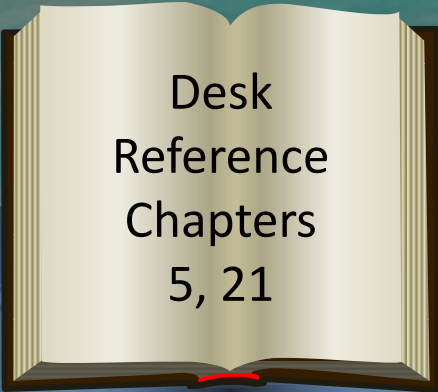


30<sup>th</sup> Annual AAAE Basics of Airport Law Workshop  
and 2014 Legal Update  
October 19-21, 2014

# AIRLINE USE AND LEASE AGREEMENTS

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*Kaplan Kirsch and Rockwell LLP*  
*October 21, 2014*



Desk  
Reference  
Chapters  
5, 21

# SESSION OVERVIEW

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- 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

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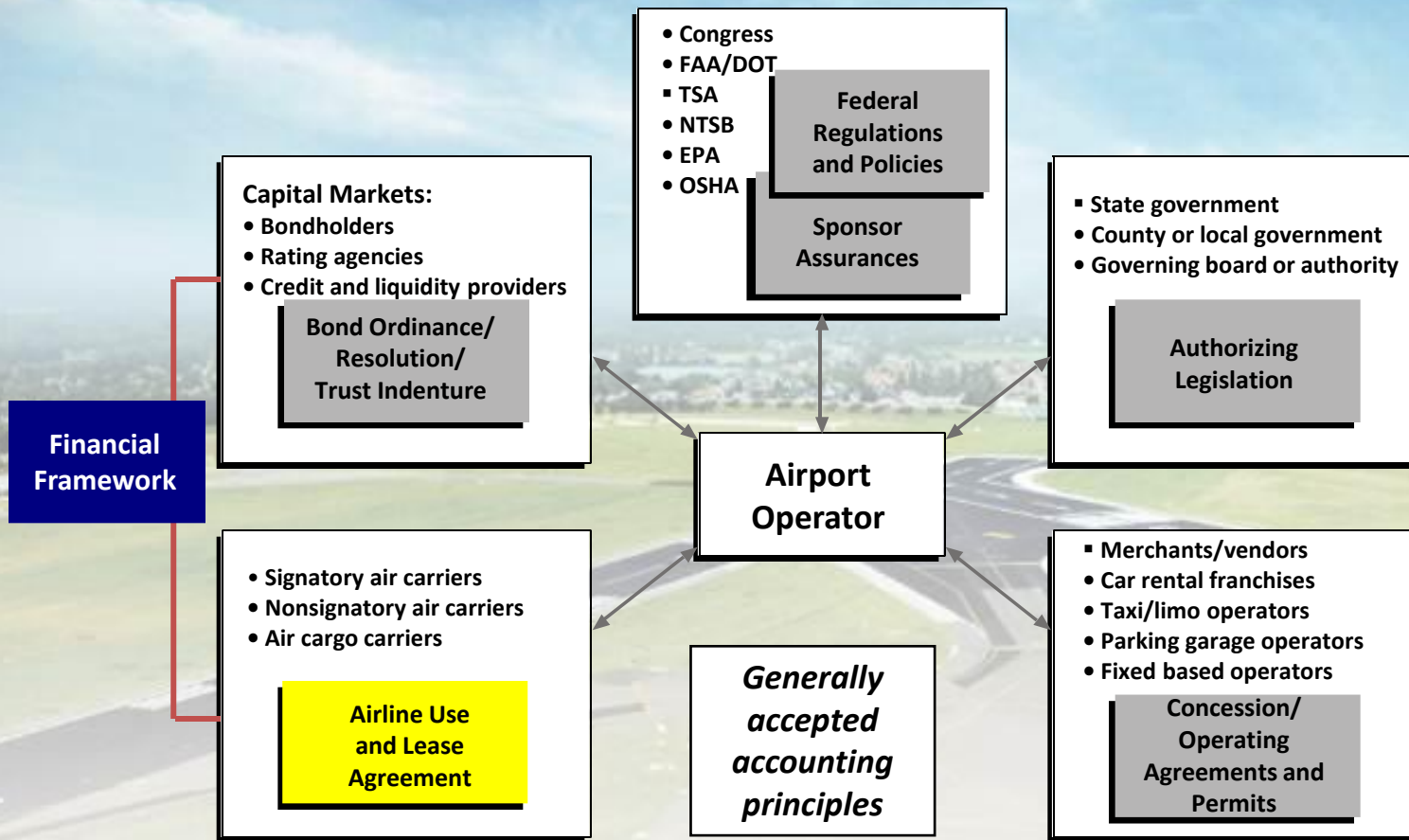
- Airport Legal/Financial Framework
- Building Blocks for Agreement
- Airport-Airline Business Relationship
- Airline Agreements
  - Ratemaking Methodology
  - Facility Management Provisions
  - Capital Project Consultation
- Other Considerations
  - Affiliate Airlines
  - Environmental
  - Insurance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

# PREVIEW OF WHAT IS AHEAD

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- Three classifications of Airline Operating Agreements
  - Residual
  - Compensatory
  - Hybrid
- First discuss common elements

# AIRPORT LEGAL/FINANCIAL FRAMEWORK



# UNDERSTAND YOUR PLAYING FIELD

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- **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

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- Cost centers
- Cost center allocations
- Terminal space inventory
- Capital program and sources of funding

## BUILDING BLOCKS FOR AGREEMENT

# TYPICAL AIRPORT COST CENTERS

### Cost Center

### Spaces Included

Terminal

Passenger terminal buildings, baggage claim, loading bridges

Other Buildings  
& Grounds

Airline and GA hangars, fueling facilities, other land/building leases

Cargo

Airline freight, express, and mail handling facilities

Airfield

Areas for aircraft landing, taking-off, taxiing, safety areas, and parking; terminal and cargo apron areas

Parking &  
Roadways

Short term, long term, and shuttle parking areas; rental car facilities; airport access roads

Reliever Airport

General aviation reliever

*General &  
Administrative*

*Indirect expenses allocated to other cost centers*



# BUILDING BLOCKS FOR AGREEMENT

# COST CENTER ALLOCATIONS

DOT Policy requires cost allocations to be reasonable and transparent

## 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

# 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

# **TERMINAL SPACE INVENTORY**

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- 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

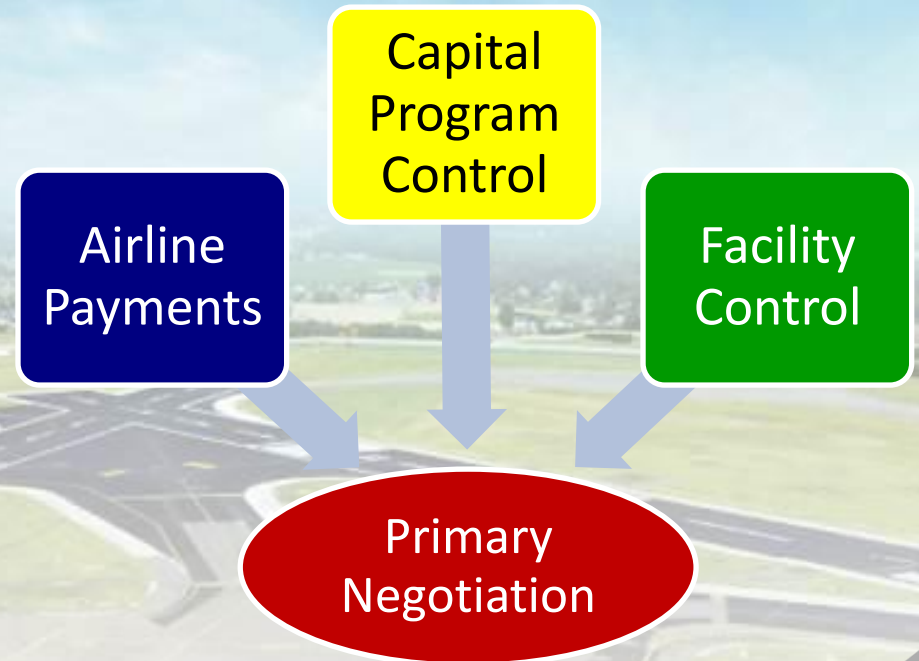
No airline agreement is required.  
Some airports operate without an agreement

# 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

## 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.



# BALANCING AIRPORT AND AIRLINE OBJECTIVES

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

# BALANCING AIRPORT AND AIRLINE OBJECTIVES

	<b>Airport Objectives</b>	<b>Compromise</b>	<b>Airline Objectives</b>
<b>CAPITAL</b>	Control over capital improvements (no MII)	Triggers for capital construction	Control over capital improvements (strong MII)
<b>FACILITY</b>	Control over facilities (common use)	Preferential use with accommodation and recapture provisions	Control over facilities (exclusive use)
<b>OTHER</b>	Promote air service Attract new entrants	Equitable treatment of all airlines	Preferential treatment of incumbents
	Historical agreement and relationships	Identify needed changes	Historical agreement and relationships



# **THE CORE DRIVER IN AIRLINE NEGOTIATIONS**

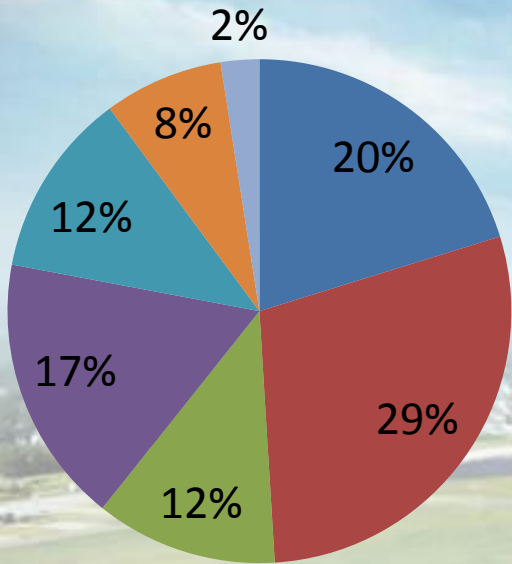
- Cost Per Emplaned Passenger (“CPE”)
- CPE represents the aggregate cost per passenger at a given airport
- How expensive is it to service the airport
- $\text{Total Costs} - \text{Revenues} = \text{Net Cost} / \# \text{ PAX}$
- Note inverse relationship between passengers and CPE

# Sources of Airport Revenue

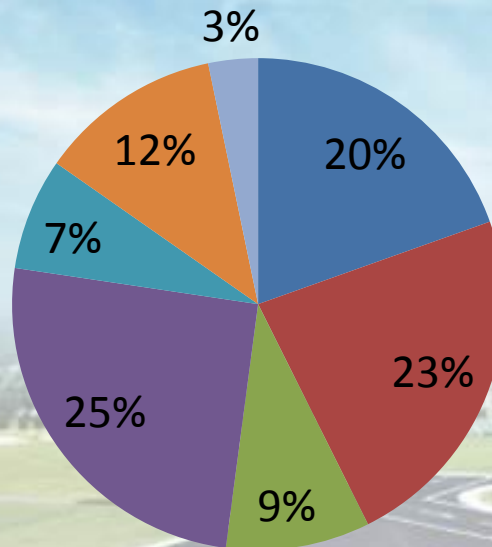
## LARGE HUB

## MEDIUM HUB

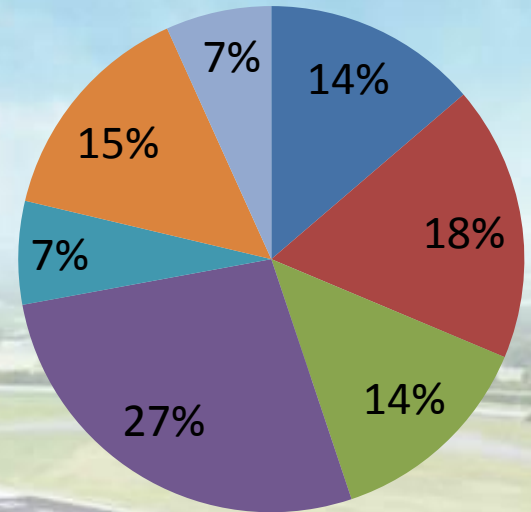
## SMALL HUB



Airline-Derived Revenue  
49%



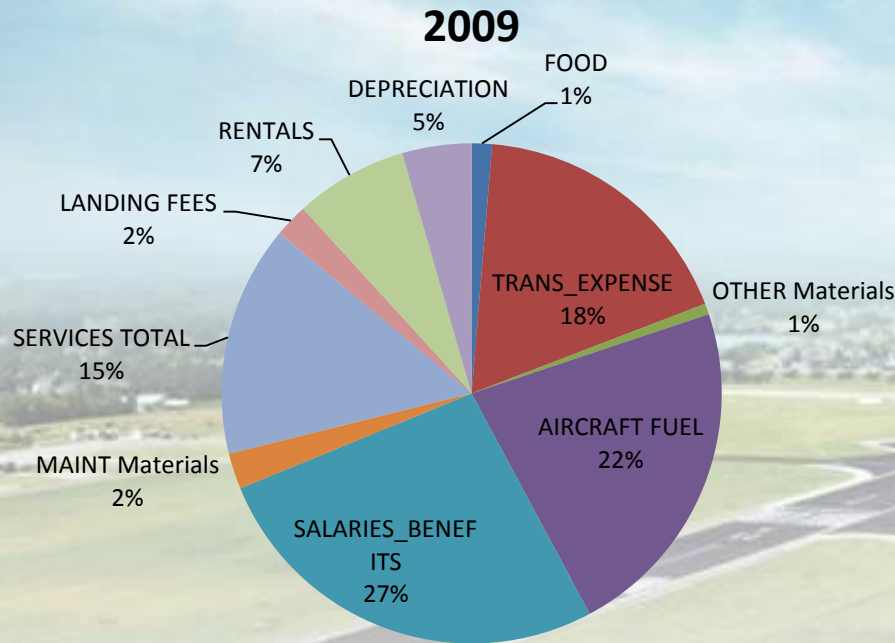
Airline-Derived Revenue  
43%



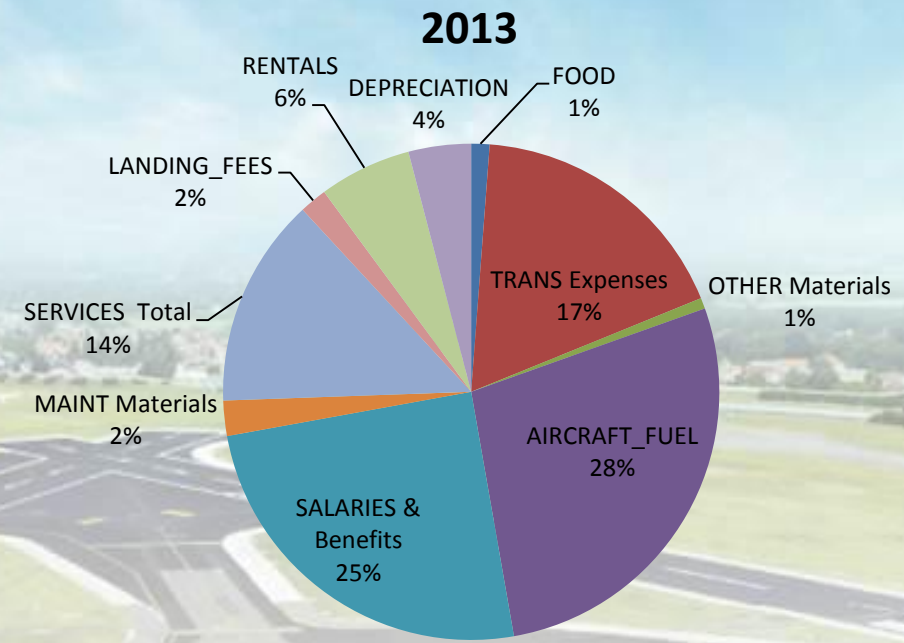
Airline-Derived Revenue  
32%



# MAJOR AIRLINE EXPENSE PROFILE



Total Airport-Based Costs: **9%**



Total Airport-Based Costs: **8%**

# RATES & CHARGES METHODOLOGY

## 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”)

# RATES & CHARGES METHODOLOGY

- 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.

Run multiple scenarios with varying assumptions to see which methodology works for your airport

# RATES & CHARGES METHODOLOGY

## METHODOLOGY AND NATURE RELATED

### Pure Residual

- Ft. Lauderdale
- Pittsburgh

### Modified Residual

- Orlando
- Dallas/Ft. Worth
- Philadelphia

### Modified Compensatory

- Colorado Springs
- Manchester-Boston
- Baltimore/Washington
- Albuquerque

### Pure Compensatory

- Boston
- Los Angeles (LAX)
- Kansas City

### Strong Airline

- Comprehensive contract regarding:
  - Rate-setting in multiple activity centers
  - Capital projects
  - Debt issuance

### Comprehensive Agreement; Shared Control

- Rate setting contract governs application of “surplus” funds; multiple cost centers
- Contractual definition of cost centers
- Airline voting on capital projects

### Differential Facilities Sub-sets

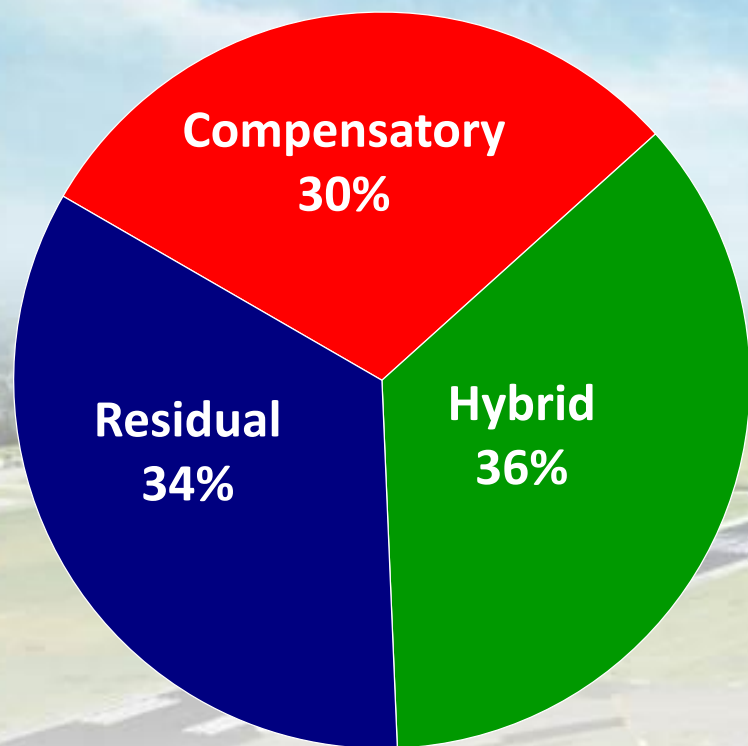
- Commercial real estate approach
- Leases for preferential and common areas with rate-setting guidelines
- Limited review of capital projects

### Strong Landlord

- No master contract
- All rates by ordinance
- Tenants-at-will for occupied premises

## RATES & CHARGES METHODOLOGY

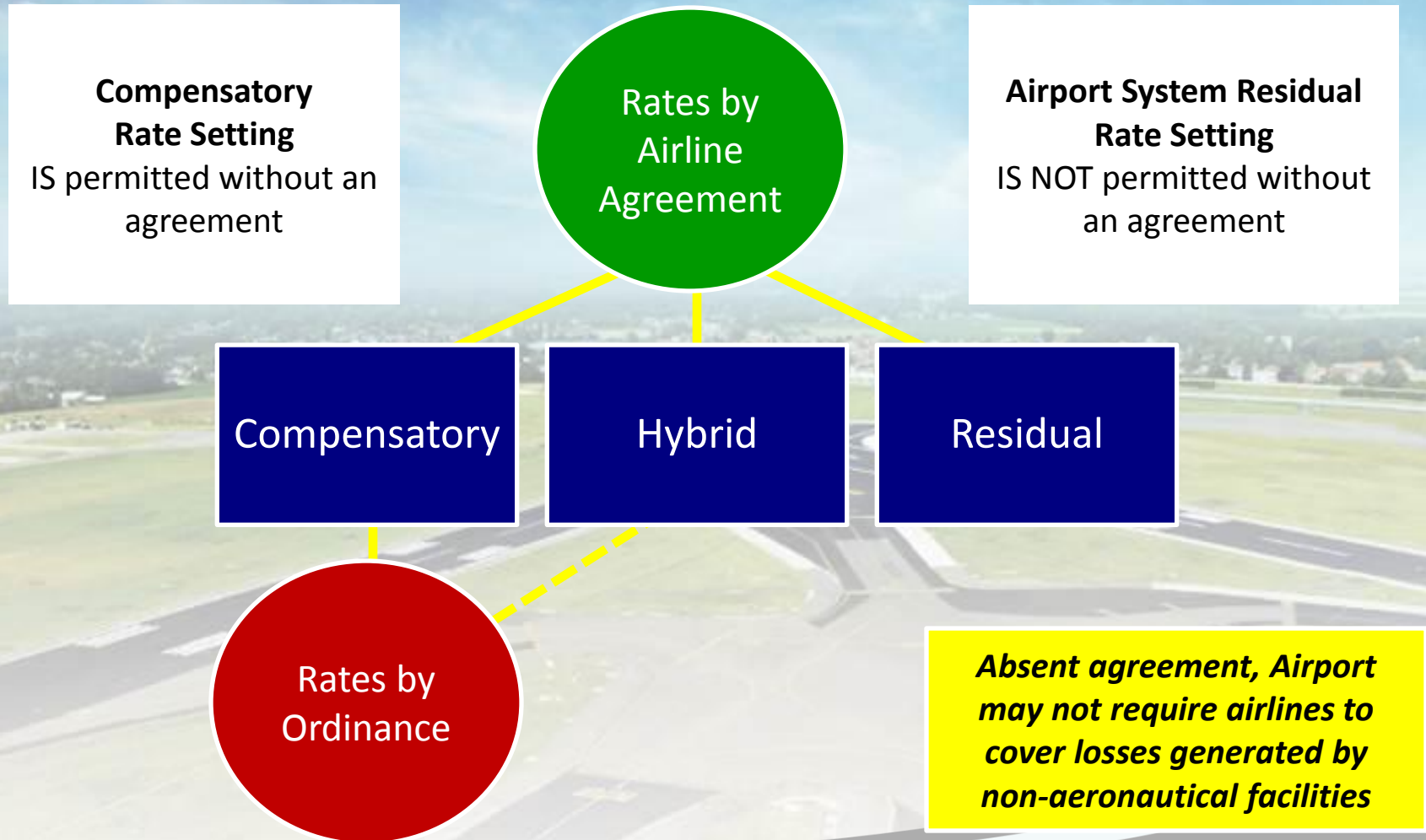
# LARGE-HUB U.S. AIRPORTS METHODOLOGY



- 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

# RATES & CHARGES METHODOLOGY

## FORM OF GOVERNING DOCUMENTS





# TRENDS

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- 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?

Lease type	Description	Example types of space
Exclusive	Exclusive right to use	Ticket counter, back office, clubrooms
Preferential	First right, airport may assign others if not in use	Gates, holdrooms
Joint	Used by many airlines	Bag claim areas
Common	Airport assigns	Circulation, restrooms

# 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

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- 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

# AFFILIATE AIRLINES

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- 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

# **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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