use in negotiations by passenger volume.

The three territorial NAS airports are not shown above as they were transferred to territorial governments.

Note: Airports still to be transferred are shown in bold.

Source: Transport Canada

Calgary Renegotiated Formula Elements and Rent Ceiling, 1996

“...after renegotiation, the final agreements treated comparable airports differently. For example, only Calgary’s renegotiated lease included, in effect, a ceiling on its total rent (base rent and participation rent) for 10 years — Transport Canada having agreed to a passenger cap below the actual number of passengers at the time of renegotiations and having eliminated the clause requiring the payment of participation rent.” (paragraph 10.95)

		Base Revenues		-	Base Costs	=	Base Rent	
		Revenues without passenger cap	Revenues with passenger cap				Rent without passenger ceiling	Base rent ceiling
Standard revenue per passenger		\$8.31	\$8.31					
Multiplied by number of passengers	Actual	□ 6,662,242**						
	Cap		□ 6,100,000*					
		55,363,231	50,691,000	-	\$33,234,819	=	\$22,128,412	\$17,456,181*
						+		
		Percentage						
		Actual Revenues	Base Revenues	=	Participation Rent			
		N/A	N/A		0			

*Per ground lease amendment

** Actual passengers

Source: Transport Canada

In 1997, Transport Canada renegotiated its lease agreement with the Greater Toronto Airports Authority only a few weeks after signing it. In effect, the airport authority was granted a rent reduction of \$185 million for capital works projects at the airport.

dollar, on the rent to be paid to the Crown. A dollar more in base capital cost means a dollar less in rent — for the duration of the lease.

10.100 In the case of Moncton, Transport Canada's own projection showed that notwithstanding the general requirement under the National Airports Policy for self-sufficiency within five years, had Transport Canada continued to operate the Moncton airport, the airport would have continued to experience significant cash flow deficits for at least 20 years.

10.101 We note that other government departments have started to make use of "fairness monitors", who focus on ensuring integrity and fairness in alternative delivery arrangements. In our September 1999 Report, for example (Chapter 18, Public Works and Government Services Canada — Alternative Forms of Delivery: Contracting for Property Management Services), we noted that a significant feature of the contracting process was the use of fairness monitors to provide the Department's senior management with independent assurance that the process was conducted fairly and in accordance with the rules. In view of the complexity of airport transfer negotiations and renegotiations, this practice could be beneficial to Transport Canada.

Toronto deal has been renegotiated

10.102 In 1997, Transport Canada renegotiated its lease agreement with the Greater Toronto Airports Authority only a few weeks after signing it. In effect, the airport authority was granted a rent reduction of \$185 million for capital works projects at the airport; \$103 million of this was credited in the first year, for a total provided to date of \$118 million. Our review of the documentation shows that the Department issued a press release when the rent reduction was announced, indicating that it was designed to cover principally a de-icing facility and a

north-south parallel runway. We also note, however, that at the time of the airport's transfer to the GTAA the Department had issued a press release that stated, "Several of these projects initiated by Transport Canada in advance of the transfer of the airport to local control were completed earlier this year. With today's transfer, however, the completion of the remainder, including a new north-south runway and a dual taxiway storm water capability in a centralized aircraft de-icing system, becomes the responsibility of the GTAA." Because of those contradictory public statements, we asked the Department to provide us with evidence to demonstrate that, at the time of transfer, the federal government had a legal commitment to finance the north-south runway and the centralized aircraft de-icing facility. There were no undertakings to this effect in the original deal, and Transport Canada was unable to provide us with any support other than the press release described above and the questions and answers prepared for use by its officials when the Department announced the rent reduction.

10.103 We have various concerns about this rent reduction. First, Transport Canada has always considered it a basic transfer principle that airports would be transferred "as is, where is". Second, the Department could not provide us with the rationale for changing the principle of "as is, where is", nor were decision makers made aware of this change. Third, we are concerned that it reopened a long-term (60-year) agreement very soon after signing it to deal with a short-term funding need, even though it had not done any analysis. As a result of the reopened negotiations, the government will receive an estimated 7 percent less rent over the 60-year term of the lease on a net present value basis.

10.104 Moreover, Transport Canada did not conduct any analysis to determine how the Toronto airport rent reduction of \$185 million would impact on fairness to other airport authorities.

10.105 Moratorium on renegotiations.

In 1997, following the approval for renegotiations at Toronto, Edmonton, Vancouver and Calgary, the Treasury Board put a moratorium on any significant future amendments pending the completion of a major review of the first round of airport transfers (the five-year review) and/or the development of an appropriate framework. As noted, this review was being finalized at the end of our audit.

10.106 Before finalizing transfer deals and renegotiated agreements, Transport Canada should ensure that those agreements undergo review and challenge by officials independent of the negotiating team to ensure that the information is complete and reliable and that the transfers are consistent with the principles established by the government.

Department's response: Transport Canada disagrees with the Office of the Auditor General's conclusions with respect to fair market value and no worse off. Transport Canada exercised due diligence and followed sound management practices throughout the transfer process.

- Determining fair value prior to transfer: *Transport Canada determined the fair value of the airports prior to their transfer, although the Department used a different approach from that preferred by the Office of the Auditor General (see paragraph 10.65). Based on advice obtained from independent financial experts, net present value of net cash flow was determined to be the most appropriate approach for determining fair value. Independent financial experts also advised the Department that formal opinions on fair market value were considered less relevant, particularly given that the government's policy was that airport divestiture would not involve an open market situation. The methodology used by Transport Canada to obtain fair value*

to the Crown was disclosed to and approved by decision makers.

- Establishing an appropriate benchmark: *Transport Canada established a floor position prior to negotiating each airport transfer.*

- Assessing and reporting the financial impact of airport transfers: *Transport Canada fully recognizes the importance of assessing and reporting the financial impact of airport transfers. The Department will undertake a review that will assess the financial impact of airport transfers.*

- Information to decision-makers: *Transport Canada followed standard government practice wherein the Treasury Board Secretariat plays an independent review and challenge role with respect to Treasury Board submissions. Regarding the airport transfers, all transfer deals, renegotiations, and changes to the financial terms must be approved by Treasury Board. In fulfilling this requirement, Transport Canada provided officials at the Treasury Board Secretariat with all of the necessary information, including all major changes to the final agreements.*

- Adherence to principles established by the government: *Transport Canada fully recognizes and appreciates that legitimate differences between airports exist in terms of, for example, the level of financial maturity, previous capital investment, and costs and revenues; the age of major capital assets; and the needs of the passengers and communities served by the airport. To ensure fair, equitable and consistent treatment among airports, Transport Canada used the same criteria, principles and approaches. The Department also recognized other mechanisms beyond the lease that met the essence of the Public Accountability Principles. Particular emphasis was placed on negotiating comparable deals for comparable airports. Furthermore, the Department uses, for all airport transfers, common legal documents, a common rent*

In 1997, the Treasury Board put a moratorium on any significant future amendments pending the completion of a major review of the first round of airport transfers and/or the development of an appropriate framework.

formula and rent definitions, and a common methodology for preparing amounts in the lease formula.

Transport Canada's Performance in Post-Transfer Matters

10.107 With the transfer of airports to airport authorities, Transport Canada has assumed a new role and gained some new responsibilities. Under the National Airports Policy, it is responsible for guaranteeing the continued integrity and viability of the National Airports System. As landlord of the transferred facilities, it ought to oversee the operations of the airports and related businesses to ensure that they comply with the transfer policy and with transfer arrangements such as leases, agreements to transfer, and by-laws of the airport authorities. Although ensuring safety and security at transferred airports is a key responsibility of the Department, as noted earlier, our current audit excluded safety and security aspects.

Transport Canada has yet to define its role in post-transfer matters

10.108 Aside from safety and security, we note that eight years into the transfer process the Department has yet to define its role as overseer of the National Airports System and guarantor of its integrity and viability. We are concerned that the lack of clearly defined roles and responsibilities for post-transfer matters has affected its ability to fulfil its current operational responsibilities in overseeing airport operations. This may have significant negative effects in the future.

10.109 Since 1992, the Department has adopted a predominantly hands-off approach to its landlord responsibilities. It has been largely passive about monitoring and overseeing the NAS. At the conclusion of our audit, the Department told us that now that NAS transfers are coming to a close and it has some experience in its landlord and oversight

role, it will be able to devote more effort to post-transfer matters.

10.110 Because the Department had not elaborated its new roles and responsibilities, we did not undertake a detailed audit in this area. We did, however, take a preliminary look, and we noted the following areas in need of urgent attention.

Transport Canada has not developed its position on the growing use of airport improvement fees

10.111 Airport improvement fees (AIFs) have become an increasingly important source of revenue for airport authorities since they were first introduced in 1993. In 1998, airport authorities with AIFs collected \$116 million in fees, or 22 percent of their combined total revenues (see Exhibits 10.9 and 10.10). At the conclusion of our audit, 15 NAS airports were charging airport improvement fees.

10.112 We found that the Department has been slow in collecting data and analyzing and assessing the reasonableness of the escalating airport improvement fees. The lack of detailed information on AIFs is disconcerting.

10.113 We also found that information about these fees that was presented to Treasury Board in 1992 was incorrect in one key respect. When the use of airport improvement fees to fund airport expansion was first contemplated, Transport Canada told decision makers that the fees would be subject to the *Competition Act*. However, airport authorities are virtual monopolies and enjoy a captive market. The monopolistic aspects of airport business, one of which is the charging of AIFs, are not covered by the *Competition Act*, unlike concession business such as parking. The Department was aware of this fact as early as 1994, but it did not inform Treasury Board and has missed several opportunities since then to do so. Although the Public

Eight years into the transfer process, the Department has yet to define its role as overseer of the National Airports System and guarantor of its integrity and viability.

Accountability Principles require CAAs (second-round transfers) to ensure that all user fees are reasonable, the Department has yet to do any substantive oversight of the reasonableness of existing AIFs.

10.114 In its five-year review, the Department found that there is little information on how airport authorities use revenues from airport improvement fees. It also found that some airport authorities have yet to conduct any costing studies to determine whether their fee structures and rates are reasonable and comply with provisions in their leases that pertain to obligations under national and international agreements. The review noted that airport improvement fees could be increased significantly at the first-round NAS airports without affecting traffic. It indicated that some stakeholders had concerns about the use of AIFs, including the quantum of fees that were being charged and the lack of redress mechanisms for the general public.

10.115 Transport Canada should move quickly to deal with the issues raised in the five-year review. It should clarify its role in the monitoring of airport improvement fees and communicate the results to decision makers along with recommendations as appropriate.

Department's response: See response following paragraph 10.139.

The advent of subsidiaries

10.116 Airport authorities have used subsidiaries to expand their business horizons. At the time of our audit there were at least 13 such subsidiaries, most of them wholly owned by the airport authorities created before 1994 (the LAAs).

10.117 Activities of subsidiaries include airport management and operational services, airport marketing and consulting services, and business ventures such as investment in airports in Eastern Europe, South America and the South Pacific.

There are different types of investments by airport authorities — wholly owned subsidiaries and minority-interest investments. Wholly owned subsidiaries can also have subsidiaries.

10.118 The Department has yet to systematically assess any of the subsidiaries or their business arrangements to review, for example, the potential risks to the Crown, and the financial implications of their activities for the operations of airport authorities and the rents they pay. We note that the transfer arrangements give Transport Canada the right to audit the activities of the airport authorities' subsidiaries, but since their emergence seven years ago it has yet to do so.

10.119 At a minimum, we would have expected Transport Canada to have such basic information on each subsidiary as:

- its board members;
- the remuneration of board members and senior executives;
- separate audited financial statements;
- disclosure of conflicts of interest and a description of transactions between related parties; and
- a list of contingencies, guarantees and commitments made by subsidiaries or by airport authorities on their behalf.

10.120 We are concerned that Transport Canada does not know the extent of airport authorities' business activities and has yet to assess the attendant financial risks.

10.121 Rent-related risk. Transport Canada does not know whether airport authorities have transferred the ownership of profitable businesses or intellectual property to off-site subsidiaries. Under the LAA lease formula, this practice would affect the rents that Transport Canada collects. (Rent is payable only on activities carried out on the airport site itself or on revenue from a local airport

The Department's five-year review noted that some stakeholders had concerns about the use of airport improvement fees, including the quantum of fees that were being charged and the lack of redress mechanisms for the general public.

The Department has yet to systematically assess any of the airport authorities' subsidiaries or their business arrangements to review, for example, the potential risks to the Crown.

authority competing business within three kilometres of the airport.)

10.122 Offshore risks. Transport Canada has yet to assess the financial and political risks of airport authorities' offshore investments. The potential costs involved in loan guarantees and equity investments, along with the possibility of economic or political instability in certain countries, could affect the viability of subsidiaries and, potentially, the viability of the airport authorities themselves. If a subsidiary defaulted on a loan and the parent airport authority had to assume responsibility for repayment, the authority might be unable to meet its rent commitments to the Crown.

10.123 Other risks. Transport Canada does not know whether the authorities have guaranteed loans from other lenders to subsidiaries. Any such guarantees would create contingent liabilities for the airport authorities that, in turn, could translate into costs for the Crown. The Department recently obtained limited and unaudited financial information on subsidiaries that suggests that in 1997 they generated a total of about \$16.3 million in revenues, had assets of \$25.7 million, and posted a net loss of \$53,000. They had also received about \$17 million in interest-free loans from parent airport authorities.

10.124 In December 1999, as part of its five-year review, the Department noted that airport users and other interested parties had concerns about the relationship between airport authorities and their private sector subsidiaries. They considered that the primary focus of the authorities and their boards of directors ought to be on overseeing the operation of first-class airports.

10.125 As part of its ongoing oversight of the National Airports System, Transport Canada should develop a systematic approach to monitoring and overseeing the activities of airport authorities' subsidiaries. It should

collect the necessary information to assess the impact of those activities on the authorities' rent and financial performance. It should report periodically to the Treasury Board or Cabinet on the implications for the public interest and should make recommendations as appropriate.

10.126 Transport Canada should complete its five-year review and alert the Treasury Board or Cabinet to any gaps in policy or accountability related to the use of subsidiaries by airport authorities.

Department's response: See response following paragraph 10.139.

Use of sole-source contracts by airports versus government's objectives of equal access and best value

10.127 The airport authorities established before 1994 (the LAAs) were not required by their original leases to tender any of the contracts they let — that is, to open them to competition in order to receive optimal value and to embrace the public sector value of equal access by suppliers. In contrast, the authorities established since the 1994 National Airports Policy (the CAAs) are expected to follow the Public Accountability Principles, which require them, as a general practice, to tender all contracts over \$75,000 for goods and services. If a CAA does decide to sole-source a contract, its annual report must disclose information on the contractor, indicate the dollar value of the contract and justify the decision to award the contract without competition. There is currently no such requirement for most LAAs.

10.128 Transport Canada reviewed the 1998 annual report of the Greater Toronto Airports Authority (GTAA), a Canadian airport authority. The report listed a significant number of sole-source contracts over \$1 million. In the Department's view, information in the report did not meet the requirements of the Public Accountability Principles,

which require disclosure of the dollar value of each sole-source contract over \$75,000. Moreover, sole-source contracts for concession revenues were not disclosed at all. The current lease agreement does not contain any clause that would penalize the authority for not complying with the disclosure requirement. The Department has advised the GTAA of its concerns and is working with the authority to resolve the issue.

10.129 Other than reviewing information in authorities' annual reports for what is disclosed, Transport Canada has yet to review the extent to which other airport authorities are using sole-source contracts and reporting on them appropriately.

10.130 **Transport Canada should periodically review contracting matters in transfer agreements to ascertain whether they adequately reflect public sector values. It should alert decision makers to its findings and make recommendations as appropriate, including enforcement considerations such as penalties for non-compliance.**

Department's response: See response following paragraph 10.139.

A largely hands-off approach to landlord responsibilities

10.131 Leased airports in the National Airports System are diverse. Some are unique — Pearson International, for example, by virtue of its size. Each has its own regional economic realities and all are at different stages of growth and expansion. Transport Canada's head office and five regions administer and co-ordinate the Department's landlord-related responsibilities for the NAS. Until 1997, all of the landlord activities were centralized at headquarters in Ottawa because only four airports had then been transferred. Consequently, at most regional offices the landlord role for NAS airports is a relatively new responsibility.

10.132 **Transfer of corporate knowledge.** The Department has yet to establish a formal training program to educate employees about lease management matters. Consistently in our meetings at all of the Department's five regional offices, staff indicated a need for such training. They noted that significant downsizing in the recent past had resulted in a substantial loss of corporate memory about airport matters. Moreover, they believed a formal training program would help them develop the skills required to move from operator to landlord of NAS airports. Regional staff also noted that they lacked some fundamental knowledge about the rationale for some of the negotiated terms in the leases they are required to administer. The Department had yet to establish a formal process for negotiators to convey critical knowledge implicit in the negotiated leases. As a result, regional staff felt they were not on a level playing field in their dealings with airport authorities and thus risked mishandling aspects of the leases.

10.133 **Auditing airport authorities.** According to the leases, the Department has the unrestricted right to audit airport authorities. In keeping with its hands-off approach, however, Transport Canada has not exercised this right at any of the major airports since 1995, when it audited the four LAAs to assess their compliance with the financial aspect of the lease formula. Those audits raised many issues that impacted on the amount of rent received by the government, and we are concerned that some are still unresolved. The Department informed us that in the summer of 2000 it would develop an audit program for auditing airport agreements, which would include issues raised in its previous audits.

10.134 **Standards and criteria.** We found that the Department has not developed standards or criteria for assessing how well authorities are complying with certain key aspects of their leases.

Regional staff of the Department noted that they lacked some fundamental knowledge about the rationale for some of the negotiated terms in the leases they are required to administer.

In keeping with its hands-off approach, Transport Canada has not exercised its right to audit airport authorities at any of the major airports since 1995.

The Department has neither carried out a comprehensive study nor performed any systematic monitoring of the financial health and viability of the National Airports System as a whole.

10.135 Leases specify that an airport authority must provide a “first-class” facility. However, the leases do not define this in terms of the size and nature of a facility and the level of services it should provide, other than having the capacity to meet the demand for service of communities within a 75-kilometre radius of the airport.

10.136 Standards and criteria would assist the Department in carrying out appropriate, effective and timely monitoring of airport expansions to help ensure that they are in line with community interests and that it can alert the Minister, Cabinet and/or the Treasury Board to any potential problems. They could help, for example, to identify overbuilding and extra costs and the potential risks to the integrity and viability of the National Airports System.

10.137 We note that airport leases require airport authorities to review and report on their own performance every five years. However, we are concerned that Transport Canada has not communicated to airport authorities its requirements and interests as overseer and landlord of the system. Consequently, it may not be able to ensure that the reports fully meet its information needs.

10.138 Transport Canada should, without delay, establish a formal training program to transfer critical knowledge and skills to its regional staff responsible for lease management, and it should ensure the continuing development of those skills over time.

10.139 Transport Canada should define its role in post-transfer matters as overseer and landlord of the National Airports System together with the systems and practices it needs to discharge that role, including the level of audit activity required.

Department’s response: Transport Canada agrees that its role as landlord and overseer of the National Airports

System should be clear to stakeholders and parliamentarians. Transport Canada had already identified these and other issues through its LAA Lease Review process and was planning to deal with them as part of a comprehensive package. Direction to be received in fall 2000 and actions arising from the results of the five-year review will further clarify Transport Canada’s and the government’s role in post-transfer matters, including those areas identified by its five-year review.

Transport Canada will continue to take steps to strengthen its existing landlord role. Examples of some of the activities currently under way include:

- *developing a lease monitoring matrix and supporting schedules to ensure a national approach to the treatment of the leases, taking into account the specific terms and conditions of each lease;*
- *implementing a more rigorous lease monitoring program that will, where appropriate, include an assessment of airport authorities’ contracting practices; and*
- *establishing a national program to transfer critical knowledge and skills to all staff responsible for lease management.*

Transport Canada’s oversight of financial viability lacks rigour

10.140 In 1997, the Department looked at the financial viability of a few less-viable airports that had yet to be transferred. Its five-year review looked at the financial viability of only the four airports transferred in the first round. The Department has neither carried out a comprehensive study nor performed any systematic monitoring of the financial health and viability of the NAS as a whole.

10.141 In our view, a systematic approach to monitoring is long overdue. However, the Department has informed us that it will study the financial viability of the NAS only after a decision has been

made to conduct a comprehensive review of the National Airports Policy. It believes that such a review could be carried out only after enough time has passed to permit meaningful results to emerge. We disagree with the Department. Monitoring the financial health of the system is something that needs to be done on a proactive, ongoing basis. It is fundamental to basic oversight activities.

10.142 We find that the delays implicit in the Department's position on monitoring may place the public purse at undue risk. The Department's position on this matter is also worrisome in light of the fact that the National Airports Policy publicly commits Transport Canada to guarantee the long-term viability and integrity of the National Airports System. The Policy clearly recognizes that the system is of vital importance to Canadians.

10.143 The underpinnings of a comprehensive study and systematic monitoring of the National Airports System's viability would include, in our view:

- developing benchmarks against which to assess financial viability;
- identifying the main drivers of financial performance and the associated risks;
- drawing comparisons with other jurisdictions;
- analyzing the ability of all NAS airports to absorb operational losses and replace aging capital infrastructure; and
- carrying out an analysis of government support and other financial commitments, together with sensitivity analyses to project into the future.

10.144 As yet, Transport Canada has neither defined its data needs nor begun to collect and maintain the generational databases it needs to both support its oversight responsibilities and facilitate the

more specific analysis required for policy development. Such data could also be used for periodic assessments of the System's financial viability to support decision making throughout the 60-year term of the leases.

10.145 We found that the Department has been reactive in assessing emerging financial risks. The recent airline restructuring issue is one example. We note that only in November 1999 did the Department begin to study the financial viability of NAS airports in the context of airline restructuring. At that time, parliamentarians were expressing a keen interest in having better information on this subject. However, the Department informed us that its study would provide only a theoretical and largely qualitative assessment of the impact of airline restructuring on certain specific airports. Consequently, it would not provide a definitive view of the viability of the NAS as a whole. The study was still under way at the time of our audit.

10.146 During our discussions with various airport authorities, several stressed the need for the Department to have a clearer vision both of how the National Airports System overall should function and of the Department's role in ensuring that the System functions at an optimum level. We noted that Transport Canada has yet to establish any specific performance objectives and measures for the System that focus on outcomes — on what the NAS ought to be achieving in areas such as sustainable development, international competitiveness, and accessibility.

10.147 **Transport Canada should design and formalize a framework for monitoring the long-term viability, integrity and overall performance of the National Airports System. It should collect the necessary quantitative and qualitative data to perform timely analyses. To the extent that it relies on airport authorities or other sources for underlying data, the Department should clearly specify the type and format of**

Although some airport authorities appear to be proactive in environmental assessment matters, there is no legal requirement for them to conduct formal environmental assessments of their projects.

the data it requires from them and should establish procedures to verify that the data are reliable.

10.148 The Department should periodically report to Parliament and other stakeholders on the performance of the National Airports System as a whole.

Department's response: Transport Canada agrees that performance monitoring and reporting are critical to its oversight and landlord role. As part of fulfilling this role, Transport Canada currently has comprehensive monitoring programs in place to monitor the leases and airports, and for policy development purposes.

The Department has defined the data types and format for some areas, and currently collects some information on airports. Most of the data are drawn from reliable sources, for example, audited statements and data from specialized statistical agencies such as Statistics Canada. Transport Canada recognizes that improving performance monitoring and reporting is an ongoing process that will require further time and effort. The Department will take steps to strengthen its data collection, validation and monitoring practices, where appropriate.

Airport authorities are still not subject to the *Canadian Environmental Assessment Act*

10.149 Although Transport Canada is not the lead department for ensuring the relevance and completeness of the provisions contained in the *Canadian Environmental Assessment Act*, the status of provisions in the Act has ramifications for the operations the Department has transferred. Transport Canada noted in its five-year review of airport transfers that there was a lack of regulatory support for environmental assessment matters and that this made it difficult for the local airport authorities to impose environmental

assessment standards on tenants. In addition, it is not clear what standards apply to various aspects of airport authority operations. As the Commissioner of the Environment and Sustainable Development first observed in 1998, airport authorities are not subject to the provisions of the *Canadian Environmental Assessment Act*. The government's stated intention to develop regulations under the Act has not been carried out. This is worrisome, given the hundreds of millions of dollars in capital works projects under way on National Airports System lands and facilities. Although some airport authorities appear to be proactive in this area, there is no legal requirement for them to conduct formal environmental assessments of their projects.

10.150 As a federal department, Transport Canada is subject to the provisions of the *Canadian Environmental Assessment Act*. Generally, any subsidy it pays — directly or indirectly — is subject to the Act. But there appear to be some exceptions. For example, the federal government would not be required to perform an environmental assessment in support of a subsidy it provided to airports, such as negative rent or rental credit, if the subsidy were not linked to a specific project. The greater proportion of the several hundred million dollars to date in approved rent reductions or negative lease payments has not been linked to specific projects. According to the Department, airport authorities were to direct much of these savings on rent to capital works projects. Until such time as the government's stated intention to develop the regulations under the *Canadian Environmental Assessment Act* is carried out, there is a need for Transport Canada to consider the appropriateness of funding future expansion projects at airports without explicitly requiring environmental assessments from airport authorities and conducting appropriate screening of those assessments.

Federal enabling legislation for transfer of airports dates back to 1992

10.151 It should be noted that the *Airport Transfer (Miscellaneous Matters) Act* is the enabling legislation for airport transfers. It was proclaimed in 1992, in the year of the first round of airport transfers, when the government still owned and operated over 100 airports. Unlike some other statutes, this Act has no provision for its formal review after five years for currency and relevancy. The Act is also silent on enforcement matters such as penalties that Transport Canada could impose on post-transfer activities.

10.152 Rent credits to subsidize capital works at airports, and other forgiveness of rent, lack transparency to Parliament.

Although rent credits and other rent reductions negotiated by Transport Canada permanently reduce revenues to the Crown, there is no requirement for specific approval by Parliament in the Estimates process — unlike other federal financial support such as payment of a grant or contribution. Even though the purpose of rent credits and other financial support is similar to that of grants and contributions and, in a number of cases, reduces revenues otherwise due the Crown, government policy does not require the Department to disclose that information to Parliament. Transport Canada notes that it follows the government policy. In our opinion, the government policy does not preclude the disclosure of relevant and pertinent information. We observed that the information on rent credits and other forgiveness of rent in the Department's Estimates documents and/or its annual Report on the State of Transportation in Canada was fragmented, incomplete, and in some years non-existent. As noted, rent credits and other forgiveness of rent that the Department has negotiated with airport authorities have been significant — \$474 million so far. Of the \$210 million forgone from 1992 to 1999,

only \$97 million was reported to Parliament. With respect to the remaining \$264 million, no information on this future commitment has been disclosed.

10.153 Transport Canada should, through the Estimates process and other accountability reporting to Parliament, make transparent the rent credits and other forgiveness of rent negotiated with airport authorities.

Department's response: Transport Canada has fully met its obligations under current government policy. As noted by the office of the Auditor General, government policy does not require departments to report rent credits and other similar financial support to Parliament. That being said, Transport Canada recognizes the importance of increasing transparency to Parliament and the public. With the implementation of the Financial Information Strategy (FIS), the Department expects to report rent credits and other forgiveness of rent negotiated with airport authorities. As per standard government practice, the Department's financial statements will be made available to Parliament and the public.

Conclusion

10.154 During the last seven years, Transport Canada has transferred 18 of Canada's largest and busiest airports to airport authorities. At the conclusion of our audit, only four airports in the National Airports System remained to be transferred. Yet Transport Canada had already renegotiated four leases, had given a qualified undertaking for at least three more renegotiations under certain conditions, and was being pressured by several authorities to enter into more renegotiations.

10.155 Our audit of the Department's handling of airport transfers, including the renegotiations, revealed many significant weaknesses in its management practices. In particular, Transport Canada did not

Information on rent credits and other forgiveness of rent in the Department's Estimates documents and/or its annual Report on the State of Transportation in Canada has been fragmented, incomplete, and in some years non-existent.

assess the fair market value of the airports to be transferred before it entered into the second round of negotiations and any renegotiations. It has yet to come up with a framework for evaluating and reporting on the overall financial impact of the transfer initiative. In addition, some of the information provided to decision makers in support of the transfers was incomplete and inaccurate, and in the transfer process the Department failed to adhere to some key government directions. Contributing factors may have been the absence of a formally codified application framework in support of airport transfers, including renegotiations, and the lack of independent review to determine whether proposed final deals adhered to government directions.

10.156 We found that Transport Canada has yet to define its post-transfer role as overseer of the National Airports System and guarantor of the System's integrity and viability. Nor has it clearly defined its role as landlord of the transferred facilities. We found that its approach to

dealing with emerging issues is far too passive, and lacks rigour in certain respects. Among other things, the Department has failed to assume a leadership role and to properly monitor the growing use of airport improvement fees, sole-source contracting at major airports, and activities of subsidiaries in order to ensure that the interests of the public are protected.

10.157 The Department has also been slow to complete its five-year policy review of airport transfers. Preliminary results have pointed to a number of concerns. Transport Canada needs to move quickly to finalize the review and make its observations and recommendations known to decision makers.

10.158 Overall, we believe there is a pressing need for Transport Canada to demonstrate more diligence in its handling and oversight of NAS airport transfers, including any renegotiation of transfer agreements and related accountability reporting to Parliament.



About the Audit

Objective

Our overall objective was to assess Transport Canada's management and administration of airport transfers since 1992, its oversight of the National Airports System as a whole and its performance as landlord of airport facilities.

Scope

Our audit focussed on Transport Canada's responsibilities relating to the National Airports System. We carried out our audit in the context of eight of the largest airports: Victoria, Vancouver, Edmonton, Calgary, Toronto, Ottawa, Montreal (Dorval and Mirabel) and Moncton. All are part of the National Airports System, representing 85 percent of its traffic in 1998 and just about all of Transport Canada's lease revenues. While we looked at aspects of negotiated lease arrangements for each of the NAS transfers in our sample, we do not provide any assurance or opinion on the overall quality and effectiveness of any one lease.

The following areas were excluded from the scope of our audit:

- Transport Canada's current negotiations of transfer agreements to complete the transfer of NAS airports;
- the transfer of non-NAS airports to territories, provinces, municipalities or private interests;
- Transport Canada's management of the Airport Capital Assistance Program;
- the performance and effectiveness of the boards of directors of individual authorities;
- the decision to cancel the transfer of Lester B. Pearson International Airport;
- the safety and security aspects of airport operations; and
- the management and administration of the first round of airport transfers.

Criteria

We expected to find the following:

Policy. Decisions regarding airport transfers and the management of the National Airports System would be guided by clear policies, protect the interests of the taxpayers, and information presented to decision makers would be accurate, relevant, timely and complete.

- Policies with respect to airport transfers and the management of the National Airports System would be updated as and when required for currency and completeness.
- Transport Canada's roles and responsibilities in and for the National Airports System would be clearly defined and appropriate governance and accountability would be in place, including mechanisms for reporting back to decision makers on related performance.

Implementation. Agreements entered into with airport authorities would reflect government directives and facilitate the effective discharge of Transport Canada’s landlord responsibilities.

- Sound management practices would be followed in the management and administration of agreements with Authorities and for the National Airports System as a whole.
- Transport Canada would keep abreast of emerging issues to ensure that Crown assets were protected and taxpayers’ interests appropriately safeguarded.

Reporting. Transport Canada would appropriately monitor, evaluate and report to decision makers and Parliament on the results and impacts of airport transfers, the functionality of the National Airports System and the management of leased facilities.

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