NEGOTIATION OF AIRLINE USE & LEASE AGREEMENTS

Joseph Messina, Esq.
Philadelphia International Airport

Eric T. Smith, Esq.
Kaplan Kirsch & Rockwell, LLP
SESSION OVERVIEW

- Introduction
- Basic Overview
- Legal Underpinnings
- Potential Rate-Setting Methodologies
- Components Contained Within Methodologies
- The Hit List – Frequent & Significant Issues
- War Stories / Lawyer Therapy Session
- Wrap Up & Questions
PLANNING & THE NEGOTIATION PROCESS

- When should an airport start the process?
- What IS the process?
- The role of the airport attorney.
- Don’t go it alone…consultants and special counsel.
- The best laid plans…
THE BASICS

- What are we really talking about?
- Rates & Charges for Privilege of Using Airport
- Landing Fees, Terminal Use (Holdrooms, Common Areas, Exclusive Use Areas), Other
- Do you really NEED a contract?
- What DO you REALLY Need?
- The Rate-Setting Methodology
- Recipes and Main Courses May Vary but…
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.
OBLIGATORY LEGAL STUFF

- Quite a bit of legal underpinnings
- Grant Assurances
- Federal legislation
- FAA policy
- FAA decisions
- Court decisions

Remember, this is just Rates & Charges 101!
LET’S SCARE THE ATTENDEES . . .
GRANT ASSURANCES

- Grant Assurance 5: Preserving Rights and Powers
- Grant Assurance 19: Operation and Maintenance
- Grant Assurance 20: Hazard Removal and Mitigation
- Grant Assurance 21: Compatible Land Use
- Grant Assurance 22: Economic Nondiscrimination (Aeronautical Only)
- Grant Assurance 23: Exclusive Rights (Aeronautical Only)
- Grant Assurance 24: Fee and Rental Structure
- Grant Assurance 25: Airport Revenues
- Grant Assurance 29: Airport Layout Plan
- Grant Assurance 31: Disposal of Land

And…
49 U.S.C. §47129

And… FAA Rates & Charges Policy
And… Case Law (FAA and Courts)
DISTILLING IT ALL DOWN: CORE PRINCIPLES

- Exclusive use
- Competition / Access
- Reasonable terms without unjust discrimination
- Residual terminal methodology by agreement only
DRILLING DOWN: VARIATIONS ON TWO BROAD PARADIGMS

Let’s keep oversimplifying things . . .

. . . but not for too much longer!
## RATES & CHARGES METHODOLOGY

| 01 | 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 |
| 02 | Compensatory | ▪ Recover only those costs allocated to occupied facilities  
▪ Airport assumes financial risk  
▪ Only pay for what you use  
▪ Airport keeps nonairline revenues |
| 03 | 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”) |
# 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></td>
<td></td>
<td>Establish rates by formula</td>
</tr>
<tr>
<td>Generate adequate discretionary cash flow</td>
<td>Financial incentives for cost control</td>
<td>Minimize costs</td>
</tr>
<tr>
<td>Provide adequate reserves</td>
<td>Extraordinary coverage protection</td>
<td>Avoid paying costs of others</td>
</tr>
<tr>
<td>Meet debt obligations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimize bankruptcy risk</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Airport Payments**

- Extraordinary coverage
- Protection
- Provide adequate reserves
- Meet debt obligations
- Minimize bankruptcy risk
- Generate adequate discretionary cash flow
- Avoid paying costs of others
- Recover all costs
- Meet debt obligations
- Minimize bankruptcy risk
- Provide adequate reserves
- Generate adequate discretionary cash flow
- Trend toward compensatory agreements
- Stabilize rates
- Establish rates by formula
- Minimize costs
- Generate adequate discretionary cash flow
- Avoid paying costs of others
- Recover all costs
## 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>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 airline</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>

- **Capital**
- **Facility**
- **Other**
COMPONENTS OF A RATE-SETTING METHODOLOGY
BUILDING BLOCKS FOR AGREEMENT

- Cost centers
- Cost center allocations
- Terminal space inventory
- Capital program and sources of funding
### TYPICAL AIRPORT COST CENTERS

<table>
<thead>
<tr>
<th>Cost Center</th>
<th>Spaces Included</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Terminal</strong></td>
<td>Passenger terminal buildings, baggage claim, loading bridges</td>
</tr>
<tr>
<td><strong>Other Buildings &amp; Grounds</strong></td>
<td>Airline and GA hangars, fueling facilities, other land/building leases</td>
</tr>
<tr>
<td><strong>Cargo</strong></td>
<td>Airline freight, express, and mail handling facilities</td>
</tr>
<tr>
<td><strong>Airfield</strong></td>
<td>Areas for aircraft landing, taking-off, taxiing, safety areas, and parking; terminal and cargo apron areas</td>
</tr>
<tr>
<td><strong>Parking &amp; Roadways</strong></td>
<td>Short term, long term, and shuttle parking areas; rental car facilities; airport access roads</td>
</tr>
<tr>
<td><strong>Reliever Airport</strong></td>
<td>General aviation reliever</td>
</tr>
<tr>
<td><strong>General &amp; Administrative</strong></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
- Airport Hotel
PLACING IT ALL IN CONTEXT
AIRPORT LEGAL/FINANCIAL FRAMEWORK

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

Bond Ordinance / Resolution / Trust Indenture

Airport Operator
- Federal Grants
- Federal Regulations and Policies
- Sponsor Assurances

Airport Operator
- Congress
- FAA/DOT
- TSA
- NTSB
- NEPA
- OSHA

Signatory air carriers
- Nonsignatory air carriers
- Air cargo carriers

Airline Use and Lease Agreement

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

Authorizing Legislation

Financial Framework
- 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

Generally accepted accounting principles
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
AIRPORT LAWYER’S MOTTO?

SPEAK SOFTLY AND CARRY A BIG STICK
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
NUTS & BOLTS

SELECT HOT TOPICS

- Survey of things your super-annuated speakers have had to deal with during their distinguished and long careers
RATES & CHARGES METHODOLOGY
TRENDS

- Term of Agreements
- 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.)
- International / Open Skys
COMMON USE ISSUES

- Changing times = new challenge
- Sponsor obligation to make airport available to all
- Legal standard
- If you have seen one airport
CAPPEDAL 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
FACILITY CONTROL

- What control does the airport have over space? Gates? Ticket counters? Access to baggage, fuel, ground services?
- Ability of existing carrier to expand?
- New entrant carrier access?
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.


What is granted to an airline and what rights are retained by the airport is very important.

<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>Extraordinary coverage protection</td>
<td>Avoid paying costs of others</td>
</tr>
<tr>
<td>Common</td>
<td>Airport assigns</td>
<td>Circulation, restrooms</td>
</tr>
</tbody>
</table>
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
### FACILITY CONTROL 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
- Reservation by airport of common use gates
- 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
PER TURN FEES

- Big 4 (or maybe 3) appear to have declared war
- Wide variety of potential iterations
- The CPE argument likely to be proffered by legacy carriers
- Perspective and insight of the battle-worn
IF THINGS DON’T GO SO WELL…

- Rocket Docket
- FAA Route
  - Part 13
  - Part 16
  - Limbo
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…
CONCLUSION / QUESTIONS

Eric T. Smith
esmith@kaplankirsch.com

Joseph Messina
Joseph.messina@phl.org