Three Dimensions of Airport Finance

(Written by Dafang Wu on January 22, 2016; PDF version)

This article introduces three dimensions of airport finance – accounting, rates and charges, and trust, and provides examples of how three dimensions vary from airport to airport.

Airport finance for a given airport is quite straightforward. For an experienced airport consultant, understanding the existing financial framework and key issues for any given airport may take only days, if not hours. On the other hand, airport finance on an industry level is complicated because each airport is unique. An airport consultant may need to understand how most airports work in order to serve a specific airport.

Financial operations at most U.S. airports are recorded according to three different sets of rules:

1. **Accounting**: Generally Accepted Accounting Principles (GAAP), which generally apply equally to all airports
2. **Rates and Charges**: airline use agreement or rate resolution, which is unique for each airport
3. **Trust**: bond document (indenture/resolution/trust agreement, etc.), which is unique for each airport

Key terms of airport finance are viewed and defined differently under the three sets of rules. For example, counting a portion of last year's revenues in the current year is at least accounting manipulation under GAAP. It may be required by an airline use agreement; it may be acceptable under a bond document. Terms defined in bond documents are typically capitalized to indicate that they are defined terms, such as Revenues, Operating Expenses, or Annual Debt Service Requirements.

Because the financial framework is unique at each airport and affects the financial results differently, an airport consultant must study the airline use agreement and the bond document for the specific airport before providing comments.

In addition, due to each airport's unique framework, most accounting ratios, such as current ratio, return on asset or profit margin, may be useful only when applied to the airport over time or to a subset of U.S. airports, and are meaningless on an industry level. This topic is discussed in a separate article.

Revenues

The following revenue components may be recorded differently under a bond document or an airline use agreement:

Surplus Revenues from Prior Year

There are two types of surplus revenues at the end of every fiscal year:

1. The planned surplus revenues, which are anticipated or budgeted at the beginning of a fiscal year.
    a. For airports with residual ratemaking methodologies (Residual Airports), the surplus revenues are mostly the rolling coverage (typically 25 percent) of debt service. Those revenues are generally the assets of the airlines if initially funded by the airlines, counted as Revenues for the ensuing fiscal year on a trust basis, and as a credit to the calculation of rates and charges in the ensuing fiscal year.

    b. For an airport with compensatory ratemaking methodologies (Compensatory Airports), the surplus revenues are net revenues after meeting all obligations, which are assets of the airport, and are not recognized as Revenues in the following years
2. The unexpected surplus revenues, which are the differences between collected rates and charges and recalculated rates and charges. At the end of every year, an airport may recalculate rates and charges based on actual traffic volume, expenses, revenues, and debt service, which is referred to as the settlement calculation or true-up. Those revenues are the assets of the airlines, but are treated differently at each airport according to their specific airline use agreements:
    a. Returned in the same year: those amounts are generally deducted under GAAP and trust.
    b. Returned in the second year:
        i. For Residual Airports, those revenues are treated as a credit to the second year's calculation of rates and charges, and are counted as Revenues on a trust basis.
        ii. For Compensatory Airports:
            1. If those revenues are returned to the airlines as a check from the airport's non-Revenue Fund, it may not affect Revenues under trust.
            2. If those revenues are returned to the airlines as a credit:
                a. The second year's Revenues would be reduced.
                b. If the airport elects to transfer the corresponding amount from its cash balance to the Revenue Fund, the same amount may be recognized as Revenues under Trust.

            For example, an airport may give the airlines a credit of $1 million in FY 2015 due to a FY 2014 over-collection, and transfer $1 million from the airport's cash account to the Revenue Fund to cover such credit. If the bond indenture recognizes the transfer as a portion of Revenues, the airport can add $1 million on top of the revenues generated in FY 2015.

Passenger Facility Charge (PFC) Revenues

If a portion of PFC revenues are used to pay PFC-eligible debt service, an airport may record the PFC revenues differently depending on its airline use agreement and bond document.

- According to the bond document, an airport may either recognize the related PFC revenues as Revenues, or as an offset to the debt service. The latter approach is becoming popular because the related debt service will be taken out of the divisor of the debt service coverage calculation, leading to a higher coverage under the trust basis. The following table illustrates the benefits of PFC as an offset:

	PFC Revenues	
	as Revenues	as an Offset
Other Revenues	$ 100	$ 100
Add PFC Revenues	20	-
Revenues	$ 120	$ 100
Less: Operating Expenses	(70)	(70)
Net Revenues	$ 50	$ 30
Debt Service	$ 40	$ 40

Less: PFC Revenues	-	(20)
Net Debt Service	$ 40	$ 20
Coverage	1.25	1.50

- Depending on how those revenues are treated according to the bond document, an airport may treat the revenues correspondingly in calculating airline rates and charges.
    - Some airports charge amortization of capital costs, rather than debt service. In that case, the costs related to the PFC-funded assets are taken from the airlines' rate base. Therefore, the PFC revenues added to the Revenues or deducted from debt service may not equal the benefits the airlines receive in the same year

Other Differences

There could be other differences between the revenues under GAAP and the Revenues recognized under the bond document:

- Interest earnings are treated as non-operating revenues under GAAP. A portion of interest earnings are typically recognized as Revenues.
- Federal or state grants are treated as non-operating revenues under GAAP. The operating grants, such as reimbursements for law enforcement officers or K9 units, are typically recognized as Revenues, and as a credit to the calculation of airline rates and charges.
- Customer Facility Charge (CFC) revenues. An airport may use CFC revenues for eligible debt service, and thus record the CFC revenues similarly as the PFC revenues
- Airline revenue sharing. The airline revenue sharing is recognized similarly as the unexpected surplus revenues, which may or may not reduce the second year's rates and charges
- Transfer and Rolling Coverage, which are not revenues under GAAP, but may be included as Revenues under the bond document

Operating Expenses

There are three broad categories of operating expenses that may be recorded differently according to the bond document:

Non-Cash Expenses

Several types of expenses are recognized as operating expenses under GAAP, but are non-cash transactions. Those expenses are generally excluded from the calculation of airline rates and charges, and, hopefully, excluded from the definition of Operating Expenses under the bond document as well:

- Depreciation. Depreciation expenses are excluded from Operating Expenses for all airports. Some airports may elect to recover capital cost via depreciation and interest.
- Amortization of bond issuance costs. Since most airports recover capital costs through debt service, the amortization of bond issuance costs is usually excluded.
- Non-cash component of post-employment benefits (OPEB). After the implementation of GASB 45, U.S. airports recognize the accrued OPEB expenses, including actual payments in the year as well as the earned benefits to be paid out in future years. The treatment of non-cash OPEB expenses generally follows the framework below:
    - If the airport has established a trust fund for OPEB liabilities and deposits the full amount of OPEB expenses, the component related to the earned profit for future years will

become a cash outlay. In that case, the related expenses are usually included in the airline rates and charges and as Operating Expenses under the bond document.
    - Otherwise, if the bond counsel concludes that operating expenses under trust must include the non-cash component, the airport may be able to include the non-cash component in the airline rates and charges, arguing that it is similar to the reserve fund requirements.
    - Otherwise, an airport may face challenges trying to include such expenses in the airline rates and charges calculation.
- Non-cash component of pension expenses. Similarly, after the implementation of GASB 68, U.S. airports are required to report pension expenses differently from annual pension contributions. The non-cash component of pension expenses is treated similarly to the non-cash component of OPEB.

Expenses Paid from Non-Revenue Fund

Under some bond documents, expenses paid from sources other than the Revenue Fund are excluded from the definition of Operating Expenses. Those expenses are typically the expenditures that must be expensed under GAAP but that have a capital nature. For example, environmental remediation expenses must be expensed in the year they were incurred, although an airport may view it as a capital project. The connection fee to a public water/sewer system is another example.

The airport may still elect to recover those expenses through rates and charges, but typically over several years instead of one year.

Other Differences

A bond document may include many other types of expenses as Operating Expenses, which are paid as the first priority out of Revenues. For example, small capital outlay and vehicle expenses may be viewed as essential to an airport's operations, and included as Operating Expenses under a bond document. Some bond documents developed in earlier years may also include repayments of the general obligation bonds as Operating Expenses.

Debt Service

A bond document defines debt service on a cash basis or a deposit basis, which is unrelated to the interest expenses recognized under GAAP.

- Debt service on a cash basis records the payments made during the accounting period. As a simplified example, an airport with fiscal years ending December 31 pays the following amounts:
    - $1 million on January 1, 2016
    - $2 million on July 1, 2016
    - $2 million on January 1, 2017

  Debt service on a cash basis for FY 2016 would be $3 million.

- Debt service on a deposit basis records the deposits required to meet future payment obligations. For the same airport above, debt service on a deposit basis for FY 2016 would be $4 million.

In addition, the bond document may recognize PFC revenues or CFC revenues differently, as discussed above.