Session 7: Tools for Negotiations with Airlines and Other Aeronautical Users

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The Airport Sponsor & Negotiations With Tenants & Users

• New Challenges & Opportunities
• Art, Not Science
• What’s in your toolbox?
Discussion Topics

1. Forms of Airport-Airline Business Relationships
2. Airport Rates and Charges and Ratemaking Approaches
3. Trends in Airline Lease Negotiations
4. Per-Turn Fees
   - Regulatory and Legal Basis
   - Implementing and Calculating Fees
5. Common & Preferential Use Gates
6. Other Aeronautical Users
Aging Infrastructure & Record Passenger Traffic

• Joe Biden on LaGuardia Airport: “I must be in some third-world country.”

• "People are going through airports built in the 1950s, the 1960s, the 1970s," says Kevin Burke, president and CEO of Airports Council International. That infrastructure, largely unchanged for decades, is struggling now to service a nearly 12-fold spike in passenger volume across the decades.
Capital Planning Is Increasingly Focused on Facility Maintenance and Renewal

American Society of Civil Engineers assigned U.S. airport infrastructure “D” grade

- Aging building systems and deferred maintenance increase operating costs
- Slow growth at some airports means that capacity-enhancing capital projects have been postponed
  - Federal funding mechanisms (AIP and PFC) and traditional planning approaches favor capacity over maintenance and renewal
  - PFC capacity committed at many airports
  - Large/medium hubs must demonstrate “significant contribution” for PFCs over $3.00
- “Re-life” vs. replace terminals?
## With or Without a Bilateral Agreement

<table>
<thead>
<tr>
<th>BILATERAL</th>
<th>UNILATERAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Negotiated with airlines</td>
<td>• Rates established through consultation</td>
</tr>
<tr>
<td>• Airfield operating agreement and terminal building lease</td>
<td>• Ordinance and regulations</td>
</tr>
<tr>
<td>• Combined “use and lease” agreement</td>
<td>• Permits and regulations</td>
</tr>
<tr>
<td>• Passenger airlines vs. cargo carriers</td>
<td>• Sometimes there are separate revenue sharing agreements (e.g., LAX, MCO)</td>
</tr>
<tr>
<td>• Bilateral agreements by definition include compromise</td>
<td></td>
</tr>
</tbody>
</table>

- Under federal law, there is an upper bound that airports can “unilaterally” charge the airlines and expect to successfully defend.
- Airports cannot set residual rates that guarantee breakeven or better results without airline agreement.
- No airline agreement is required, and some airports operate without an agreement, but the vast majority of airports have agreements.
Why Have an Airline Agreement?

- Prescribe what airlines can do and what airport is obliged to do for airlines
- Establish airline payments
  - Costs in rate base
  - Cost center structure
  - Rents, fees, and charges
  - Calculation methodologies
- Prescribe airline role in capital decisions (Majority-In-Interest vs. consultation)
- Determine control over and use of gates and facilities (exclusive, preferential, common use)
- Provide legal protection: indemnification, insurance, environmental, etc.
Relatively Few U.S. Airports Set Rates by Ordinance/Resolution (Less than 20%)

<table>
<thead>
<tr>
<th>Airport</th>
<th>Hub Size</th>
<th>CY 2015 e.p.</th>
<th>Time Under Resolution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Los Angeles International</td>
<td>L</td>
<td>36,351,226</td>
<td>Since 1993^2</td>
</tr>
<tr>
<td>Phoenix Sky Harbor International</td>
<td>L</td>
<td>21,351,445</td>
<td>&gt; 30 years</td>
</tr>
<tr>
<td>Orlando International</td>
<td>L</td>
<td>18,759,938</td>
<td>Effective November 2013^3</td>
</tr>
<tr>
<td>Boston Logan International</td>
<td>L</td>
<td>16,290,323</td>
<td>&gt; 30 years</td>
</tr>
<tr>
<td>Oakland International</td>
<td>M</td>
<td>5,506,672</td>
<td>Since 2000</td>
</tr>
<tr>
<td>Raleigh-Durham International</td>
<td>M</td>
<td>4,954,717</td>
<td>&gt; 30 years</td>
</tr>
<tr>
<td>John Wayne Airport-Orange County</td>
<td>M</td>
<td>4,945,175</td>
<td>&gt; 20 years</td>
</tr>
<tr>
<td>Sacramento International</td>
<td>M</td>
<td>4,714,723</td>
<td>Since June 2008</td>
</tr>
<tr>
<td>San Juan Luis Munoz Marin International</td>
<td>M</td>
<td>4,218,785</td>
<td>&gt; 20 years, but airport privatized March 2013</td>
</tr>
<tr>
<td>Omaha Eppley Airfield</td>
<td>M</td>
<td>2,046,155</td>
<td>&gt; 30 years</td>
</tr>
<tr>
<td>Charleston International</td>
<td>S</td>
<td>1,669,960</td>
<td>Since 2001</td>
</tr>
<tr>
<td>Grand Rapids Gerald R. Ford International</td>
<td>S</td>
<td>1,280,801</td>
<td>&gt; 30 years</td>
</tr>
<tr>
<td>Long Beach /Daugherty Field</td>
<td>S</td>
<td>1,220,906</td>
<td>At least 10 years</td>
</tr>
<tr>
<td>Des Moines International Airport</td>
<td>S</td>
<td>1,156,450</td>
<td>Since January 1, 2014</td>
</tr>
<tr>
<td>Bill &amp; Hillary Clinton National (Little Rock)</td>
<td>S</td>
<td>958,510</td>
<td>Since 2009</td>
</tr>
<tr>
<td>Northwest Arkansas Regional</td>
<td>S</td>
<td>629,903</td>
<td>Since January 1, 2015</td>
</tr>
<tr>
<td>Lexington Blue Grass</td>
<td>S</td>
<td>606,977</td>
<td>Since 2001</td>
</tr>
<tr>
<td>Asheville Regional</td>
<td>N</td>
<td>393,379</td>
<td>Since October 2016</td>
</tr>
<tr>
<td>Lehigh Valley International (Allentown, PA)</td>
<td>N</td>
<td>320,544</td>
<td>Since 1993</td>
</tr>
<tr>
<td>Santa Barbara Municipal</td>
<td>N</td>
<td>316,508</td>
<td>Since October 2007</td>
</tr>
<tr>
<td>Rapid City Regional</td>
<td>N</td>
<td>264,170</td>
<td>Since 2015</td>
</tr>
</tbody>
</table>

1. Source for enplanements and hub size: FAA, ACAIS CY 2015, Primary Airports, August 2016. There are 132 large, medium, and small hub airports.
2. On January 1, 2013, a new rate agreement went into effect at Los Angeles (LAX).
Source: Large, medium, and small hub U.S. Airports setting rates by resolution compiled by LeighFisher.
Rates by Resolution

- Without an airline agreement, airline fees set by rate ordinance, resolution, regulation, or tariff
- Governed by U.S. DOT Rates & Charges Policy and case law
- Key underlying principles and requirements:
  - Expressed preference for local resolution
  - Endeavor to be self-sustaining
  - Rates must be “reasonable” and not “unjustly discriminatory”
  - Cost allocation must be “transparent” and comply with U.S. DOT rules
  - Justification for significant changes in rate-making approach
  - Must consult with airlines
  - Compensatory rate-setting permitted without agreement
  - Residual rate-setting **not** permitted without agreement

Any unilateral rate methodology must be designed to recover from the air carriers using the airport their fairly allocated share of airport costs in accordance with the U.S. Department of Transportation’s *Policy Regarding Airport Rates and Charges*, 78 Fed. Reg. 55330 (September 10, 2013), and other applicable law.
Two Paths for Airline Business Model

- Negotiate new agreement or amendment/extension
- Implement rates by resolution (or as back-up)

**New Airline Agreement Negotiations Track**
- Conclude negotiations of AUA amendment
- Prepare for negotiations
- Negotiate terms
- Send execution copies to airlines

**Rate Resolution Track**
- Develop rates by resolution
- Draft:
  1. Rate Resolution
  2. Rate Book
  3. Operating Permits
  4. Letters of Authorization
  5. Operational Procedures
Resolution of Airline-Airport Fee Disputes

Very intense, time consuming, and expensive process for airports

Timeline - U.S. DOT Rates and Charges Dispute Resolution (Part 16 or “Rocket Docket”)

- Day 0: Airlines file complaint with DOT
- Day 14: Airport comments due
- Day 30: DOT determines significance of dispute
- Day 90: ALJ’s recommended decision
- Day 120: DOT’s final decision

Dispute resolution period (120 days start to finish)

Maximum allowed: 60 days

Written notice of rate increase

ALJ holds hearings

Key cases:
- LAX I & II (asset valuation/cost allocation/coverage)
- MIA (equalized terminal rents)
- EWR (tenant/non-tenant)
- LAX III (commercial compensatory/FMV/discrimination)
Airport Rates and Charges and Ratemaking Approaches
Airport Rentals, Fees, and Charges Account for a Small Share of U.S. Scheduled Airline Operating Expenses

Airport Rates & Charges = 5.1%

- Landing fees 2.0%
- Terminal rentals 3.1%
- Other 4.9%
- Depreciation 5.2%
- Maintenance 7.4%
- Outsourcing 8.6%
- Transport related expenses 13.9%
- Aircraft rentals 2.5%
- Food 1.7%
- Commissions 1.0%
- Labor 29.7%
- Fuel 19.9%

Airline Rates & Charges = 45%

- Parking 19.3%
- Rental car 8.7%
- Terminal concession 9.7%
- Land rentals 3.0%
- Other revenues 8.4%
- Other non-aero revenues 5.2%
- Passenger airline landing fees 16.9%
- Passenger airline terminal fees 24.7%
- Other airline other payments 4.0%


Note: The figures do not include data for all airlines, such as commuter airlines operating aircraft with fewer than 60 seats. Such carriers are exempt from filing certain financial information with DOT.

Airport Rates and Charges are Also More Predictable than Other U.S. Airline Operating Expenses

Note: The figures do not include data for all airlines, such as commuter airlines operating aircraft with fewer than 60 seats. Such carriers are exempt from filing certain financial information with DOT. The historical data in the early 1980s is less reliable than the data for more recent years.

Source: U.S. DOT, Form 41 as compiled by LeighFisher, November 2016.
Some Airlines Pay a Higher Share than Others

Airport Rates and Charges as a Percent of Total Operating Expenses: U.S. Scheduled Passenger Airlines

Source: U.S. DOT, Form 41 as compiled by LeighFisher, November 2016.
## Legal Framework

### FAA’s View of Airport Rate-Setting

<table>
<thead>
<tr>
<th>Aeronautical</th>
<th>Non-aeronautical</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airfield</td>
<td><strong>No Federal restrictions, per se;</strong></td>
</tr>
<tr>
<td>Fuel</td>
<td><strong>However, airports must be self-sustaining (Fair Market Value requirement)</strong></td>
</tr>
<tr>
<td>Roadways</td>
<td>Many other issues such as:</td>
</tr>
<tr>
<td><em>Historical cost/imputed interest</em></td>
<td>- Term of agreement</td>
</tr>
<tr>
<td></td>
<td>- Investment in property</td>
</tr>
<tr>
<td></td>
<td>- Revenue use</td>
</tr>
</tbody>
</table>

*Imputed interest allowed as long as assets acquired with non-aeronautical revenue. Debt service coverage permitted if required under financing documents and coverage is “needed.”*
Airline Rate-Making Methodologies

Residual
- Recover net costs after credit of nonairline revenues
- Financial risk transferred to airlines
- Usually requires airline approval on capital investment decisions
- Limited accumulation of airport equity

Compensatory
- Recover only those costs allocated to occupied facilities
- Airport assumes financial risk
- Only pay for what you use
- Airport keeps nonairline revenues

Hybrids
- Mixture of both methodologies
- Balance of risk and facility control
- Carve outs of self-supporting cost centers
- Net revenue-sharing formulas (usually in return for “safety nets”)
Ratemaking Continuum ("Bookends")

<table>
<thead>
<tr>
<th>MINIMUM BILATERAL RATES</th>
<th>Hybrid</th>
<th>Pure Compensatory</th>
<th>Commercial Compensatory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pure Residual</td>
<td>Tampa</td>
<td>Kansas City</td>
<td>Boston</td>
</tr>
<tr>
<td>• Spokane</td>
<td>• Denver</td>
<td>• St. Louis</td>
<td>• Grand Rapids</td>
</tr>
<tr>
<td>• Chicago (ORD)</td>
<td>• Washington, DC</td>
<td>• Houston</td>
<td>• Phoenix</td>
</tr>
<tr>
<td>• San Francisco</td>
<td>• Fort Myers</td>
<td>• Baltimore</td>
<td>• Sacramento</td>
</tr>
<tr>
<td>• Indianapolis</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Share all non-airline revenues
- Rentable space divisor
- Revenue sharing
- Extraordinary coverage protection
- Total or usable space divisor
- Rentable space divisor

Focus on the results, not the philosophy

- Residual rate-setting is not permitted without an agreement
- Under unilateral rates, the airport must assume terminal vacancy risk (which is not a significant factor for GEG)
Rate-Making Methodologies — **Compensatory**

- Airport assumes risk that nonairline revenues will cover nonairline costs and retains for its discretionary use any net cash flow.
- Typically, airport retains control over capital investment decisions.

<table>
<thead>
<tr>
<th>Revenue Source</th>
<th>O&amp;M expense, debt service, and coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Landing Fees</td>
<td></td>
</tr>
<tr>
<td>Terminal Building Rentals</td>
<td></td>
</tr>
<tr>
<td>Parking Revenue</td>
<td></td>
</tr>
<tr>
<td>Cargo/ Hangar Revenue</td>
<td></td>
</tr>
<tr>
<td>Commercial Property Revenue</td>
<td></td>
</tr>
<tr>
<td>General Aviation Revenue</td>
<td></td>
</tr>
</tbody>
</table>

**Airport Net Cash Flow**
## Rate-Making Methodologies — Residual

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Nonairline Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Equipment and small capital outlays</td>
<td>- Parking and rental car</td>
</tr>
<tr>
<td>- Operating and maintenance</td>
<td>- Ground/building rent</td>
</tr>
<tr>
<td>- Amortization</td>
<td>- General aviation</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Terminal concessions</td>
</tr>
<tr>
<td>minus</td>
<td>- Commercial property</td>
</tr>
<tr>
<td></td>
<td>- Interest income</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>equals</td>
<td></td>
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<tr>
<td></td>
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</tr>
</tbody>
</table>

Airport discretionary cash flow for capital improvement or reimbursed to signatory air carriers
Rate-Making Methodologies —
Typical Hybrid Rate-Setting Structure

Airfield cost center residual

- Expenses
  - Operating Capital Reserves
- minus
- Nonairline Revenues
  - Other Airfield Revenues (Fuel Flow Fees, etc.)
- equals
- Airline Landing Fees

Terminal compensatory

- Airline share of terminal concession revenue
- equals
- Airline Terminal Rents

- Expenses
  - Operating Capital Reserves
- minus
  - Nonairline Revenues
    - minus
    - All other cost centers
  - equals
  - Airport Net Revenues

Airport discretionary cash flow for capital improvement

Airline share

### Summary of Airline Business Relationships – Large and Medium Hubs

<table>
<thead>
<tr>
<th>Metric</th>
<th>Large Hubs</th>
<th>Medium Hubs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Percent</td>
<td>Number</td>
</tr>
<tr>
<td><strong>Methodology</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Residual</td>
<td>8</td>
<td>27%</td>
<td>10</td>
</tr>
<tr>
<td>Compensatory</td>
<td>11</td>
<td>37%</td>
<td>9</td>
</tr>
<tr>
<td>Hybrid</td>
<td>11</td>
<td>37%</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>30</td>
<td>100%</td>
<td>31</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Form of Agreement</th>
<th>Large Hubs</th>
<th>Medium Hubs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Percent</td>
<td>Number</td>
</tr>
<tr>
<td>Ordinance</td>
<td>4</td>
<td>13%</td>
<td>6</td>
</tr>
<tr>
<td>Agreement</td>
<td>26</td>
<td>87%</td>
<td>25</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>30</td>
<td>100%</td>
<td>31</td>
</tr>
</tbody>
</table>

- Blurring of distinctions between traditional rate-making approaches with significant number of hybrid approaches

Trends in Airline Lease Negotiations
Trends in Airline Lease Negotiations

1. Business Relationship

- Increasing number of airports setting rates by resolution
- Move away from long-term leases (10 years or longer) -- an area of mutual agreement between both airports and airlines
- Airline consortiums to manage airline equipment (e.g., ORD, SFO, DTW, MDW, MIA)

Trends in Airline Lease Negotiations

2. Airport-wide Ratemaking Methodology

- Residual cost rate-making is not dead yet contrary to popular belief

U.S. Airport Ratemaking Methodology

<table>
<thead>
<tr>
<th>Methodology</th>
<th>2003</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residual</td>
<td>23%</td>
<td>29%</td>
</tr>
<tr>
<td>Compensatory</td>
<td>24%</td>
<td>20%</td>
</tr>
<tr>
<td>Hybrid</td>
<td>53%</td>
<td>51%</td>
</tr>
</tbody>
</table>

Trends in Airline Lease Negotiations

3. Airfield/Terminal Rate Method

**Landing Fee: 59 responses**

- Airfield cost center residual: 63%
- Airport system residual: 22%
- Other: 15%

**Terminal: 62 responses**

- Commercial Comp: 39%
- Residual: 37%
- Comp.: 24%
- Others: 22%

Trends in Airline Lease Negotiations

4. Common Use Charges

- Move away from 20/80 common use formulas (per capita/passengers) to no or lower per capita allocation and combination of passengers and operations

![Bar charts for Common Use Holdroom and Bag Claim Area](source: ACI-NA, 2015 Business Terms Survey for 2015, October 2015.)
Trends in Airline Lease Negotiations

5. Other Common Use Space Charges

- Offering of per-turn fees for low frequency airlines that do not want to lease space/gates
- Response from FAA to industry requests on per-turn fees
- Establishing cost recovery security fees (security checkpoint, bag screening space, etc.)
Trends in Airline Lease Negotiations

6. MII Clauses

- Move away from restrictive Majority-in-Interest (MII) provisions

Trends in Airport-Airline Lease Negotiations

7. Other Capital Program Control

- Pre-approved capital improvement programs
- Airlines requesting seat at table to set capital programs

Source: Exhibit K to Amended Airline Use & Lease Agreement, Kansas City International Airport.
Trends in Airport-Airline Lease Negotiations

8. Facility Control

- Move away from exclusive use to preferential and common use space/gates
- More common use systems, including outbound baggage systems
- Preserving the flexibility to reallocate or reassign exclusive use space to accommodate changing mix of airlines and market shares
- Airlines “right-sizing” (returning space after bankruptcies, mergers, lease renewals)
Trends in Airport-Airline Lease Negotiations

9. Other Provisions/Trends

- Modernize legal boilerplate (environmental, insurance, indemnification)
- Stronger payment and security features (bankruptcy protection)
- FAA considering revisions to Rates & Charges Policy

Per-Turn Fees: Regulatory Basis and Calculations

• “The three largest carriers not just in the US but also in the world, and which also control the three clubs—the global alliances—that control 50% of the world’s traffic, are trying to shut the door on any competition or potential competition. That’s what’s going on here.”

Etihad general counsel & company secretary Jim Callaghan
Why is This an Issue?

• With airline consolidation, smaller airports have little negotiating leverage; they need to retain existing and attract new service
• Some network airlines are pushing for regimes that price the less-than-daily airlines out of the smaller markets
• Low frequency airlines can’t afford to lease full ticket/gate modules
• Setting a per-turn fee at a reasonable level:
  – Promotes competition and fosters an encouraging environment for variety of business models and new entrants
  – Accomplishes the airport’s obligation to serve the public interest (both airlines and travelers)
  – Provides an airport with the means to remain financially self-sufficient
• If an airport does NOT maintain a reasonable per turn fee, it might be considered unjustly discriminatory - a de facto exclusion of low-frequency carriers from the market
Objectives for Per-Turn Fees

- Offer competitive rates to attract and/or retain air service
  1. Daily, low-frequency service
  2. Less-than-daily service
  3. Seasonal service
  4. Charters

- Avoid giving an incentive to signatory airlines to give back space

- Provide a transparent and defensible policy that is reasonable and not unjustly discriminatory

- Retain flexibility to apply to all airline business models
  - Overflow activity for signatory airlines
  - Low volume carriers
Regulatory Basis for Per-Turn Fees

Little guidance under the USDOT Rates & Charges Policy

• The only reference in the Rates and Charges Policy is:
  – 1.1.3 *Airport proprietors* should consider the public interest in establishing airport fees, and *aeronautical users should consider the public interest* in consulting with airports on setting such fees

• U.S. DOT’s statutory responsibilities include:
  – Ensure… “the availability of a variety of … low-priced services without unreasonable discrimination or unfair or deceptive practices” (49 U.S.C. § 40101(a)(5))
  – “Encourage[ing] entry …by new and existing air carriers and …strengthening of small air carriers to ensure a more …competitive airline industry ” (49 U.S.C. § 40101(a)(13))

• Under airport competition plans, the U.S. DOT encourages airports to retain common use gates for new entrants and expanding incumbents
What is A4A Saying?

Some airports have “gone off reservation” by:

1. “Arbitrarily” discriminating based on differential rates by concourse
2. Basing per-turn fees on unreasonable usage assumptions - 8 turns per gate per day
3. Offering per-turn fee to some airlines, but not others
4. Disproportionately shifting costs to signatory airlines by not including a fixed fee component in their common use space allocation methodology
5. Imposing or threatening to impose ordinance rates - not good faith negotiations
Types of Terminal Space / Per-Turn Fee (ticket, common baggage, gates)

Ticketing/Queue, Baggage Systems, Gates (Holdrooms, Loading Bridges, Aircraft Apron)

Source: Airline Operating and Use Agreement, Des Moines International Airport.
Methodologies to Allocate Common / Joint Use Space

- **Units**
  - Passengers
  - Operations
  - Fixed or per capita
  - Bags
  - Time of use

- **Formulas**
  - Passengers / fixed (split equally among users)
    - 80/20, 90/10, 85/15
  - 100% passengers
  - Passengers / operations – 50/50, 70/30
  - Passengers / operations / fixed – 35/55/10
  - Bags

- **Carve-outs/exceptions**
  - Affiliates
  - Low volume carriers (e.g., 2% - 5% of passenger market share)

- **Issues**
  - Turns per day
  - Premium for non-signatories
  - Limiting per-turn fee option to airlines flying less than [x] flights per week
Common / Preferential Use Issues

- Airline right-sizing / vacancy risk
- Airport flexibility to relocate airlines to balance utilization
- CUSS systems
  - Airline acceptance / proprietary systems
  - Capex / opex
  - Airport liability
- Common use gates (new entrants, expanding incumbents, seasonal, itinerants, diversions)
Other Aeronautical Users

• FBOs / minimum standards
• Cargo trends
  – New delivery providers (Amazon)
  – Future delivery systems (UAV / drones)
• Specialized aeronautical service organizations
• Commercial service at GA airports (e.g., Surf Air)
Comments/Questions

Sheri Ernico, LeighFisher
Eric Smith, Kaplan Kirsch & Rockwell LLP