SESSION OVERVIEW

• Basics!
• Generalities
• A lot to cover and WAY too many slides, BUT...
• Questions & Discussions Welcome!
• Goal is to give you a good working knowledge & overview of the topic
SESSION OVERVIEW

- Airport Legal/Financial Framework
- Building Blocks for Agreement
- Airport-Airline Business Relationship
- Airline Agreements
  - Ratemaking Methodology
  - Facility Management Provisions
  - Capital Project Consultation
- Other Considerations
  - Affiliate Airlines
  - Environmental
  - Insurance
  - Bankruptcy
PREVIEW OF WHAT IS AHEAD

• Three classifications of Airline Operating Agreements
  – Residual
  – Compensatory
  – Hybrid

• First discuss common elements
AIRPORT LEGAL/FINANCIAL FRAMEWORK

Financial Framework

Capital Markets:
- Bondholders
- Rating agencies
- Credit and liquidity providers

Bond Ordinance/Resolution/Trust Indenture

Airline Use and Lease Agreement

Generally accepted accounting principles

Federal Regulations and Policies

Sponsor Assurances

Authorizing Legislation

State government
- County or local government
- Governing board or authority

Merchants/vendors
- Car rental franchises
- Taxi/limo operators
- Parking garage operators
- Fixed based operators

Concession/Operating Agreements and Permits

Airport Operator

- Congress
- FAA/DOT
- TSA
- NTSB
- EPA
- OSHA

State government
- County or local government
- Governing board or authority
UNDERSTAND YOUR PLAYING FIELD

- **Limitations**: what are your fixed elements? *i.e.* those things that you can’t change
- **Legal**: Federal Law, Bond Ordinances, Existing Agreements
- **Physical**: Built space, projects under construction. Survey “rentable space” and needs of airlines.
- **Financial**: Flow of funds, PFCs, Debt Service, Bond Reserves, Bond Covenants
BUILDING BLOCKS FOR AGREEMENT

• Cost centers
• Cost center allocations
• Terminal space inventory
• Capital program and sources of funding
## BUILDING BLOCKS FOR AGREEMENT

### TYPICAL AIRPORT COST CENTERS

<table>
<thead>
<tr>
<th>Cost Center</th>
<th>Spaces Included</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terminal</td>
<td>Passenger terminal buildings, baggage claim, loading bridges</td>
</tr>
<tr>
<td>Other Buildings &amp; Grounds</td>
<td>Airline and GA hangars, fueling facilities, other land/building leases</td>
</tr>
<tr>
<td>Cargo</td>
<td>Airline freight, express, and mail handling facilities</td>
</tr>
<tr>
<td>Airfield</td>
<td>Areas for aircraft landing, taking-off, taxiing, safety areas, and parking; terminal and cargo apron areas</td>
</tr>
<tr>
<td>Parking &amp; Roadways</td>
<td>Short term, long term, and shuttle parking areas; rental car facilities; airport access roads</td>
</tr>
<tr>
<td>Reliever Airport</td>
<td>General aviation reliever</td>
</tr>
<tr>
<td>General &amp; Administrative</td>
<td><em>Indirect expenses allocated to other cost centers</em></td>
</tr>
</tbody>
</table>
**Building Blocks for Agreement**

**Cost Center Allocations**

### What are you allocating?
- **Operating**
  - O&M expenses
  - Equipment and capital outlays
  - Bad debt, assessments, settlements, judgments
- **Capital**
  - Debt service and coverage
  - Amortization of investments
  - Net of grants and PFCs
- **Reserves**
  - Debt service
  - O&M
  - Renewal & replacement

### How are you allocating it?
- Ensure cost recovery
- Connect charges with use
- Basis for allocating costs
  - Activity
  - Accounting system with time card records or work orders
  - . . . or management judgment
- Allocating indirect expenses
  - Direct expenses
  - 50% revenues/ 50% direct expenses
  - Negotiated percentages
  - . . . or management judgment

**DOT Policy requires cost allocations to be reasonable and transparent**
# Understand Your Cost Centers

## Airline
- Airfield Area
- Terminal Complex
  - Ticket Counters
  - International Facilities
  - Baggage Claim
  - Baggage System
    - Airport Owned?
    - Airline Owned?
    - Conventional
    - Automated
  - Transit System/People Mover
  - Airline Tenant Finishes and Equipment
    - Landside Terminal
    - Loading bridges
      - Airport vs. Airline owned
  - Concourse Ramp Area
  - Fueling System

## Non-Airline
- Rental Car Facilities
- Concessions
- Public Parking Area
- Employee Parking Area
- Commercial Vehicle Facilities
- Cargo Area
- Airline Maintenance/Support Areas
- Tenant Leased Land
- Airport Maintenance
- General Aviation
- Airport Mail Facility
- Snow Equipment
BUILDING BLOCKS FOR AGREEMENT

TERMINAL SPACE INVENTORY

• Obtain current drawings
• Define functional categories
• Parameters for defining “rentable” space
  – Ticket queue
  – Security checkpoint
  – Luggage Screening
• Survey airlines regarding current and future space needs
**Airport-Airline Business Relationship**

**Bilateral**
- Negotiated with airlines
- Airfield operating agreement and terminal lease
- Combined “use and lease” agreement
- Passenger airlines vs. cargo carriers

**Unilateral**
- Established through consultation
- Ordinance and regulations
- Permits and regulations

No airline agreement is required. Some airports operate without an agreement.
AIRPORT-AIRLINE BUSINESS RELATIONSHIP

RATES BY ORDINANCE

• Without an airline agreement, airline fees set by rate ordinance, resolution, regulation, or tariff

• Governed by DOT Rates and Charges Policy and case law

• Endeavor to be self-sustaining

• Rates are “reasonable” and not “unjustly discriminatory”

• Airport proprietor may not require airlines to cover losses generated by non-aeronautical facilities

• Cost allocation must comply with DOT rules, for example:
  – Aeronautical users shouldn’t pay costs properly allocable to other users or groups
  – Aeronautical cost-based fees may not exceed the costs properly allocated to those users
  – Roadway costs can be allocated back to other cost centers
AIRPORT-AIRLINE BUSINESS RELATIONSHIP

AIRLINE AGREEMENTS

• Establish what airlines can do at airport and what airport is obliged to do for airlines

• Airline payments
  – Costs in rate base and cost center structure
  – Rents, fees, and charges calculation methodologies

• Airline role in capital decisions and consultation

• Control over and use of gates and facilities

• Other provisions: affiliates, insurance, environmental, etc.
## Airport-Airline Business Relationship
### Balancing Airport and Airline Objectives

<table>
<thead>
<tr>
<th>Airport Objectives</th>
<th>Compromise</th>
<th>Airline Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recover all costs</td>
<td>Trend toward compensatory agreements</td>
<td>Stabilize rates</td>
</tr>
<tr>
<td>Generate adequate discretionary cash flow</td>
<td>Financial incentives for cost control</td>
<td>Establish rates by formula</td>
</tr>
<tr>
<td>Provide adequate reserves</td>
<td>Extraordinary coverage protection</td>
<td>Minimize costs</td>
</tr>
<tr>
<td>Meet debt obligations</td>
<td></td>
<td>Avoid paying costs of others</td>
</tr>
<tr>
<td>Minimize bankruptcy risk</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**AIRLINE PAYMENTS**
<table>
<thead>
<tr>
<th>Airport Objectives</th>
<th>Compromise</th>
<th>Airline Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control over capital improvements (no MII)</td>
<td>Triggers for capital construction</td>
<td>Control over capital improvements (strong MII)</td>
</tr>
<tr>
<td>Control over facilities (common use)</td>
<td>Preferential use with accommodation and recapture provisions</td>
<td>Control over facilities (exclusive use)</td>
</tr>
<tr>
<td>Promote air service</td>
<td>Equitable treatment of all airlines</td>
<td>Preferential treatment of incumbents</td>
</tr>
<tr>
<td>Attract new entrants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Historical agreement and relationships</td>
<td>Identify needed changes</td>
<td>Historical agreement and relationships</td>
</tr>
</tbody>
</table>
Airport – Airline Business Relationship

The Core Driver in Airline Negotiations

- Cost Per Emplaned Passenger (“CPE”)
- CPE represents the aggregate cost per passenger at a given airport
- How expensive is it to service the airport
- Total Costs – Revenues = Net Cost / # PAX
- Note inverse relationship between passengers and CPE
Sources of Airport Revenue

**LARGE HUB**

- **Airline-Derived Revenue:** 49%
- **Landing Fees:** 17%
- **Concessions:** 12%
- **Terminal Rentals:** 12%
- **Other Aviation:** 8%
- **Rental Cars:** 2%
- **Parking:** 2%

**MEDIUM HUB**

- **Airline-Derived Revenue:** 43%
- **Landing Fees:** 25%
- **Concessions:** 12%
- **Terminal Rentals:** 12%
- **Other Aviation:** 7%
- **Rental Cars:** 3%
- **Parking:** 3%

**SMALL HUB**

- **Airline-Derived Revenue:** 32%
- **Landing Fees:** 15%
- **Concessions:** 14%
- **Terminal Rentals:** 18%
- **Other Aviation:** 7%
- **Rental Cars:** 7%
- **Parking:** 14%

*Source: FAA, AAS-400, CATS, Report Form 5100-127, accessed September 2013*
MAJOR AIRLINE EXPENSE PROFILE

2009
- TRANS_EXPENSE: 18%
- AIRCRAFT_FUEL: 22%
- SALARIES_BENEFITS: 27%
- DEPRECIATION: 5%
- FOOD: 1%
- RENTALS: 7%
- LANDING_FEES: 2%
- MAINT Materials: 2%
- SERVICES Total: 15%

Total Airport-Based Costs: 9%

2013
- TRANS Expenses: 17%
- AIRCRAFT_FUEL: 28%
- SALARIES & Benefits: 25%
- DEPRECIATION: 4%
- FOOD: 1%
- RENTALS: 6%
- LANDING_FEES: 2%
- OTHER Materials: 1%
- MAINT Materials: 2%
- SERVICES Total: 14%

Total Airport-Based Costs: 8%

Source: USDOT Form 41 for 12 months ending December 31, 2013
**Rates & Charges Methodology**


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

A compensatory rate is not universally higher or lower than a residual rate.

Residual rates vary with nonairline revenue and dependent upon:
- Air traffic levels
- Agreements with concessions, rental cars, etc.
## Rates & Charges Methodology

### Methodology and Nature Related

<table>
<thead>
<tr>
<th>Pure Residual</th>
<th>Modified Residual</th>
<th>Modified Compensatory</th>
<th>Pure Compensatory</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Ft. Lauderdale</td>
<td>• Orlando</td>
<td>• Colorado Springs</td>
<td>• Boston</td>
</tr>
<tr>
<td>• Pittsburgh</td>
<td>• Dallas/Ft. Worth</td>
<td>• Manchester-Boston</td>
<td>• Los Angeles (LAX)</td>
</tr>
<tr>
<td></td>
<td>• Philadelphia</td>
<td>• Baltimore/Washington</td>
<td>• Kansas City</td>
</tr>
</tbody>
</table>

### Strong Airline
- Comprehensive contract regarding:
  - Rate-setting in multiple activity centers
  - Capital projects
  - Debt issuance
- Rate setting contract governs application of “surplus” funds; multiple cost centers
- Contractual definition of cost centers
- Airline voting on capital projects
- Commercial real estate approach
- Leases for preferential and common areas with rate-setting guidelines
- Limited review of capital projects
- No master contract
- All rates by ordinance
- Tenants-at-will for occupied premises
Rates & Charges Methodology

Large-Hub U.S. Airports Methodology

- Trend away from pure residual ratemaking
- In early 1980s, 58% of large- and medium-sized airports used a residual approach
- Blurring of distinctions between traditional rate-making approaches with significant number of hybrid approaches

Pie chart showing:
- Compensatory: 30%
- Residual: 34%
- Hybrid: 36%
Compensatory Rate Setting IS permitted without an agreement

Rates by Airline Agreement

Airport System Residual Rate Setting IS NOT permitted without an agreement

Compensatory
Hybrid
Residual

Absent agreement, Airport may not require airlines to cover losses generated by non-aeronautical facilities
TRENDS

• Away from residual cost rate-making toward compensatory and hybrid methods

• Increased use of “activity-based” rates

• Establishment of cost recovery security fees (security checkpoint, EDS space, exit lane staffing, etc.)
**CAPITAL PROJECT CONTROL**

- Airline approval/disapproval rights vary:
  - None
  - Airport doing project at all
  - Including project costs in airline rates and charges
  - Issuing bonds for project
  - Certain types of projects

- Many airports have obtained “pre-approval” for capital programs in their agreements

- Majority-in-interest (MII) of airlines represent a majority of passengers, landed weight, or payments to airport
MAJORITY-IN-INTEREST (MII) STRATEGIES

• Approval vs. disapproval
• Veto vs. deferral
• MII voting formula (e.g. 50% in number and 50% in weight)
• Typical exemptions
• Project cost thresholds
**Facility Control**

- What rights do airlines have to space they lease?

<table>
<thead>
<tr>
<th>Lease type</th>
<th>Description</th>
<th>Example types of space</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusive</td>
<td>Exclusive right to use</td>
<td>Ticket counter, back office, clubrooms</td>
</tr>
<tr>
<td>Preferential</td>
<td>First right, airport may assign others if not in use</td>
<td>Gates, holdrooms</td>
</tr>
<tr>
<td>Joint</td>
<td>Used by many airlines</td>
<td>Bag claim areas</td>
</tr>
<tr>
<td>Common</td>
<td>Airport assigns</td>
<td>Circulation, restrooms</td>
</tr>
</tbody>
</table>
UNDERSTAND YOUR FACILITY

• Types of Space – from Public to Private
• Terminal:
  – **Public Areas:**
  – **Common Use or joint use:** Costs that can be prorated according to amount of use (# of bags or passengers).
  – **Preferential Use:** Airline has right of first use but may have to share. Airport retains right to allow other airlines to use the area “to the extent such other use does not infringe on the Airline’s preferential use as herein defined.”
  – **Exclusive Use:** Traditional leasehold areas that are exclusively used by the Airline.
Facility Control

Use-It-or-Lose-It and Accommodation

• If an airline isn’t using the space efficiently and someone else needs it, airport can take it back

• Thresholds in airline agreements range from:
  – Ex. 3 to 7 turns per gate per day
  – Airport-wide average utilization

• Primarily applies to gates, but some agreements have similar provisions for ticket counters and associated office space

• Accommodation provisions
  – Ability to reallocate space at select intervals
  – Ability to force sharing

• A Note About Competition Plans, PFCs and Grant Assurances
TRENDS

• Recent agreements trend toward preferential use
  – Optimize facility use and reduce capital needs
  – PFC funds only for preferential/common use space or exclusive use space with lease less than 5-years

• Preserving the flexibility to reallocate or reassign exclusive use space to accommodate changing mix of airlines and market shares

• Move toward common use terminal systems
**Other Considerations**

**Affiliate Airlines**

- Affiliate definitions include:
  - Wholly-owned subsidiaries
  - All seats sold in the name of signatory airline
  - Operates under the same trade name and uses essentially the same livery
  - Airlines with a code sharing agreement

- Typically require affiliates and signatory to formally declare relationship

- Affiliates typically do not sign the airline agreement
Other Considerations

Environmental & Insurance

• Often most time-consuming section of airline agreement to negotiate

• Establishes:
  – Types and amounts of insurance airlines must have to operate at Airport
  – Indemnity provisions – a VERY important risk-containment method for airports
  – Environmental procedures, audits, and compliance

• Not only negotiating with airline property reps, but their legal counsel as well
OTHER CONSIDERATIONS

AIRLINE BANKRUPTCY

• Airline Bankruptcies Have Become A Regular Occurrence in Post 9-11 Era
• Hope for best, but plan for worst
• Impact of Bankruptcies and Airline consolidation over past 10 years
• Crystal Ball says....
QUESTIONS?

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