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The Airport-Airline Relationship

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The Airport Use Agreement



Airlines Must enter into Contract with Airport

- Use of airport requires airline to sign an agreement with the airport
  - Airport Use Agreement
  - A contractual relationship
  - Specifies obligations of each party
- Two types
  - Signatory airline
    - Usually has greater obligations of airline, but for lower fees
  - Non-signatory
    - This still requires signing a contract
    - Higher fees, lower priorities
- Airline has large number of contracts
  - TK: 260+ destinations
    - Some low frequency, some high frequency
    - Plus other airports for charter services
- Airline may have GSAs at other airports
  - General sales agents

Airline Use Agreement

- There is no universal standard agreement
- Agreements tend to be similar within a given country
- But will vary substantially between nations

What is covered?

- Rights, privileges, and obligations for each party
  - and defines how the airport is to be used by the airlines
- Business arrangement
  - Premises and facilities leased by the airlines and the degree of control by the lessee
    - (e.g., exclusively leased, preferentially leased, leased in common, etc.)
    - Ticket counters, boarding gates, lounges, offices
    - Maybe baggage systems
- Rate-setting methodology with the airlines
  - (e.g., compensatory, residual, hybrid)
- Control over the expenses at the airport, if any
- General party responsibilities and obligations
  - for indemnification, insurance, environmental issues, and other governmental inclusion

Responsibilities of the Airline

- Payment of landing fees and security charges
- Collection of ‘Airport Improvement Fee’ (AIF) or ‘Passenger Facility Charge’ (PFC)
- Maintenance and repair obligations (e.g., terminal complex space, apron area, etc.)
- Ownership of improvements
  - But landlord has guidance on improvements
  - Improvements are usually tradable

Responsibilities of the Airline

- Agreement usually implies a collective agreement among all the airlines and the airport
  - Collectively the airlines may guarantee coverage of the airport's costs
    - This is true for residual pricing agreements
    - Even with compensatory agreements there may be collective guarantees
- Airport revenue bonds
  - Used in some nations
    - Common in U.S.
  - Airlines collectively guarantee an airport's bond payments
    - Airlines willing to do so as it means the airport has lower risk and hence lower financing costs
    - Airline realize that ultimately they will end up paying an airport's expenses
  - Airports pay landing fees into a trust fund
    - Trust fund first pays the interest (and principal) of airport bonds
    - Then excess is transferred to the airport

Responsibilities of the Airline

- Conditions of use
  - Fees
  - Payment terms
  - Provision of data
    - Number of passengers
      - Broken down by revenue and non-revenue
  - Noise procedures
  - Payment of property taxes
  - Operational issues
    - Radio frequencies
    - Gate scheduling process

Slots

- Will be covered later in the course
- Slot coordination role varies by airport
  - Largest carrier
  - Independent slot controller
    - UK airports, Toronto – Airport Coordination Ltd., AC Canada
  - Airports
    - Airports increasingly seeking role of slot coordinator
      They want to control access and productivity of their assets
  - Government
    - FAA in US as key airports

Responsibilities of the Airport

- Airport must provide signatory airlines with
  - Operational data
  - Financial data
  - Capital and operating plans
  - Right to audit airport finances
- Airport usually convenes an consultative committee of the airlines
- Airport must operate the airport adhering to all applicable safety regulations
- And must carry insurance
  - Insurance companies may impose their own standards on the airport
- Airport must show and adhere to its pricing methodology

Other Airline – Airport Agreements

- Airline Use Agreement
- Specific agreements for lease of space and facilities in the airport terminal
  - Office space
  - Space for lounges
    - Australia – airline has right to operate retail within its lounges
    - Most airports do not allow this
  - Sublease for gates, ticket counters
    - Exclusive use – no other airline may use
    - Preferred use – airline has priority on use of gate
      but when not in use airport may assign use to other airlines
    - Common use – airport schedules all use
  - Terminal lease
    - Some airlines lease entire terminals
      - E.g., Terminal 1 in Chicago O'Hare
      - United designed and has exclusive use
      - Has concession rights within terminal

Other Airline – Airport Agreements

- Land lease for
  - Operations centre
  - Maintenance facilities
  - Cargo facilities
- Provision of services by airport
  - Ex) Hamburg airport can provide (51 subsidiary companies)
    - Customer service (check-in, boarding)
    - Ground handling
    - Fuelling
    - Crew transport
    - Passenger transport
- Right to operate ground handling
- Airline consortium agreements
  - Some airports allow fuelling consortia

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Signatory vs. Non-signatory Airlines



Signatory Status – example of US airports

- Airports have access to municipal bond market as a method to fund capital improvements
  - Interest income on municipal bonds is tax free
- Financial markets look for commitment from the airlines that:
  - They plan to operate at the airport
  - Pay fees in accordance agreement for the full term of any outstanding bonds
- Signing a long-term agreement signifies a commitment to a payment stream to the airport
  - In return for lower fees being charged to signatory airlines
    - Lower financing cost is benefit ultimately enjoyed by airline
    - (*residual* rate-setting)

Signatory Status

- Signatory airlines may also play significant role in airport investment decisions if they agree to the **majority-in-interest (MII)** clauses in the use agreement
  - **MII**: signatory airlines have to approve all significant planned developments or changes at airport
- MII clauses can be a problematic if non-signatory airlines are prevented from gaining access to terminal space and gates
  - Some cases in US (E.g.., MSP) where airlines refused terminal expansion that was intended to accommodate new entrants
- As a result, increasing use of **`use it or lose it`** clauses
  - **`Use it or lose it`**: control of assets are returned to airport if airline does not use facilities as intended

Non-signatory Status

- Non-signatory airlines are those that are not willing to commit a revenue stream for the full term of any outstanding bonds
- Simpler agreement, but usually pay higher landing fees and rents than do signatory airlines
- Non-signatory airlines generally operate limited or seasonal service

Rate-Setting Methodologies

- **Residual**: airlines assume the financial risk and guarantee to provide the airport with sufficient revenue to cover its operating and debt-service costs
  - Airport deducts an agreed amount of non-airline revenue from its expenses, leaving the airlines responsible for the remaining (residual) amount
  - Other general points:
    - Airport has less incentive for maximizing non-aeronautical revenue sources
    - Airport has less incentive for controlling operating expenses
    - As a trade off, airports generally have weaker balance sheets, reduced debt service coverage margins, and limited liquidity
    - With limited available cash, airports generally have a higher cost of capital

Rate-Setting Methodologies

- **Compensatory:** airline pays for only the cost of facilities used or leased at a specific airport
  - Usually at mature airports that have achieved successful revenue generation
  - Airport bears financial risk, but retains concession revenue for discretionary capital improvements
  - Other general points:
    - Airport has incentive to maximize non-aeronautical revenue
    - Airports generally have higher levels of liquidity and discretionary cash
    - Airports generally carry stronger operating and debt service coverage margins

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Ground Handling



Ground Handling Overview

- Ground handling services cover passenger handling, baggage handling, freight and mail handling, ramp handling, fuel and oil handling, and aircraft services and maintenance
- Airport determines who provides ground handling services
- Sometimes airport operator provides ground handling services but provided by airline or handling at most airports
- Historically, the national airline or airport operator have had a monopoly in ground handling

Self Operation and Regulations

- Some airport operators earn significant revenues from provision of ground handling services to airlines
  - Not in North America, common in Europe
  - Often was a monopoly or near monopoly in the past
  - Sometimes over half the total income of the airport
  - A study (1992) of European airports showed 44 percent of aircraft movements were handled by airport operators
- Providers of monopoly services claim that providing competition would duplicate resources, lower efficiency, and increase congestion
- Critics argue that monopolies push up prices and tend to reduce service standards

Self Operation and Regulations

- In 1996, EU adopted the Ground Handling Directive
  - End all ground handling monopolies and duopolies within the EU
  - Open up the market to third party handlers
  - Recognize the right of airlines to self-handle
    - In North America, often there is no right to self handle
    - Airport determines how many total GHs and whether some will be independent non-airline
  - EC concept is to guarantee some choice for airlines in provision of ground handling services
- Key features:
  - For airports with >1M pax, airlines have right to self-handle
  - For airports with >2M pax, third party handling allowed
    - At least one handler must be independent from airport operator or dominant airlines with more than 25% of traffic

Contract Ground Handling

- To avoid congestion, there are typically limits on how many airlines can provide ground handling services
- Airlines with less-frequent service or fewer resources at a particular airport sometimes subcontract ground handling to another airline or third-party handler
- According to IATA, conservative estimates indicate airlines outsource more than 50% of ground handling
- In cases where airport doesn't provide service, it will earn rental fees and perhaps a small concession from the airlines/agents providing the ground handling

PFCs and AIFs



Passenger Facility Charge

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- Created by legislation (1992)
  - Formally, a tax (49 US Code § 40117)
- Currently, up to $4.50 per enplanement
  - Assessed on connecting passengers
  - Not indexed to inflation (hence, declining value)
- Administered by FAA, airlines collect
  - Airlines receive a collection fee (currently, 11 cent s – 2.4%)
- PFC requires airport application for a capital project
  - Life limited to specific project/program
  - Significant accounting rules

Airport Improvement Fee

- No legislation, not a tax
- First fees collected 1994 (YVR)
  - Direct collection method, from passenger, prior to security
  - Airline collection today, but via contract with airlines (contract between National Airlines Council of Canada and individual airports)
- No limit on the fee (presently $25 at YYZ)
- Most airports do not assess AIF on connecting passengers
- Airlines receive collection fee (4% - 7% depending on airport size)

Airport Improvement Fee

- If airlines collect fee for airport:
  - Fee can only be used to finance a specific capital program
  - Airlines review and either:
    - Approve
    - Disapprove and delay collection for 3 years
- Airport can collect fee itself and ignore airlines or use AIF for operations
  - Currently all AIF airports in the NACC agreement

Commonality?

- **Both US and Canada both use PFC/AIFs as financing vehicle for major capital programs**
- **Airports in both countries recognise the sensitivity of airlines and passengers to the total package of fees charged**
  - Hence they seek to minimise use and magnitude of PFC/AIF
- **However, without access to paid in equity capital PFC/AIF is necessary**
  - Debt markets will not provide 100% debt financing to airports
  - There must be equity of some form
  - Reserves or 'Retained Earnings' from PFC/AIF provide the needed 'equity'

Commonality

- **Both have consultation and review of capital programs**
  - US: by FAA by regulation and granting process
  - Canada: by contract with major customers

Differences

- **Canadian airports have much greater flexibility in their use of AIFs**
  - This has enabled the airports to undertake massive remedial and deficiency capital investments following a decade of neglect by former operator (current landlord)
  - It will also allow Canadian airports to meet the onerous end-of-lease provisions they face
  - Canadian airports not constrained by inflation

Differences

- **Canadian AIFs are not revenues against which depreciation is charged**
  - AIF collection begins in advance of project
    - It does not write down the construction-in-process values
    - Nor is construction in progress depreciated against the AIF
  - When asset is put into use
    - Asset is depreciated against revenues per GAAP/IFRS
  - AIFs/PFCs are means to finance projects when there is no access to paid in equity capital

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Strategic Relationship of Airport to Airline



Airport critically affects Airline

- Connectivity
  - Severe airport congestion
    - reduces routes/flights an airline can operate
    - Increases connection times
      As airline unable to time flights for rapid connections
- Operating Cost
  - Unreliable airport service increases airline costs
    - Operating costs of flights
    - Overtime of customer service staff
    - Interrupted trip expense

Airport Critically Affects Airline

- Aircraft Productivity
  - Long taxi distances
    - E.g., 5th runway at AMS
    - DFW crossings of active runways
    - *This is a function of airport design*
  - Operational delays on airfield
  - Inadequate de-icing facilities, causing delays
  - Delays in reassigning gates
  - Etc.

  - These all increase time aircraft must spend on the ground
    - Reduces number of flight cycles an aircraft can perform during the day
    - Especially important for aircraft making multiple short/medium haul flights

Example - Runway

- Airport with 2 independent runways in primary wind direction, but single runway in cross wind
  - Average taxi time/delay increases from 15 minutes to 60 minutes
  - Average of 500 operations per day
  - $3500 per hour aircraft operating cost
  - Delay conditions 25% of time
  - Annual operating cost: $120 mn

- Additional costs
  - Misconnected passengers
    - 500 misconnected pax per event @ $300 cost (staff, pax cost, lost revenue)
    - $15 mn annual
  - Lost pax from low service
    - At YYZ, one estimate was that airport improvements would increase traffic 5%
    - Increase in revenue was $600mn per annum
    - Increases in traffic was largely via increased load factor, so high profit leverage

Example - Terminal

- Airline that moved to new terminal found traffic increased 3% almost immediately
  - Surveys found that some pax were intentionally booking other airline due to poor travel experience

Airport Strategic Air Access Forum

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- Traditional airline-airport relationship
  - Was junior VP level station manager
    - Reported to a VP-"real estate"
    - Orientation was cost control
      - Opposed most airport investment
        "a bus station standard is all we need"
      - Perceived terminal investment as being driven by desire of airport to increase non-aeronautical revenue, at expense of airline fees

- Strategic dialogue desired
  - Engage all major airlines at one session
  - But dialogue was at CEO level
    - E.g., CEOs of AA, CX, KE, AC
    - Included senior officers of inspection and security agencies
  - Message: lack of airport capacity decreases our aircraft productivity, increases our costs, reduces our connectivity and market scope, and decreases our shareholder value

Hubs and Gateways

- Hub: airline has substantial operations
  - and self connects flights
- Gateway: airlines interconnect
  - Alliances, of course
  - But substantial non-alliance interconnects

- Congested and inadequate hubs and gateway
  - Perhaps single most important destroyer of airline value
  - Economics of hub are powerful
    - Revenue and cost
  - This is source of market scope
  - And driver of customer satisfaction
    - Effectiveness of connections
    - Customer experience
    - Service redundancy for higher flight completion rates

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Government Policy



Advocacy for Government Policy

- Traditional airport – government owned and operated
  - Airport perceived it had no role in commenting on government policy or advocating for changes or awards
  - If airport was local government (e.g., US), it would be more likely to provide letters of support for route awards
  - Offering discounts to airlines was rarely done
    - Quantity discounts
    - Discounts or other incentives for new services

Advocacy for Government Policy

- Modern airport
  - Privatized
  - Or local based not-for-profit airport authority
    - These organizations have “letters patent” which specify the purpose of the organization
    - Often the key objective is operation and development of the airport for the economic development of community
  - But increasingly also government run airports

- Government policy strongly affects airports
  - Revenue
    - Open air access increases revenues
  - Customer Service
    - Staffing of security and border processing (Customs, immigration, agriculture)
    - Cargo gateways more effective with 24/7 customs services
  - Costs
    - Regulations imposed on airports
    - Rent to government land owner

Advocacy for Government Policy

- There are many common areas for airline-airport advocacy to government
  - Border services staffing and policies
  - Security services staffing and policies
  - Visa policies
    - Often airports and airlines suggest changes to visa policies
      - Online visas
      - Visa exemption countries
      - In-transit visa requirements
      - Visa offices and processes in foreign countries
  - National Tourism marketing
    - Which countries are targeted and staffed
    - Marketing support for new air services
  - Airport rents and taxes
  - Regulations

Advocacy for Government Policy

- There are areas where airline and airport interests differ
  - International route policy
    - Airports tend to support open skies relationships
    - Enables airports to seek new routes
    - And to seek competing services in order to keep costs down
    - Entrant airlines often seek airport support for their application for a route right or for start of negotiations

    - Incumbent carriers may strongly oppose the airport
      - And exert pressure on airport to not support

    - Example: second home carrier designation on transpacific route
      - Incumbent argued that it would be unable to sustain competition and would fail
      - Airport indicated it would delay support for 2nd designation for 3 years but at end of period strongly supported 2nd designation

    - Currently some airlines exerting strong pressure (service threats) on airport supporting GCC carriers

Advocacy for Government Policy

- There are areas where airline and airport interests differ
  - Passenger facility charge increase in US
    - Airports seeking increase from $4.50 to $8.00
      - Partly an inflation adjustment
    - Airlines strongly opposing
      - Increases price of travel

- Airport grants for terminal expansions to facilitate competition
  - Was an issue in US in 1980s/90s when a number of US hubs were dominated by a single carrier

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Fees



Airport Fees & Charges

- Generally an adversarial relationship on fees between airport and airlines

- Airlines seek
  - Transparency of costs
  - Clearly articulated methodology and strategy
  - Fees that cover costs but leave no profit
  - Cost control
    - Operating costs
    - Especially capital projects
      - These are largest cost item for an airport
      - Capital investments embed new operating costs

Airport Fees & Charges

- Airports seek
  - Right to impose charges
    - Critical to airport bond rating and equity costs
  - Coverage of all costs
  - Return on their investment
    - Even not-for-profit airport organizations seek return on capital to generate equity capital to fund future projects
  - Right to decide capital projects unencumbered by current customers
  - Flexibility to offer incentives for new services

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Thank You