Emerging trends in airport–airline use and lease agreements in the USA

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Abstract

Over the past several years the negotiation strategy and goals of airports in the USA have changed significantly with regard to agreements with their airline partners. Increased volatility and changing airline and airport business models have resulted in the displacement of the traditional term periods for use and lease agreements, resulting in much shorter agreements that are designed and anticipated to meet the needs of the parties for the near term only. Given this new context, it is important to understand where the use and lease agreement fits within the overall financial framework of the airport. This paper identifies some of the most important considerations in drafting a use and lease agreement in the current climate, including rate-setting methodologies and restrictions, cost centres, control over revenue and capital expenditures, access and competition, and risk allocation. In the end, it is important for each airport operator’s negotiating strategy to clearly reflect its financial, operational and developmental goals, and to account for the practical strengths and limitations of the airlines with which it is negotiating. This paper will be particularly useful to new chief financial officers, controllers and airport property personnel, as well as persons on airport governing bodies.

Keywords

airport–airline use and lease agreements, airport cost centres, rates and charges methodology, balancing airport objectives

INTRODUCTION

Over the past several years the negotiation strategy and goals of airports in the USA have changed significantly with regard to agreements with their airline partners.

Dating back to the 1970s, airports had structured the term periods of their use and lease agreements with the airlines providing commercial, regularly scheduled service to correspond with the term period of bonds for major capital transactions such as the construction of a new terminal. It was therefore common to see 30-year agreements. Many of these agreements are now reaching their
end date, requiring the negotiation of replacement documents.

Increased volatility and changing airline and airport business models over the past 10–15 years have resulted in the displacement of the traditional term periods for use and lease agreements. During this time, almost every US airline has filed for bankruptcy. Airlines have ceased to exist, merged, acquired, or been acquired. Airports seeking to adjust in the face of more competitive pressures have morphed into more business-like entities with diversified income streams. The entire airline and airport industry is barely recognisable from the state of affairs that existed prior to 11th September, 2001, let alone those at the dawn of US airline deregulation. The industry has realised that just about all that can be predicted for the airline and airport industry over the next 30 years is that the predictions will almost surely be incorrect.

Given all of this, the current trend is for much shorter agreements that are designed and anticipated to meet the needs of the parties for the near-term only. Generally speaking, airlines value near-term predictability and cost containment and airports seek more autonomy to engage in development and revenue generation. It is within this context that airports are more exposed to the volatility of the airline industry, resulting in the more frequent negotiation of agreements. All of this adds an additional measure of uncertainty as to how to implement and finance long-term capital projects. If properly negotiated, however, these short-term agreements can result in significant flexibility for airport operators to nimbly react to current economic trends and address the ongoing concerns of the market.

Negotiation and structuring a new airline use and lease agreement requires an assessment of a multitude of factors. It is important to understand where the use and lease agreement fits within the overall financial framework of the airport (see Figure 1).
RATE-SETTING METHODOLOGIES

Within the above framework, one also needs to consider what general model would best serve the (often competing) interests of airports and airlines. There are three primary rate-setting methodologies: residual, compensatory, and hybrids of both (Table 1). Each of these methodologies contains its own set of risks and rewards for the parties.

Under a pure residual methodology, the airlines bear the overall financial risk for all airport operations. In exchange for assuming this risk, the airlines generally require full control over airport capital projects. This method basically results in an airline guarantee of the airport operating costs. As a trade-off, the airlines usually limit the unrestricted cash available to the airport and reduce debt coverage margins which results in weaker airport balance sheets. Having the airlines backstop the financial exposure of the airport may be viewed positively by financial markets due to the reduction in uncertainty about the airport's ability to absorb unforeseen, extraordinary expenses.

A pure compensatory methodology is exactly the opposite, wherein the airport operator assumes all of the financial risk for airport operations. This is a ‘cost-based’ approach which only requires airlines to pay for the cost of facilities used or leased at the airport. This method requires an airport operator to have sufficient cash on hand to weather any financial storm.

Any mixtures or combinations of the two methods are called hybrid methodologies. These ‘mix and match’ agreements borrow aspects of both residual and compensatory models and seek to share control of facilities and non-airline revenue streams by agreement. The business arrangement based on the relative level of risk of each of the parties will determine the revenue sharing that results in the hybrid approach.

LEGAL REQUIREMENTS FOR AIRLINE RATE SETTING

The federal law of the USA does not require any single approach to airline rate setting. There is significant leeway given to airports and airlines to negotiate and fit the particular issues facing the operations at each individual airport. This is not to say, however, that the parties are unfettered by federal requirements. Use and lease agreements and the methodologies employed therein must conform to the US Department of Transportation ‘Policy Regarding Airport Rates and

<table>
<thead>
<tr>
<th>Pure residual</th>
<th>Modified residual</th>
<th>Modified compensatory</th>
<th>Pure compensatory</th>
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<tbody>
<tr>
<td>Airline-centred control</td>
<td>Airport and airline shared control</td>
<td>Differential facility sub-sets with airport-centred control</td>
<td>Airport-centred control</td>
</tr>
<tr>
<td>• Comprehensive contract regarding means and methods of instituting:</td>
<td>• Contractual governance of application of ‘surplus’ funds including:</td>
<td>• Commercial real estate approach:</td>
<td>• No master contract:</td>
</tr>
<tr>
<td>• Rate-setting in multiple activity centres</td>
<td>• Retention of certain funds by airport for use in its discretion</td>
<td>• Lease of particular areas to airlines with general rate-setting guidelines</td>
<td>• All rates set by airport via ordinance</td>
</tr>
<tr>
<td>• Capital projects</td>
<td>• Maintenance of airline-centred approval of major capital expenditures</td>
<td>• Limited airline control over capital expenditures</td>
<td>• Airlines have no input on use of fees/rentals</td>
</tr>
<tr>
<td>• Debt issuance</td>
<td></td>
<td>• Expanded airport discretion over use of funds</td>
<td>• Tenants at-will for occupied premises</td>
</tr>
</tbody>
</table>
Charges and must be consistently applied to similarly situated aeronautical users. That policy identifies five fundamental principles that must be followed:

- Airline rates, fees and charges must be 'fair and reasonable.'
- Airline rates, fees and charges must not 'unjustly discriminate' against aeronautical users.
- The fee structure must make the airport as financially self-sustaining as possible.
- The preference is for a negotiated rate setting approach that is based on the local market.
- Airport operators may expend revenue generated by the airport only for statutorily allowable purposes.

Each of these will impact particular provisions of the use and lease agreement and how the parties may address their particular concerns. For example, the sharing of non-airline revenue generated in one cost centre to subsidise another cost centre can run afoul of Grant Assurance 24 or 25. Additionally, airports must comply with the Federal Aviation Administration's Passenger Facility Charge Assurances.

COST CENTRES
Regardless of which model is ultimately used in coming to an agreement, a common aspect of modern use and lease agreements continues to include the creation and utilisation of various 'cost centres' that are used to account for costs and revenue applicable to particular areas of the airport. Traditionally, these cost centres were broad and generalised. The recent trend, however, has been to increase the number of cost centres to more specifically identify the costs and revenue associated with various functions of the airport, and to address issues such as control over revenue and assumption of particular operational risks. Typical cost centres are shown in Table 2.

Historically, particularly when used in the context of pure residual agreements, these cost centres were designed to break even so that the net requirement of each cost centre is equal to the calculated airline revenue. The sought-after result under this strategy is that the airlines using those cost centres would bear the financial burden of those facilities.

Recently, the trend has been towards a top-down assessment of what the parties desire in terms of reaping the benefit and assuming the risks associated with each
Table 2  Typical cost centres

<table>
<thead>
<tr>
<th>Cost centre</th>
<th>Space/costs/revenue included</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airside terminal</td>
<td>Ticketing positions, pre-security common areas</td>
</tr>
<tr>
<td>Landside terminal</td>
<td>Hold areas, loading bridges, post-security common areas, gate-area concessions</td>
</tr>
<tr>
<td>Concessions areas</td>
<td>Centralised concessions locations</td>
</tr>
<tr>
<td>Airfield</td>
<td>Areas for aircraft landing, taking-off, taxiing, safety areas and parking; terminal and cargo</td>
</tr>
<tr>
<td>Parking and roadways</td>
<td>Short-term, long-term and shuttle parking areas; rental car facilities; airport access roads</td>
</tr>
<tr>
<td>Cargo facilities</td>
<td>Airline freight, express and mail-handling facilities</td>
</tr>
<tr>
<td>Commercial development areas</td>
<td>On-airport but non-aeronautical areas such as office parks, businesses 'outside the fence' but</td>
</tr>
<tr>
<td></td>
<td>on airport property</td>
</tr>
<tr>
<td>Police and fire</td>
<td>Indirect overhead expenses</td>
</tr>
<tr>
<td>Other aeronautical areas</td>
<td>General aviation areas, fuelling facilities, hangars</td>
</tr>
<tr>
<td>Administrative</td>
<td>Overhead expenses for operation and administration of airport</td>
</tr>
</tbody>
</table>

cost centre. For example, some airports have a robust and profitable concessions operation. Traditionally, these revenues were part of the general terminal cost centres and revenues derived from such operations went dollar-for-dollar to reduce the rates paid by airlines for terminal space rental/use. Today, many airports are looking to those funds as a source of revenue to fund the development or maintenance of other areas of the airport. Therefore, at those airports, the concessions areas may be segregated from general terminal cost centres to better address those desires.

On-airport, non-aeronautical commercial development is another area that has, in the past, served to subsidise airline rates and charges. Many airports have aggressively developed the land surrounding the airport operational area (ie 'outside the fence'). These revenues have traditionally also helped to reduce the rates airlines pay for terminal use, with cost centres under legacy agreements broadly defined as including all areas surrounding the airport as being within the terminal cost centre. Increasingly, agreements are more precisely defining the various areas on the airport to better address the particularised interests of the airport and airlines. Additionally, flexibility should be written into the agreement to include the possibility of adding new cost centres where appropriate.

CONTROL: REVENUE, CAPITAL EXPENDITURES AND ASSOCIATED ASSUMPTION OF RISK

Airlines and airports both want as much control as possible. Control over the upside revenue, however, is only part of the equation. Control over expenditures is also a central driver. In legacy, pure residual use and lease agreements, airlines controlled major capital expenditures via what is commonly referred to as 'majority in interest' (MII) clauses, under which airports were required to obtain approval from a majority of the airlines in order to embark on major capital expenditures (for example, approval of expenditures in excess of US$500,000). The rationale was, and reasonably so, that the airlines were paying, through the rates and charges, for the associated costs.

Both airports and airlines have reasons to criticise the MII approach. Airports express frustration about having to obtain MII approval for many initiatives that serve their local populous that may
be viewed by airlines as extravagant or unnecessary. Airlines, for their part, often argue that under a purely residual agreement they assume the risk of higher than budgeted costs — not just with regard to capital expenditures, but with regard to airport operations as a whole. For example, if an airport has had a particularly bad winter that has resulted in an exponential increase in snow removal costs, the airlines simply have to accept increased rates and charges for that year.

These contrasting concerns are present when structuring a new use and lease agreement. The question becomes about who wants to assume what risk in exchange for sharing in the upside revenue potential associated with any particular cost centre. It is with these pieces to move around the board that the parties approach the negotiation of a new use and lease agreement.

ENSURING ACCESS AND COMPETITION

The nature and extent of competition within the airline industry has been ever-changing. Carriers have come and gone. The advent of so-called 'low-cost carriers' (and now ultra low-cost carriers) fundamentally changed the industry and then the tragic events of 9/11 occurred, sending shockwaves through the aviation world. Since that time, five major airline mergers have created an industry that is dominated by four carriers that control the majority of flights within the USA.

Legacy use and lease agreements often provided for exclusive use of specified gates for the term of the agreement. The result of this was that new entrant carriers had a difficult time entering markets where the airport was space confined. The consolidation of airlines has only exacerbated this phenomenon. In order to address these types of concerns, airports are increasingly allotting gates on a preferential basis, which allows the airport to reallocate space in the event that a new carrier wishes to enter the market.

The Grant Assurances come into play in this arena. In particular, Grant Assurance 22 (Economic Non-discrimination) and Grant Assurance 23 (Exclusive rights) are of particular interest. Grant Assurance 22 deals with both the reasonableness of airport access and the prohibition against adopting unjustly discriminatory conditions which have the potential for limiting access. Grant Assurance 23 prohibits granting any party an exclusive right to use the airport. An exclusive right can be conferred by either an express agreement or by the imposition of terms, standards or requirements (or, for that matter, any other means) that has the effect of excluding others from enjoying or exercising similar rights (such as the provision of air service). The FAA interprets both of these assurances, together and when read as part of the overall Grant Assurances, to require the airport to make reasonable efforts to accommodate new entrant carriers by providing the necessary facilities or by providing the opportunity for the new entrant carrier to obtain those facilities.

These obligations cause substantial concern for airports because, if the FAA finds it to be in violation, the withholding of Airport Improvement Program funds is among the FAA's remedies. Accordingly, airports are increasingly pushing for more competition-friendly provisions in use and lease agreements.

The federal preference towards laying the groundwork for robust and meaningful competition does not end with the Grant Assurances. Certain airports are required under federal law to have competition plans. The US Department of Transportation reviews airport competition plans and
the associated use and lease provisions to ensure that meaningful opportunities for access exist at airports and, where gates are fully subscribed, that the airport has reserved rights sufficient to ensure that there is ‘room at the inn’ where necessary. To what extent the Department of Transportation has the ability to directly influence the content of a use and lease agreement regarding these topics is open to debate. Airports are not eager to run afoul of any of the above constraints, however. Despite the fact that airlines will almost always resist any attempt to reduce control over gates, airports are placing a high value on competition-centred provisions.

AIRPORT-SPECIFIC FACTORS

The continued change within the airline industry has led to variations of many of the long-standing concerns of airports and airlines. The consolidation of carriers has led to the elimination of many hubs, causing many airports to go through times of painful adjustment. With fewer competitors, smaller airports are finding it increasingly more difficult to retrain and attract air service. A predicted pilot shortage over the next 10–15 years will only exacerbate this concern. Air service is of the utmost importance to local businesses and elected officials, as is the employment generated by a robust airline presence.

Airport-centred concerns do not end with air service. Indeed, issues such as providing the local air traveller with quality facilities are often a top priority. Many airports face aging infrastructure. The need to build new (or substantially renovate) terminals, parking garages and rental car facilities is common. Of course, these do not come without significant cost and the question of how to pay for them is always at the forefront.

Airports seek to be as attractive to airlines as reasonably possible. How this fits into an individual airport’s situation is necessarily a case-by-case matter. Airports, however, are cognisant that control of their facilities and certain revenues must be delicately balanced alongside keeping the airport an attractive place, from a cost perspective, for airlines to serve.

THE NEGOTIATING PROCESS

Before beginning negotiations for a new agreement, the airport operator must determine financial, operational and developmental goals and objectives (Table 3). As part of this process, the airport operator should critically examine its existing agreement to determine what is working and what is not working so that the deficient areas can be addressed.

Airport operators should also anticipate the approach and bargaining position of the airline with which it will

| Table 3 | The negotiation process |
| --- | --- | --- |
| **Airport objectives** | **Compromise** | **Airline objectives** |
| Capital | Control over capital improvements (no MIL) | Triggers for capital construction | Control over capital improvements (strong MIL) |
| Facility | Control over facilities (common use) | Preferential use with accommodation and recapture provisions | Control over facilities (exclusive use) |
| Other | Promote air service | Equitable treatment of all airlines | Preferential treatment of incumbents |
| | Attract new entrants | | |
| | Historical agreement and relationships | Identify needed changes | Historical agreement and relationships |
be negotiating. The airline will determine how that specific airport fits into its overall corporate strategy. For example, if an airport has strong originations and destination traffic, that fact greatly improves its negotiating position. If, on the other hand, the airport relies on connecting traffic from a hub carrier, then the airline has the stronger negotiating position.

The airport operator cannot go into negotiations in a vacuum. A realistic view of the relative strengths and weaknesses of each position is critical in preparing a priority list of goals. More and more airlines are relying on their financial experts at the ‘home’ office to guide the discussion with each individual airport.

**Let the experts speak**

The use and lease agreement is an all-encompassing document that governs all aspects of the airport and airline relationship. For this reason, many highly specialised subject areas are subsumed within this document. These specialised areas of the agreement should be left to the subject matter experts. Specifically, bankruptcy, environmental, security and insurance matters are usually negotiated by specific subcommittees containing expertise (from both inside and outside the airport) in those specific areas.

Industry standards will be a common theme throughout the negotiations on these parts of the overall agreement. The dollar value cost must be figured into the overall business arrangement of the parties, however. If the airport operator insists on insurance that will result in high dollar value premiums, the airlines will seek cost savings elsewhere to lower the overall costs to operate at the airport.

**Is a written agreement necessary?**

Although this paper is focused upon use and lease agreements, one option that is always present is operation of the airport without a formal written agreement with the airlines. This is generally referred to as ‘operation by ordinance’. Under this model, the means, methods and rates to be charged relating to the operation of the airport are set via legislation and follow-on issuance of permits or related regulations.

There are many reasons for an airport to prefer this route over a consensual agreement. Among these is the fact that the airport operator retains ongoing control over how rates are set and how operations of the airport will be conducted and there is no need to wait until the expiration of a contract to make changes. Another reason is where the airport and airlines were unable to come to a consensual agreement with regard to a new use and lease agreement and the airport operator, by necessity, resorted to operation by ordinance.

Whatever the reason, if the airport operator decides that the compensatory methodology is the best fit for the airport, it still must ‘consult’ with the airlines. Thereafter, the airport uses local ordinances, regulations, tariffs, or resolutions to establish the rates and charges in those situations where there will be a written agreement (Table 4).

Given the concentration of airlines today, airport operators are facing more pressure from airlines to yield to their demands when negotiating a new use and lease agreement. As a result, airport operators now understand that it is absolutely critical that they let the airlines know, early and often, that they are ready, willing and able to impose rates by regulation if good faith negotiating methods do not result in a consensus for a written agreement. It is
Table 4  Consultation methodology

<table>
<thead>
<tr>
<th>Bilateral</th>
<th>Unilateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negotiated with airlines</td>
<td>Consultation only</td>
</tr>
<tr>
<td>Airfield operation agreement and terminal space lease/licence</td>
<td>Instituted via ordinance and/or regulation</td>
</tr>
<tr>
<td>Combined into integrated ‘use and lease’ agreement</td>
<td>Issuance of permits and/or regulations by airport</td>
</tr>
</tbody>
</table>

Prudent, if negotiations are going down to the wire, for the airport operator to file a protective ‘rates by regulation’ notice at local governmental level so as to ensure the seamless financial operation of the airport.

While instituting rates by ordinance does give the airport operator substantial latitude in the means and methods to be employed in setting such rates, the operator must stay within certain parameters. First, before setting rates by regulation, the airport sponsor must ‘consult’ with the airlines and provide enough information for the airlines to evaluate the reasonableness of the new proposed rates.

Secondly, the fee structure imposed by the airport operator must be fully consistent with the FAA’s Rates and Charges Policy. This is significant, given that under a consensual agreement format, the parties may agree to vary from the parameters set forth in the Rates and Charges Policy.6

What this amounts to is that the structure that is imposed must meet the previously mentioned core criteria that it be fair and reasonable,7 non-discriminatory, self-sustaining, and that funds be spent by the airport operator for airport capital and operating costs and certain other facilities directly and substantially related to air transportation, as permitted by 49 U.S.C. §§ 47107(b) and 47133.

With respect to the last requirement (ie the ‘Allowable use’ requirement), a significant implication exists. Namely, the fee and rate calculation for use of airport space may only involve ‘rentable’ space and will exclude common use areas and unused space. Thus, the airport operator faces the challenge/risk of not being able to ‘rent’ all of the space available within the airport.

Despite the above-discussed challenges, having the ‘rate by ordinance’ option open to an airport operator is a meaningful tool and a factor that has an impact on the negotiation process.

CONCLUSION: BUILDING A RELATIONSHIP, AND A DOCUMENT, THAT WILL STAND THE TEST OF TIME

Irrespective of the path chosen to establish the rate-making methodology of the airport, one must realise that the relationship between the airport and the airlines with regularly scheduled service is ongoing. Airlines today have many airport options for connecting traffic and are more concerned with the bottom line than ever. The days of airlines lowering fares simply to establish market share are long gone. A balancing approach to rates and charges for the airport is not only preferred but essential.

References and Notes

(1) 78 FR 55330, 10th September, 2013, pp. 55330–55336.
(2) The reasonableness requirement is set forth in three different statutory provisions: (1) the Anti-Head Tax Act (49 U.S.C. § 40116(e) (2)); (2) the Airport and Airway Improvement Act of 1982 (AAIA), as amended (49 U.S.C. 47107(a)(1)(2)(13); and (3) 49 U.S.C. 47129,
'Resolution of Airport-Air Carrier Disputes Concerning Airport Fees' (rules at 14 CFR Part 302, Subpart F).

(3) Id.


(7) It is of note that the US Supreme Court has ruled that compensatory rate-setting is not inherently unreasonable as long as they are calculated on a break even cost recovery basis. See: *Northwest Airlines v. County of Kent*, 510 US 355 (1994).