Town of Port Hedland

Port Hedland INTERNATIONAL AIRPORT

Exploring an alternative governance model

Port Hedland International Airport governance review

June 2014

1. Executive summary

The Port Hedland International Airport is owned and operated by the Town of Port Hedland (TOPH). The airport will soon transform to a modern and well-serviced airport that provides a welcoming gateway to Australia's North West. The $100 million plus redevelopment program will include refurbishments, infrastructure upgrades, new subdivisions and new business opportunities.

The airport has experienced rapid growth with passenger numbers multiplying from 110,000 in 2005 to more than 515,000 in 2013. With this unprecedented growth, the airport needs to expand. There is now a significant opportunity to leverage existing work and deliver a modern and well-serviced airport for Port Hedland.

The redevelopment strategy will require an investment of more than $100 million over the next five years. Funding sources include airport capital reserve, revenue from Kingsford Smith Business Park, new revenue sources and loan funds.

Given the size of the required investment, there is an opportunity to review the airport's governance structure and determine if a more efficient and economically viable operating model is available.

As part of the airport strategy development, work has commenced to review the airport's governance model and identify alternative approaches. The Airport Group were engaged to provide an overview and analysis of alternative governance models and recommend next steps for the Town of Port Hedland to consider. Workshops have been held with elected members to review governance and ownership options.

Of the governance and ownership options examined it was identified that:
- there is a clear preference for consideration of a Council Controlled Organisation model (that will include increased commercialisation), or a lease option, since both these options are retaining ownership; and
- there is no support for a freehold sale, and little support for amalgamations, shared services, management agreements or the continuation of the owner / operator model.

In discussion it was noted:
- under the current Local Government Act, it is very difficult to be commercially nimble (Commercialisation and Corporatisation models)
- legislative amendment will be needed for a Council Controlled Organisation (CCO) if there is to be a true separation of commercial risk from TOPH to the airport; and
- leasing can occur without legislative change – albeit needing to be in accordance with the provisions of the Local Government Act (LGA).

The agreed governance objectives were:
- retain ownership of the asset
- the overall financial return must be better than the status quo if any change is to proceed (eg: comparable financial return, plus a sizeable initial financial incentive)
- real figures of the cash flow and the asset value of the airport as a full disclosure stand-alone entity must be used in any decision on the governance model (real value figures will be lower than the current, whole of ToPH figures used)
- essential services (such as Royal Flying Doctor Service) must be maintained
- there must be an expanded benefit (eg: sense of place) to the local community
- depth of management expertise must be enhanced through access to a wider pool of qualified people
- the overall level of risk to the Town must be reduced through an appropriate governance structure (ie: financial and operational risks must be capped, limited or transferred) and
- maximise the use and the return from the existing land and facility at the airport through smart planning and infrastructure, irrespective of the governance model chosen.

It was confirmed there is an appetite to progress with the airport governance review:

- to determine what the asset is worth
- to investigate leasing options
- to investigate opportunities and restrictions around corporatisation and a CCO

The immediate next step is to investigate the three preferred options which broadly speaking includes:

- Commercialisation
- Council Controlled Organisation
- Leasing

As identified at the workshop and in earlier reports, there are a number of key considerations in structuring future ownership and/or governance arrangements from both the Town of Port Hedland's perspective and from the perspective of potential new owners/investors/operators. This paper provides a summary of these considerations including:

- agreed objectives and critical success factors
- details of the three preferred models and their advantages and disadvantages
- standalone financial analysis and estimated returns to the Town of Port Hedland
- comparison of each model against the agree objectives and critical success factors
- conclusions and recommendations

2. Ownership and governance considerations

2.1. Residual Risk Exposure

The airport must continue to operate in accordance with all relevant legislative requirements, and not expose the Town to any greater liability risk under any alternative models.

Of particular relevance is the increasing complexity of airport legislation, which requires up to date and specialised knowledge of airport regulations. This requires experienced and well trained airport staff and a sound succession plan to ensure critical positions are covered for sudden absences or departures.

The airport must continue to operate to prescribed safety and security standards, have a funded asset management program, a well-managed OH&S process, continue to be financially viable and have an effective process for identification and treatment of risks.

2.2. Net Contribution

The airport should not place any greater burden (and preferably less burden) on the governance, finances and resources of TOPH under any alternative model than it currently does.

Some Local Government airports operate at a loss, consuming Local Government resources to maintain community service obligations while others generate sufficient financial returns to provide valuable contributions back to the Local Government for other activities.

Airport expansion, and for that matter, ongoing asset replacement must often compete with other TOPH social infrastructure priorities in terms of financial and physical resourcing.

Any change to airport ownership, management or governance must assess and measure the net benefit to TOPH (or economic cost to TOPH) as a result of the change.

This would extend to an assessment of the revenues and costs before and after any change. There may be opportunities for additional revenues to TOPH – eg: from rate income under some ownership/governance models. Similarly, there may be opportunities for cost efficiencies, for example by a reduction in TOPH direct costs of operating the airport.

This needs to be assessed against any additional costs that the TOPH may incur from a different oversight of airport governance – this could particularly arise in the instance of a complex lease regime.

To the extent that any change in ownership involved consideration by way of lease payment, the Town needs to assess the relative benefits of receiving an ongoing annuity stream of airport lease payments over the term of the lease versus receiving the proceeds as a lump sum, which may create the capacity for the Town to substantially close its asset management renewal gap, retire debt or fund priority community infrastructure projects.

A hybrid model, should a lease arrangement be considered, could be some form of up-front payment, together with an ongoing lease payment and perhaps even a profit-share component which would allow the Town to participate in future upside.

The Town also needs to carefully assess the capacity of any third party to meet their ongoing financial and operational obligations in the event the airport ownership/governance arrangement is changed. The Town needs to be certain that current assets are not "sweated" to a diminished value, and that it does not need to step in to retake control of the airport or be pursuing a recalcitrant or failed airport lessee.

2.3. Supporting Economic Growth

Airport infrastructure should be appropriate for the current and reasonably foreseeable future demand for aviation services in the region. This requires the airport infrastructure to be "fit for purpose", regularly maintained and provided to an appropriate standard.

Airport planning processes must be sufficiently rigorous to ensure an appropriate scale and nature of development on the airport. A requirement for the airport to develop and at least consult with key stakeholders on its master plan should be incorporated into any legislation, regulations or by-laws that are enacted in relation to any change in ownership or governance.

2.4. Supporting Community Service Obligations

Regional airports, to varying extents, play an important role in supporting their local communities, through their direct and indirect economic contributions and also by facilitating essential services, such as search and rescue, fire- fighting, medical and access to remote communities.

It is not always feasible to price the provision of the services necessary to support such community service obligations at their true economic cost, however any change in ownership or governance needs to ensure that existing community service obligations continue to be met.

2.5. Owner/Investor/Operator Considerations

The privatisation of Australia's major airports and case studies of some smaller airports have provided a reference point for the design and implementation of an ownership/governance regime.

Whilst some of the considerations that have been identified as important may have less significance or relevance to Port Hedland International Airport, given its size and the markets it serves, they are included here for completeness.

Key features of an ownership/governance regime that will impact on attracting interest and securing an appropriate level of consideration by a potential owner/investor are:

- **An appropriate balance of autonomy and control**
  New owners/investors/operators require a high level of autonomy in conducting their business. If the airport remains tightly controlled by its existing Town owners, this can stifle decision making and accountability and ultimately impact on the airport attracting and retaining the right people.

  This requires a balance to ensure the Town does not completely abdicate its responsibility over the airport and retains an ability to step in under exceptional circumstances to protect the community interest.

- **An appropriate degree of regulation**
  A change in airport ownership in particular needs to be supported by a regulatory framework that is not too "heavy handed" in terms of its obligations on airport owners and operators, while protecting key stakeholders from unreasonable conduct by the airport owners or operators.

  Complex and onerous reporting obligations and inflexible regulations will impose additional compliance costs on the owners and operators, which can lead to under-investment and inhibit the incentive to diversify the airport's business. Moreover, changes to the regulatory framework can increase the perceived risk of the airport to potential investors, thereby lessening investor interest and any consideration they are prepared to pay for the particular airport ownership/governance arrangement.

- **Appropriate tenure for proposed arrangement**
  Any new ownership/governance arrangement needs to be set for a period that provides the new party with sufficient time to earn a reasonable return on their investment.

  If the sale of a leasehold interest is proposed, the lease term needs to be of sufficient length to allow the investor to raise the necessary finance to fund the lease and to invest and attract others, such as tenants to invest in the business.

- **Town infrastructure supports airport**
  The relationship with the Town must be productive, collaborative and complementary. Towns provide essential civil works infrastructure, such as roads, which must support airport activities.

  Towns can also significantly assist airports in the sensitive area of aircraft noise by ensuring only complementary developments are permitted in areas impacted or likely to be impacted by aircraft noise. Similarly, airports must have due regard to the impact on the Town infrastructure of airport activities.

3. Agreed objectives and critical success factors

3.1. Agreed Objectives

The following principles were agreed at a workshop with elected members and TOPH executive team for the ultimate governance model:

- retain ownership of the asset to ensure the Town has an ongoing influence of strategic outcomes that will benefit Port Hedland's community and economy
- the overall financial return must be better than the status quo if any change is to proceed (eg: a comparable financial return, plus a sizeable initial financial incentive) – this could be achieved via a one off capital payment or an ongoing annual annuity with the overall principle being that the Town must be financially better off from any new governance structure (in the short term and longterm)
- real figures of the cash flow and the asset value of the airport as a stand-alone entity must be used in any decision on the governance model – stand-alone reporting of revenues and expenditures to an EBITDA level must be understood to enable a true assessment of the airport's value

- essential services (such as Royal Flying Doctor Service) must be maintained – ongoing access to medivac services, emergency services, airfreight and postal services must be maintained under any new governance model
- there must be an expanded benefit (eg: sense of place) to the local community – the quality of the experience must be enhanced through a greater ability to provide appropriate facilities to meet community expectations
- depth of management expertise must be enhanced through access to a wider pool of qualified people
- the overall level of risk to the Town must be reduced through an appropriate governance structure (ie: financial and operational risks must be capped, limited or transferred)
- maximise the use and the return from the existing land and facility at the airport through smart planning and infrastructure, irrespective of the governance model chosen.

3.2. Critical Success Factors

The following critical success factors were identified as a prerequisite for any governance transition:

- allowing greater access to debt funding against airport asset base and quarantining of debt risk to the airport assets
- establishing an appropriate level of airport operator autonomy and maintaining a reasonable degree of strategic influence while maximising financial returns to the Town of Port Hedland
- establishing a greater level of commercial focus by allowing for sufficient decision making flexibly to ensure financial sustainability
- ongoing operational decision making and operating and capital expenditure rests with others, who have the necessary airport management expertise to efficiently run the airport
- allowing access to qualified staff and greater economies of scale through wider commercial network and
- a full understanding and transparency (full disclosure) of financial details.

4. Preferred Models and their strengths and weaknesses

The governance review workshop identified that the Town had a clear preference to further examine and explore increased Commercialisation, Council Controlled Organisation (CCO) and Airport Leasing. These are described below.

4.1. Commercialisation

The process of commercialisation is often commenced in the lead up to the corporatisation of a government run entity, although corporatisation can be effected as a single stage process.

Commercialised entities remain as separate business entities (but not separate legal entities), within the government agency, with the objective of conducting the business of the entity in a manner that replicates as far as possible the commercial world.

The aims of commercialisation should be to achieve value for money in the consumption and delivery of Gov't services by applying commercial principles.

Commercialisation requires competitive neutrality, establishment of clear objectives, accountability, an appropriate degree of autonomy and clear performance measurement. Before embarking on commercialisation approach, there would be a public benefits test to ensure the financial, social and economic benefits outweighed the costs.

Commercialisation can be an effective means of a graduated move towards a broader policy agenda – such as corporatisation (i.e. CCO) or possible privatisation as it provides the government entity with an initial checkpoint to assess the success of the strategy before the more substantive step of corporatisation occurs.

Commercialisation requires the adoption of a corporate mindset and culture to ensure the agency personnel will proactively support the initiative.

Commercialisation will apply disciplines used in private enterprise in areas such as pricing of goods and services, asset valuation, investment assessment criteria – eg: hurdle rates, performance monitoring and measurement, capital management policy, HR policies and potentially income tax planning.

The strengths of commercialisation, if implemented well can include:

- the ability to achieve a greater commercial focus - revenue diversification and improved cost control by the organisation
- the board or airport committee focus exclusively on airport issues
- more transparency of the organisation’s performance, achieved by a more explicit recognition of organisation costs and standalone reporting
- the retention of the ownership with the Town, or not “selling the farm”, which allows the Town to step in under certain circumstances and
- possibility of freeing up the Town’s staff for other council initiatives of possibly greater community utility who would otherwise be, to a varying extent, allocated to airport activities.

The key weaknesses of a commercialised entity within the context of the Local Government Act would include:

- requirements for operational oversight and monitoring are not reduced and the Town retains responsibility introducing a further layer of management reporting
- political pressure can still be exerted over the airport’s operation and strategic management processes
- financial reporting and standalone costings still need to be amalgamated and incorporated with overall Town financial reports
- Ability to raise and quarantine debt funding to airport asset base is limited under the Local Government Act
- the Town and rate payers are still exposed to financial and operation risks associated with the airport
- decision making is still constrained by the requirements of the Local Government Act reducing the ability to be commercially nimble and
- additional management costs are incurred through board/committee reporting processes with no corresponding increases in returns to the Town.

4.2. Council Controlled Organisation

The original concept of the creation of CCO has been developed out of an increasing focus on issues of sustainable development and urban regeneration, which has given rise to discussion on a number of potential roles for local government in the commercial sector. This is beyond its traditional role as a planning authority, and it has been noted that there are measures that might be taken by local government to infrastructure redevelopment objectives at the local level that might not be practicable under development models pursued by existing State and local government agencies.

At the same time, there has been a broad recognition of the need for local government to broaden and diversify its sources of revenue. Development of and investment in commercial enterprises is a potential source of such revenue.

However, the involvement of local government in other commercial enterprises beyond its traditional “core” functions raises a number of issues including real or perceived conflict of interest between the regulatory and ownership roles of local government, the capacity and competence of local government to undertake such enterprises and the exposure of ratepayers to financial risk.

The most efficient way to avoid potential or actual conflicts of interest, to minimise financial risk and to engage the necessary commercial and corporate expertise is through the creation of an arms’ length vehicle such as a wholly-owned company or an investment trust to hold and manage the commercial interests of a local government. The development of the concept of a CCO came out of this desire to avoid conflicts of interest, financial risks and minimise risks, with the essence of such an entity being that the Board or trustees are legally obliged to operate at arm’s length from the local

government, within the performance parameters laid down in its constitution, and to act independently of all other factors (including political pressure) within the regulatory parameters applicable to any other corporate entity.
However, Western Australia is unique among Australasian jurisdictions in imposing a blanket prohibition on the use of corporate governance structures by local government. The current statutory framework for local government in Western Australia, as set out in the Local Government Act and associated regulations, contains a number of provisions that constrain local government from operating on normal commercial terms. Of particular significance are section 3.58 – 3.60 inclusive and section 6.21 which, taken together, provide almost insurmountable hurdles to the commercially efficient use of local government assets or the conduct of trading activities on normal commercial terms. More specifically there are three specific provisions in the Local Government Act 1995 constraining local government activities in property dealings and the use of corporate structures:

- **Section 3.58** requires that a local government can only dispose of property by public auction, public tender, or otherwise by giving State-wide public notice of the proposed disposition and inviting public submissions that must be considered before the disposition is made. This is a significant disincentive to private bodies seeking to undertake potentially risky development projects (such as transport infrastructure redevelopment), as they normally seek to prove up the commercial feasibility of a project before investing in a project, and would be reluctant to expose commercially sensitive information to their competitors.
- **Section 3.59** requires that before a local government undertakes a major land transaction (currently defined as any transaction greater than $1 million in value) it must prepare and advertise a business plan that includes details of the expected effect on the provision of facilities and services by the local government, and on other persons providing facilities and services in the district, its expected financial effect on the local government and on matters referred to in the local government's Annual Plan, and the ability of the local government to manage the transaction. The business plan must be advertised State-wide for public submissions, and if through any change of circumstance or as a result of any matters raised in submissions the local government decides to vary its proposal in any significant way, it must repeat the entire process.
- **Section 3.60** provides that a local government cannot form or take part in forming, or acquire an interest giving it the control of, an incorporated Company or any other body corporate … unless it is permitted to do so by regulation. Regulation 32 of the Local Government (Finance and General) Regulations 1996 provides that a local government may participate in an incorporated association or a body corporate established under the Strata Title Act 1998, but there is no general provision permitting the establishment of trading or investment entities.
- Of potentially more wide-ranging effect is the prohibition in **Section 6.21** on giving security over assets in relation to any borrowings by a local government. Section 6.21(2) provides that the only such security that may be given is the general fund (in essence, the annual rates revenue). A local government that might own a commercial business or investment properties cannot therefore borrow against the value of any business or that property to improve it, for example, inevitably leading to a decline in economic value. This provision also severely constrains the scale of investment that can be undertaken.

Therefore the Local Government Act 1995 would need to be amended to provide a comprehensive suite of measures to permit the establishment of incorporated local government entities.

The amendments to the Act would include:

a) a new section 3.60 to provide that a local government may establish or participate in a CCO subject to a defined consultation process and the approval of the Minister
b) a proviso that a local government may not establish a CCO for the purposes of dealing with any regulatory function
c) requirements for the development of a Statement of Intent and a Business Plan for any proposed CCO, which must be published as part of the statutory consultation process and monitored thereafter
d) requirements for the adoption of a clear and transparent policy and process regarding the appointment of directors and trustees, including a provision that a person may not be appointed solely by virtue of their status as an elected member of Council
e) a prohibition on the giving of guarantees or security for the performance of a CCO, or the granting of shareholder finance on preferential terms
f) detailed performance monitoring and reporting requirements for CCOs

g) special provisions to cover circumstances such as CCOs owned by more than one local government, or where the purchase of shares by a local government would give rise to CCO status in a company not previously of that form
h) investment in a CCO, if all other requirements are met, be deemed an approved investment under section 6.14. and
i) section 6.21 to be amended to provide that a local government may give security over any freehold land in addition to its general fund.

It should be noted that the above changes requires the drive and support of the State Government to effect these changes to the Local Government Act. The concept of establishing a CCO has been debated since 2010 with little progress made to date. It is therefore evident that this proposal has not been high on the State's agenda, and it is also now apparent from the statements made in the Draft WA State Aviation Strategy that the State's preferred governance option is leasing.

The strengths of a CCO, if changes to the Local Government Act were implemented would include:

- the ability to achieve a greater commercial focus - revenue diversification and improved cost control by the organisation
- the ability to employ professional directors/trustees and management with experience specific to the commercial objectives of the entity
- more transparency of the organisation's performance, achieved by a more explicit recognition of organisation costs and standalone reporting
- removal of detailed investment decisions from day-to-day political processes while retaining political oversight of the broad strategy
- the retention of the ownership with the Town, or not "selling the farm", which allows the Town to step in under certain circumstances
- the ability to quarantine the Town and ratepayers from legal liability and financial risk arising from commercial or investment activities
- greater flexibility to enter into joint venture and partnering relationships with the private sector on conventional commercial terms
- ongoing annuity stream via dividend payments and
- releasing the Town's staff for other Town initiatives of possibly greater community utility who would otherwise be, to a varying extent, allocated to airport activities.

The key weaknesses to the establishment of a CCO entity within the context of the Local Government Act would include:

- extensive changes required to the Local Government Act and its regulations
- political pressure would need to be exerted on the State to change its preference for a changed governance model from leasehold structures to CCO arrangements
- financial reporting and standalone costings still need to be amalgamated and incorporated with overall Town financial reports
- Ability to raise and quarantine debt funding to airport asset base is limited under the Local Government Act
- Until changes to the LGC are established council and rate payers are still exposed to financial and operation risks associated with the airport
- decision making is still constrained by the requirements of the Local Government Act reducing the ability to be commercially nimble
- loss of council control of fees and charges resulting in possible price increases
- CCO failing to meet its obligations, resulting in community dis-satisfaction
- CCO structure may result in income tax liabilities, which could impact the Town dividends and
- additional management costs are incurred through board/committee reporting processes with little financial upside from a Town dividend perspective.

4.3. Leasehold

In consideration of a leasehold structure it should be noted there are a number of key additional elements to address, which are:

- having the ability to access adequate levels of equity and debt
- operating at a sufficient level of scale and efficiency
- having the capacity to access private equity and expertise through joint ventures or partnerships
- having the ability to make commercially sound and efficient business decisions
- complying with statutory constraints
- being responsive to local or sub-regional needs and priorities
- exhibiting best practice governance

Under a leasehold structure the Town is able to address each of these key elements as a lease arrangement allows, (through a public tender process), the ability to access/attract large infrastructure companies with particular expertise in the area of airport management and airport financing.

Larger infrastructure investment companies have the ability to access large pools of debt funding and equity sources through their national and global structures and are very sophisticated in their approach enabling the establishment of cost effective funding sources. Additionally, through their well-established corporate treasury processes they have the ability to regularly refinance and resource large capital programs consistent with those programs normally required for airport operations and development.

These companies operate at a sufficient level of scale and efficiency to generate acceptable commercial returns and levels of productivity which are attractive to investors and lessors who benefit from an increased return from the ultimate asset ownership. In the case of the Town it is anticipated that a leasehold structure would generate a higher return than other governance models.

A typical infrastructure investment fund which would operate under a leasehold structure has the capacity and expertise to access private equity and joint venture financing partners as they are generally managed directly by, or indirectly through large financial institutions. These institutions provide management oversight either through contracted management agreements or governance oversight shareholder appointed directors who sit on the airport leasehold company’s board.

Typically the larger infrastructure investment funds own a number of airport businesses across Australia and in some instances globally which provides them with the expertise to make commercially sound and efficient business decision when it comes to running an airport as a commercial enterprise. Through these firms a greater depth of management expertise can be sourced through their wider network of airport ownerships. Given this the ability to comply with regulatory and compliance constraints/requirements is enhanced thus ensuring safer and more efficient airport operations.

More often than not these companies operate across regional areas and recognise the need to be responsive to local or sub-regional needs and priorities. Typically these needs are managed through its local teams and via its shareholder representatives (directors) as it is recognised that in meeting these needs the best interests of the local community and the airport business are met.

These companies generally own a large and diverse number of infrastructure investments with often very sophisticated governance structures and exhibit best practice governance oversight. They have access to a larger group of expert directors with diverse skill sets thus ensuring sound financial and commercial decision making.

Finally it is noted there is no need to undertake any legislative change as the provisions of the Local Government Act allow for leasehold arrangements. Provided the appropriate legal and probity advice is obtained, the relevant business plans are prepared and the prerequisite public notice periods are complied with The Town is able to enter into a lease for the airport provided it obtains a fair market return.

More specifically this is dealt with under the provision for disposing of property under the Local Government Act 1995 (WA) Section 3.58.

The strengths of a leasehold governance structure include:

- the ability to achieve a greater commercial focus - revenue diversification and improved cost control by the organisation
- the ability to employ professional directors/trustees and management with experience specific to the commercial objectives of the entity
- more transparency of the organisation's performance, achieved by a more explicit recognition of organisation costs and standalone reporting
- removal of detailed investment decisions from day-to-day political processes while retaining political oversight and ownership of the broad strategy via an annual lease audit/compliance process
- the retention of the ownership with the Town, or not "selling the farm", which allows the Town to step in under certain circumstances
- the ability to quarantine the Town and ratepayers from legal liability and financial risk arising from commercial or investment activities
- greater flexibility to enter into joint venture and partnering relationships with the private sector on conventional commercial terms
- freeing up Town staff for other Town initiatives of possibly greater community utility who would otherwise be, to a varying extent, allocated to airport activities
- any lump sum consideration received can be applied towards other Town commitments, or reducing Town debt/deficits
- an ongoing lease payment instead of a lump sum provides an annuity stream to the Town
- ongoing capital expenditure and operating expenditure is the responsibility of the lessee
- lessee will be subject to Local Government rates
- quality of service standards can be established for the lessee
- lessor can benefit from business development initiatives resourced by lessee – eg: increased aviation activity driving local business, tourism, commercial development generating additional rate income
- no legislative changes required to the Local Government Act and therefore no legal restrictions to entering into a lease arrangement.

The other key issues to the establishment of a lease would include:

- there does exist a small risk of lessee failure although it is noted this is highly improbable, it remains a possibility
- lease and sale documentation can be complex
- lessee failing to meet its obligations, resulting in community dissatisfaction, (although this can be mitigated via ongoing surveillance/administration of the lease)
- need for a degree of ongoing surveillance/administration of the lease
- lessee company increasing prices for leased assets and facilities, (although this can also be managed via the lease) and
- discount on land values and less appeal to prospective tenants due to leasehold nature of land. (This was initially the case with leased capital city airports, however the market has come to terms with this, given the long term of these leases).
- understanding that the lessee must have the quiet enjoyment of the property.

5. Standalone Financial Analysis

At the present time, the financial performance of Port Hedland International Airport is reflected in the TOPH financial statements and budget under the Transport Portfolio. The current year amended operating budget, adjusted to reflect Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) and excluding non-operating revenues and expenditure is shown below.

Description	**2013/14 Budget**
Operating Revenue	
Airport Administration	$16,790,413
Airport Cafe	$148,000
Total Operating Revenue	$16,938,413
Operating Expenditure	
• Airport Administration	($4,321,376)
• Airport Maintenance (excl Depreciation)	($1,138,378)
• Airport Plant Operating	($124,792)
• Council Transfers/Dividends (incl depreciation)	($4,507,486)
Total Operating Expenditure	($10,092,030)
Operating Profit	$6,846,383
Add Back: Depreciation Interest Expense	 $1,460,702 $74,390
EBITDA	$8,381,475

The budgeted expenditure for PHIA includes the following allocations of costs and transfers from PHIA to TOPH – recorded under the heading Council Transfers/Dividends in the table above.

- Admin Cost redistribution $1,241,784
- Transfer to Municipal $1,805,000

- Depreciation $1,460,702

The redistribution of administration costs recognises that the TOPH incurs a range of financial and administrative cost overheads on behalf of PHIA. Recently, TOPH and PHIA staff has undertaken analysis to update the relevant cost drivers for TOPH employee costs, to more accurately determine the extent to which these costs could be attributed to PHIA.

The results of this analysis indicate that in addition to employee costs already directly allocated to PHIA and reflected in Airport administration, approximately 13 Full Time Equivalent resources within the TOPH are engaged in PHIA activities, such as Governance and Corporate Services, HR, ICT, Economic Development, Property and Services at an annualised salary cost, including on-costs of $2.139m.

In addition, management has estimated the additional governance costs associated with establishing and maintaining a separate Board for PHIA. These costs include an allowance for director fees, travel and administration costs for 6 directors, meeting monthly.

The table below shows the present amended operating budget for PHIA, adjusted for these calculations of standalone costs.

Account Description	**Amended Budget FY 14 Existing**	**Amended Budget FY 14 Standalone Costs**
Operating Revenue		
Airport Administration	16,790,413	16,790,413
Airport Café	148,000	148,000
Total Operating Revenue	16,938,413	16,938,413
Operating Expenditure		
• Airport Administration	(4,321,376)	(4,321,376)
• Airport Maintenance (excl Depreciation)	(1,138,378)	(1,138,378)
• Airport Plant Operating	(124,792)	(124,792)
• Council Transfers/Dividends	(4,507,486)	(1,460,702)
• PHIA Standalone Costs	-	(2,138,660)
• PHIA Board Costs	-	(319,200)
Total Operating Expenditure	(10,092,030)	(9,503,108)

Operating Profit	6,846,383	7,435,305
Add Back: Depreciation Interest Expense	 1,460,702 74,390	 1,460,702 74,390
EBITDA	8,381,475	8,970,397

The add back of depreciation and interest expense to derive Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) helps to establish a theoretical enterprise value for the airport, based on applying a multiple to EBITDA. This is the approach generally used as a benchmark assessment for infrastructure based businesses.

The multiple applied to a particular business will depend on a range of factors, including the relative risks of that business and the sector it operates in, investor demand for that particular asset, the market position of the asset and potential upsides, such as those presented by the availability of commercially developable land.

In the lead up to the Global Financial Crisis, airport leasehold transactions achieved EBITDA multiples of in excess of 20x, however since the GFC, multiples have tightened somewhat, albeit in the case of the airport sector, with not many transactions.

Using the restated EBITDA figures from the table above, the implied valuation of PHIA could be:

Multiple	Indicative Valuation
10x	$ 89.7m
15x	$134.5m
20x	$179.4m

It should be noted that the realisation of the valuation of PHIA can only be achieved through a leasehold process and the values shown above are indicative. To obtain a more comprehensive assessment of the potential valuation of PHIA, it would be necessary to develop a financial model, which would use a discounted cash flow analysis, which takes into account the capital expenditure program and future earnings of the airport.

Leasehold vs Status Quo

The following table sets out the implications for the TOPH if it decides to go down the leasehold route for the future ownership/governance of PHIA.

Implications to TOPH		
	Leasehold	**Current**
Revenues	• TOPH receives up-front lease payment, annuity or combination as consideration for grant of lease. • TOPH may receive rates income from PHIA. • All recurrent and new revenues (landing fees, property, retail etc) received by lessee.	• No rates income received • TOPH receive approx. $17m pa in operating revenue.
Expenses	• All recurrent operating costs for PHIA met by lessee. • TOPH will have some continuing costs for lease oversight.	• TOPH funds approx. $5.58m in direct operating costs for PHIA (excl depreciation) and TOPH incurs a further $2.1m of indirect costs on behalf of PHIA. • Will be transaction costs associated with the leasehold process, including advisory fees, legal fees and success fees. • If PHIA is commercialised or set up as a CCO (assuming Act can be changed), TOPH would incur a further ~ $0.3m pa in Board related costs. •
Capital Expenditure	• Lessee funds all capex	• TOPH funds approx. $61.5m of capex next 3 years
Cash Flow	• TOPH receives up-front lease payment, annuity or combination as consideration for grant of lease. • TOPH receives no dividends or returns from lessee	• TOPH funds approx. $61.5m of capex next 3 years • TOPH receives approx. $4.5m pa of current dividends/transfers

6. Preferred model comparisons

The three governance structures have been assessed against the objectives and critical success factors as detailed below. For completeness, the CCO governance structure has been considered on the basis of two scenarios – that changes to the Local Government Act have and have not been achieved.

	Commercialisation	Council Controlled Organisation	Lease
Objectives			
• retain ownership	✓	✓	✓
• increased financial return	✗	✗	✓
• standalone reporting	✓	✓	✓
• essential services maintained	✓	✓	✓
• expanded community benefit	✓	✓	✓
• better access to management expertise	✗	✗/✓	✓
• reduced the Town risks	✗	✗/✓	✓
• improved planning outcomes	✗	✗/✓	✓
Critical Success Factors			
• improved ability to access debt	✗	✗/✓	✓
• quarantining debt risk to airport	✗	✗/✓	✓
• autonomy of airport decision making	✗	✗/✓	✓
• ongoing strategic oversight	✓	✓	✓
• more effective commercial focus	✗	✗/✓	✓
• greater financial sustainability	✗	✗/✓	✓
• daily operation decision making rests with others	✓	✓	✓
• the Town is released from future capex costs	✗	✗/✓	✓
• better economies of scale	✗	✗	✓

It is apparent from the above that only the **Leasehold option** addresses all of the stated Town objectives and critical success factors. While the establishment of a CCO could potentially address the majority of the stated objectives and critical success factors, it would require substantial changes to the Local Government Act which may take a number of years to achieve. The Commercialised approach falls short in a number of key areas, but could be considered as a key step in achieving a transparent standalone reporting entity capable of being more accurately assessed in terms of its ultimate enterprise value.

7. Conclusions and recommendations

In practical terms and given the current constraints of the Local Government Act, the leasehold option achieves all of the Town's stated objectives and critical success factors. This structure has the potential to realise substantial value and increase airport returns to the Town, and while it can be recognised that this initial assessment indicates that a leasehold arrangement is worth further consideration, it needs to be noted that further programs of work are needed as part of the Governance review program.

Therefore the following six recommendations previously considered in the governance workshop should now be progressed:

- review governance oversight, including alternative options such as a Board,
- review current PHIA cost structure and ToPH allocation of overheads,
- review current financial reporting to better support effective decision making, planning and management of risk,
- develop a financial model for PHIA,
- develop a PHIA risk framework that is specific to PHIA needs,
- review the strategic planning process to better support business decisions and governance.

Once the above parcels of work are completed it is anticipated that they will become part of an information memorandum to be released to the market as part of an RFP or tender process.

8. Estimated Program Timeframes

If the Town of Port Hedland determines to progress with the initiatives identified in this paper, it will be necessary to scope a more comprehensive project timeline and to ensure appropriate project oversight disciplines are established. Indicatively, and based on experience with other airport privatisations, the process would involve the following stages (these stages may merge and some aspects may be done concurrently).

1. Vendor due diligence
2. Development of lease documentation and obtaining necessary approvals
3. EOI Process
4. Lessee Due Diligence
5. Selection of approved Lessee, completion of lease documentation
6. Financial close

It is recommended that to ensure continuity and consistency throughout the entire process, and drawing on a substantial base of experience in other airport transactions, that the Town of Port Hedland engage the Airport Group as transaction advisers prior to the commencement of this process. As the appointed advisers they would have carriage of the entire process through to financial close providing experience and expert advice to the Town of Port Hedland. It is noted that the costs of this advice is to be settled at financial close and would be picked up by the Lessee Company.

Phase 1 -Vendor Due Diligence

This phase involves preparing PHIA for eventual lease, with the objective of maximising buyer interest and ultimately proceeds from the lease. This phase will require all of the six recommendations outlined above to be planned and executed and a high standard of collateral developed. Additionally, a core element of this process will require an analysis of legal and financial risks to ensure that these are appropriately disclosed during the ensuing phases.

During this process, it would be expected that the initial business plan and community consultation process would need to be commenced.

Indicative timeframes for this process are:

- Review of governance oversight, including establishment of interim Board (noting that the lessee will ultimately determine the Board for the leased entity) – 2 months.
- Review of cost structure, including TOPH allocation of overheads – largely complete.
- Review of current financial reporting – 1 week (but could be influenced by interim Board requirements).
- Development of financial model for PHIA – 1 month (subject to appropriately up to date inputs, such as traffic forecasts and capex estimates and assuming the model is not audited).
- Development of risk framework – 2 months (allowing for Council approval of specific risk assessment metrics).
- Review of strategic planning process – 1 month (also influenced by interim Board requirements).
- Legal and financial risk assessments – concurrent with risk framework.
- Asset condition reports – will likely be required by potential lessees during lessee due diligence – need to ensure sufficient information available from existing asset systems – 1 month (assuming existing data is adequate).

A number of these tasks can be conducted concurrently, with the overall vendor due diligence process expected to be completed within 3 months.

Phase 2 – Development of Lease Documentation and obtaining approvals

This phase will require input from legal and financial advisers and will be defined by the type of lease arrangement ultimately approved by Council (which will likely require specialist advice in the first instance). Indicative timeframe for this phase – 3 months.

A potential wildcard in this stage could be whether there is any scope to parcel up one or more other Pilbara Airports into the process, which could potentially present a more attractive proposition to potential lessees. This could lengthen the timeframe for this phase.

Phase 3 – EOI Process

The nature and timing of this process will be determined by the appointed adviser in consultation with TOPH, and will require the development of a sales document, establishment of data room and buyer due diligence process and protocols. This phase may involve an initial EOI process, followed by a short-listing of acceptable lessees (based on pre-defined criteria).

Indicative timeframe for this process: 3 months.

Phase 4 – Lessee Due Diligence

This process will see short-listed potential lessees undertaking their own due diligence on PHIA. It will require PHIA and TOPH executives to be available to respond to due diligence questions (subject to defined criteria specified in Phase 3) and to be available for presentations and site inspections to potential lessees.

Indicative timeframe – 2 months

Phase 5 - Selection of approved Lessee, completion of lease documentation

On receipt of final bids from short-listed parties, there will need to be a process of bid – evaluation, which will be informed by the assessment of each bid's compliance with pre-established bid acceptance criteria.

Final drafting of lease documentation will require substantial input from TOPH legal advisers.

Indicative timeframe – 2 months.

The Phases identified may to some extent overlap. **All-up, an indicative timeframe for the entire process, commencing once the Town of Port Hedland has approved the recommendation, would be in the vicinity of 6-12 months, with a mid-point of 9 months achievable, subject to the qualifications noted**.

Greater certainty around this timeframe will be achieved following a more comprehensive review.