ACI-NA 2017-18 Business Term Survey

2018 Business of Airports Conference

Airport/Airline Business Working Group

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Agenda

- Background
- Rates and Charges
  - Methodology Overview
  - Expenses and Recovery
  - Rate Details
- Other Contents
  - Capital Review
  - Preferential Gate
  - Miscellaneous

The ACI-NA business term survey is one of the most valuable sources of airport ratemaking.

- History
  - Since 2003, ACI-NA has conducted several business term surveys regarding airline use agreements.
  - This working group has conducted a major revamp of the survey in 2016-17
- Since 2015, Professor Jonathan Williams has assisted ACI-NA in building a web-based survey that provides a convenient interface for responding and generating outputs.
  - Respondents can populate the 2017-18 survey using the 2016-17 responses. Only new questions need to be reviewed
  - The survey will be moved to a new platform in 2018

ACI-NA received 61 responses in the 2017-18 survey, compared to 60 responses in the prior year

- ***If you have not responded to the survey, please send your airline agreement to us; we will help populate the responses!***

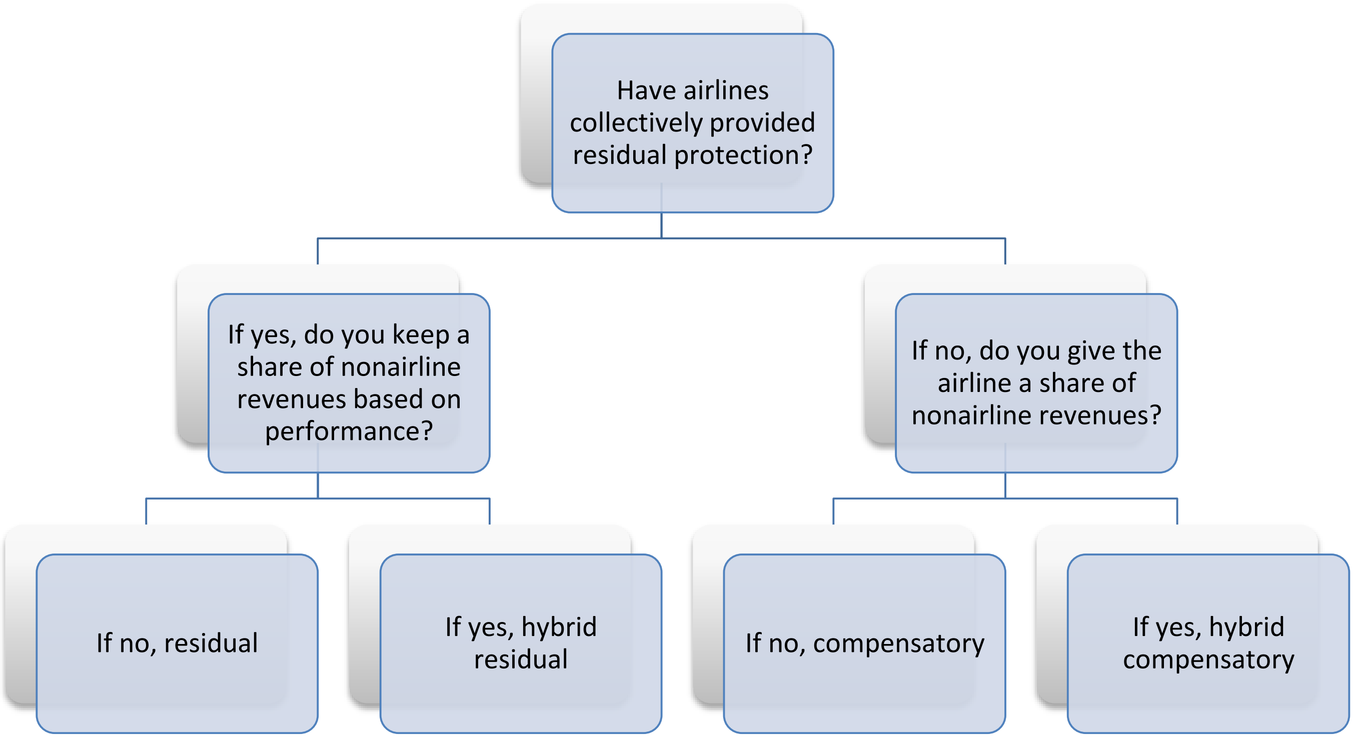
FAA 2016 hub category	Complete or partially complete	Number of airports	% responded	Missing information
Large	23	30	77%	None, need airport approvals
Medium	19	31	61%	Missing 12
Small	19	71	28%	Mostly unknown
Total	61			

Rates and Charges Overview

There is some confusion regarding the rates and charges methodology.

- Traditionally, there are only two rate methodologies:
  - Residual: airlines agree to pay any costs of running the airport that are not allocated to other users.
  - Compensatory: the airport operator assumes the major financial risk of running the airport and charges the airlines only for their fair share of costs (instead of whatever is necessary to break even).
- A third category – hybrid – was created in the most recent decade, which leads to confusion.
- The working group has further split hybrid between hybrid residual and hybrid compensatory.

Residual protection and revenue sharing are two key issues to determine rate methodology.



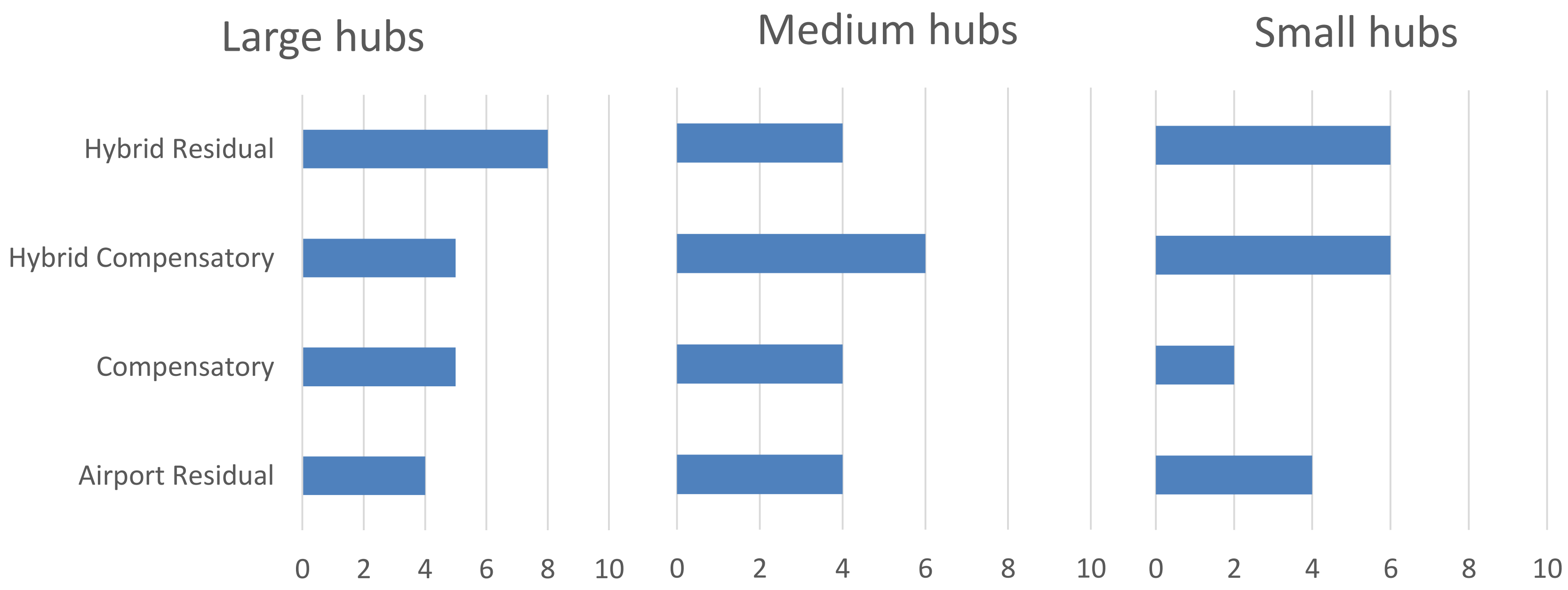
- Materiality
  - A residual airport can have a small cost center not guaranteed by airlines.
  - A residual airport can keep a small portion of nonairline revenues (e.g., profit/loss from cargo cost center) and still be called residual instead of hybrid.

Airport-wide ratemaking may not be the same as the cost center ratemaking methodology.

Residual (airport-wide)	Residual (dual cost center)	Hybrid Residual	Hybrid Compensatory	Compensatory
Landing fee is sized to recover all costs, net of all other revenues. • Terminal rental rate can be any methodology	Airfield: residual, or net of some landside profit/loss	Airfield: any method	Airfield: any method	Airfield: any method
	Terminal: residual, net of all other landside profit/loss	Terminal: any method	Terminal: any method	Terminal: compensatory
		Landside: shared, with residual protection	Landside: shared, without residual protection	Landside: kept by airport

Residual/hybrid residual and compensatory/hybrid accounted for roughly 50% each.

- 4 large hubs and 5 medium hubs reported rate-setting under unilateral resolutions.
- 12 large-hub airports reported residual or hybrid residual.
- 8 medium-hub airports reported residual/hybrid residual.



Surprisingly, long-term agreement is still popular among large hubs, likely due to capital program.

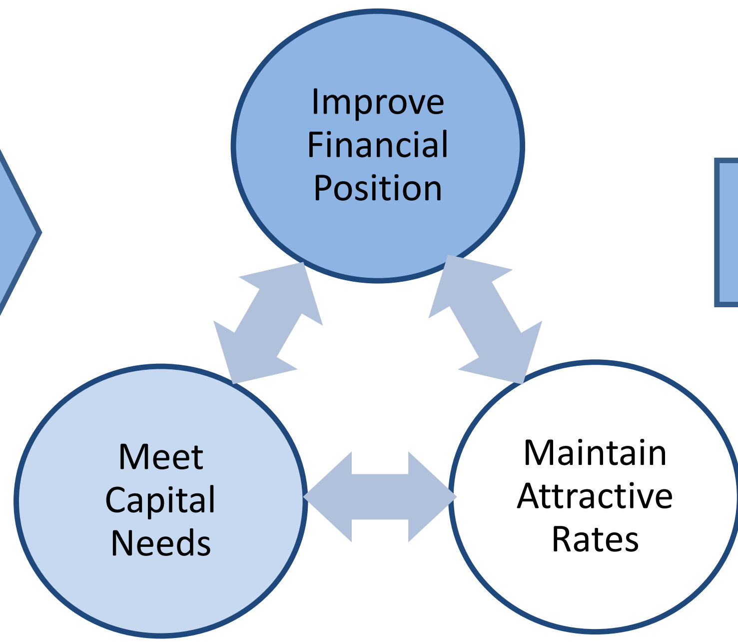
Less than 5	5-7 years	10 years	> 10 years
• Rate by resolution airports (BOS and PHX) • Rate agreement (MCO) • Auto-renew (HNL)	• BWI • DEN (WN) • PHL • SAN • SEA	• CLT, DCA, DFW, IAD, LAS, LAX (rate agreement), PDX, SFO, SLC, TPA (extended)	• ATL, DTW, FLL (extended), IAH, MDW, MIA, MSP, ORD (new agreement)

The ratemaking methodology is determined by capital needs, priorities, and negotiation power

Capital Affordability

- Costs
- Schedule
- Cash flow
- Funding sources
- Financing structure
- Expenses
- Nonairline revenues

Evaluating Priorities



Negotiation

- Risk and reward
- Degree of control
- Fairness and competition

Expenses and Recovery

Administrative expenses are typically allocated based on direct expenses.

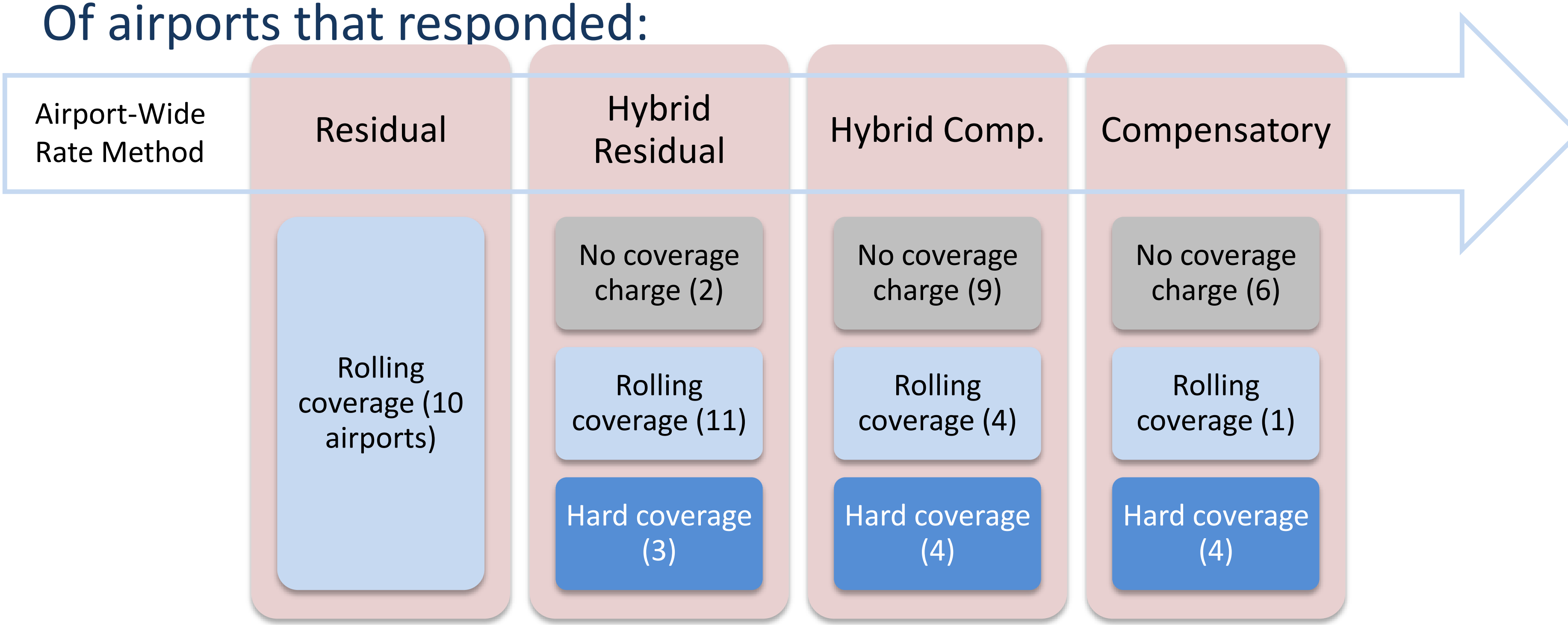
- A majority of the respondents (53 out of 56) reported that they include some kind of operating expense allocation procedure in the airline agreement.
  - This ranges from a simple statement such as “Indirect expenses shall be allocated according to the distribution of direct expenses” to very detailed exhibits showing the allocation ratios of each function.
  - Note: A different number of airports responded to each question.
- 34 out of 47 respondents reported that they allocate administrative expenses according to direct expenses, and another 13 responded that they allocate administrative expenses based on management estimates.
  - 4 airports included operating revenues as one factor to allocate administrative expenses.

Debt service or internal cash spent on capital projects could be included in airline rate base.

- About 83% of respondents reported that they allocate debt service to airline cost centers to recover debt service instead of using depreciation/amortization for bond-funded assets.
- About 75% of respondents responded that they recover investments made from airport internal cash
  - 15 airports reported that they do not recover such cash.
  - The other 42 airports recover the cash spending using:
    - Average borrowing rate (12 airports)
    - Projected borrowing rate (7 airports)
    - Fixed rates (5 airports)
    - Certain index, ranging from the Bond Buyer Index to treasury rate

Debt service coverage requirement is typically funded by rolling coverage.

- The bond document typically requires two tests: a flow test to ensure adequate cash flow, and a coverage test to preserve a safety margin.
- Rolling coverage funds the safety margin only once.
- Of airports that responded:



Investing discretionary cash flow and recovering through amortization is a key action to improve financials

- Amortization of cash investment creates true cash flow that rating agencies value
  - Through a cash flow coverage calculation, rating agencies exclude all non-cash-flow items, such as rolling coverage, or even landing fee credit from prior year
  - Amortization, on the other hand, is a recurring revenue stream recovered from airline rates. It serves as a cushion for debt service coverage

	Pure Residual Ratemaking			
	Year 1		Year 10	
	Airport A	Airport B	Airport A	Airport B
O&M Expenses	$ 100	$ 100	$ 100	$ 100
Debt Service	20	20	25	20
Discretionary Cash	5	5	5	5
Amortization	-	-	-	5
Total Revenues	$ 125	$ 125	$ 130	$ 130
Coverage	1.25	1.25	1.20	1.50

Rate Details

Residual landing fee methodology is the norm.

- Although an airport cannot impose airport-wide residual ratemaking on airlines, the landing fee rate can be calculated using an approach similar to residual:
  - Aggregate of airfield-related direct and indirect operating expenses, debt service, and fund deposit
  - Net of general aviation-related fuel flowage fee and other revenues
  - Divided by the sum of signatory and non-signatory airline landed weight
- Comparatively, a compensatory landing fee is calculated by dividing the net requirement by the total landed weight (commercial airlines plus general aviation and other activities).
- ***Revising landing fee methodology may have tax implications – discussion with tax counsel is a must!***

More airports are using a compensatory or commercial compensatory for terminal ratemaking.

Airport-Wide Rate Method.	Residual	Hybrid Residual	Hybrid Comp.	Compensatory
Terminal Rate Methodology	Residual (10 airports) Commercial comp. (1)	Residual (8) Comp. (6) Commercial comp. (3)	Residual (1) Comp. (5) Commercial comp. (11)	Comp. (5) Commercial comp. (6)
Admin Space In Divisor	n.a.	No (15) Yes (2)	No (14) Yes (3)	No (5) Yes (6)

Airports tend to customize revenue sharing to fit their specific needs

- Of hybrid residual and hybrid compensatory airports, 24 airports reported revenue sharing, with many variations.
  - 11 airports tie revenue sharing with net remaining revenues.
    - 8 airports share a fixed % of net remaining revenues.
    - 3 airports share a variable % of net remaining revenues, and/or subject to a floor amount or a ceiling amount.
- As to allocation of revenue sharing:
  - 11 airports allocate revenue sharing partly based on enplaned passengers
  - 6 airports allocate partly based on landed weight
  - 7 airports allocate partly based on rented space
  - 3 airports allocate partly based on airline payment
  - 4 airports allocate partly based on incremental enplaned passengers

More airports are using 90/10 or 100/0 formula to allocate baggage claim expenses

- Historically, 80/20 has been the standard formula allocating baggage claim expenses.
  - 80% based on enplaned or deplaned passengers
  - 20% based on the number of users
- In this survey, 11 airports reported 100/0 (no fixed fee portion), 7 reported 90/10, and 22 reported 80/20.
  - Some airports exclude low-volume carriers from the allocation of the fixed fee portion.
  - 6 airports allocate baggage claim costs based on bags.
  - 5 airports allocate baggage claim costs on other methods, such as seats, turns or space.

Baggage makeup space is not necessarily available on a common use basis.

- Many airports have common use baggage makeup of some kind, but more than 25% of airports reported that they do not offer baggage makeup on a common use basis.
- Among 43 airports with common use baggage makeup space:

15 airports	80/20 based on enplaned passengers
5 airports	90/10
10 airports	100/0
4 airports	Outbound bags
9 airports	Based on departures, seats, gate counts or ticket counter hours

Holdroom cost allocations tend to include turns as a factor.

- 25% of airports reported that they do not offer common use holdrooms.
- Among 47 airports with common use holdroom space:

21 airports	• Based on turns
15 airports	• Based on a blend of turns and enplaned passengers
2 airports	• Based on seats
9 airports	• Combined into other fees or methods

A good airline ratemaking methodology encourages sound decisions

- In many cases, many options are acceptable to balance priorities
  - Residual vs. compensatory for risk/reward
  - Preferential vs. common use to balance utilization
  - Using flight vs. using seats to allocate costs
  - Allocating revenue sharing to incentivize service
- In some cases, there are clear preference
  - Including amortization of cash investment to encourage prudent financial planning
  - Excluding administration space to eliminate odd incentives
  - Properly allocating expenses to airline cost centers, such as roadway costs

Other Contents

The capital review process is closely tied to ratemaking methodologies.

- Affirmative MII: an airport cannot proceed unless it receives enough airline approvals.
- Negative MII: an airport can proceed unless it receives a certain amount of airline disapprovals.

Airport-wide Rate Method.	Residual	Hybrid Residual	Hybrid Comp.	Compensatory
	No MII (2 airports)	No MII (2)	No MII (6)	No MII (9)
	Affirmative MII (4)	Affirmative MII (none)	Affirmative MII (4)	Affirmative MII (1)
	Negative MII (6)	Negative MII (15)	Negative MII (7)	Negative MII (1)

The capital review process is also influenced by known capital needs.

- Other issues to consider in the capital review process:
  - Exempted projects
  - Pre-approved CIP
  - Annual allowance or deposits to maintenance reserve
  - Small capital outlay or equipment purchase
  - Separate MIIs for airfield vs. terminal (how about one for int'l arriving building/FIS?)
- One-third of airports reported that they cannot proceed with a project if airlines rejected it twice under the negative MII.
  - For the remaining two-thirds, one phrase is recommended to add: "Airport can proceed with the proposed capital projects after a delay of <<>> months, ***and include the related operating expenses and capital costs in the calculation of airline rates and charges.***"

There is a wide range of qualification criteria for preferential gates.

- Of 61 airports responding, 34 have not set a threshold
- Of the remaining 27 airports:
  - 14 airports selected 4-7 daily turns as the criteria, with 6 turns being the most popular (5 airports).
  - 6 airports selected seats as the criteria, ranging from 500 seats to more than 1,000 seats, tied to airport overall utilizations.
  - One airport allocates gates based on the August seat schedule.
  - Other airports use airport average or assign gate at the airport’s discretion
- Some issues to consider:
  - Should the threshold be dynamically tied to seats or turns?
  - Should there be an initial threshold and a maintenance threshold, similar to equity investment?
  - Should the common use fee for an airline be capped if they qualify but can’t get a gate?

Preferential gate allocation becomes a hot topic in recent airline negotiations

- Key aspects of negotiation:
  - Frequency: annually vs. as-needed
  - Timing: how many months before the fiscal year?
  - Number of common use gates preserved before allocating preferential
    - Limitation
    - Incremental annual changes
  - Basis: seats, passengers or flights?
  - Evaluation period: one month or one year?
  - Data source: airline report or 3rd party sources?
  - Reasonability: how to prevent an carrier claiming unnecessary gates?
  - Financial affordability: should common use fee be capped at preferential gate costs?

Next Steps

ACI-NA plans to conduct a webinar later this year to discuss this survey and recently completed airline negotiations

- How can participants benefit from this survey?
  - Survey result summary, such as this presentation
  - Follow-up to confirm and revise responses
  - Experience from airports recently completing negotiations
  - Research on key topics, such as gate allocation
- This can be a good learning opportunity for your staff. Please email dwu@dwuconsulting.com if:
  - You are not certain whether your airport has responded to the survey, or
  - Your staff wants to learn more about the survey questions.

- Please feel free to send suggestions and observations!

Thanks to everyone who has assisted with this survey!