Airline Agreement Negotiation – A Story from a Financial Modeler

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There are always moments that one just cannot fall asleep. After getting up at 4AM to catch an early flight, sleeping through the 5-hour journey, eating double lunch at ATL, and having in-room dining of 12 chicken wings and a burger, I woke up in a hotel room at Daytona Beach at 2AM and began to think about everything in my life.

During my career as an airport consultant, I have covered many topics from drawing cost center maps to applying for a 559 agreement, but financial modeling has taken a large chuck of my time. Financial modelers are somehow like coders. After spending 9 pleasant years working in Cincinnati, Ohio, I relocated to the Bay Area in 2009 and got to know a lot of friends from the IT industry (clearly, like other workaholics, the friends are friends of my wife). The popular joke for startups is: "We have the business idea, we have the seed funding, and now we just need a coder!" That pretty much speaks for the perception of a financial modeler, except that a financial modeler is not even needed for a simple airline negotiation!

For any negotiation that involves a capital program or a major change of business deal, a financial modeler is a key member of the negotiation team. There is a wide range of financial modelers, from entry-level consultants updating an existing model, to senior consultants advising on the rates and charges structure. A financial modeler combines the knowledge of airport-specific financial framework and FAA rates and charges policy, and translates the knowledge into an Excel model. Specifically, the financial modeler will:

1. Identify the lower boundary of rates and charges with managerial input
2. Evaluate the upper boundary of rates and charges with rate counsel advice
3. Construct a robust financial model to test scenarios
4. Suggest rates and charges options based on industry knowledge

Identify the Lower Boundary

As mentioned in this article Rates and Charges Methodologies, there are two fundamental ways to split risks/rewards between the airlines and an airport. Under a residual ratemaking, the airlines collectively agree to pay any costs of running the airport that are not allocated to other users or covered by nonairline sources of revenues. The airport has relatively low risks, and reaps relatively low rewards. The rates and charges calculated under a residual ratemaking indicates the lowest level of airline payments needed to operate an airport, and thus forms the lower boundary of an airline negotiation.

The calculation is not a simple math with the sum of debt service and operating expenses offset by nonairline revenues – managerial inputs regarding capital needs and capital review process is key to produce a reasonable projection of the lower boundary. Because airlines are theoretically taking unlimited risks under a residual agreement, they typically require a strong form of capital review process, which may require the airport to delay or cancel capital projects. However, an airport must spend a reasonable amount of fund annually to maintain existing assets or to develop additional assets, and such amounts need to be specified in the form of a renewal/replacement fund or pre-approved allowance.

Evaluate the Upper Boundary

The rates and charges calculated under the FAA rates and charges policy and adopted through a resolution or ordinance are the highest amounts that an airport can charge unilaterally. Unless an airport is a strategic market that an airline must serve, the airlines theoretically would not want to pay rates and charges higher than the resolution rates. Therefore, such rates and charges form the potential upper

boundary. An airport and the airlines will then negotiate between the lower and upper boundaries, and reach an agreement to fine-tune the split of risks and rewards.

A financial modeler works side-by-side with the rate counsel to evaluate the resolution rates. The financial modeler will examine the detailed records of operating expense allocation, debt service allocation, amortization of cash-funded assets, terminal space classification and usage, among other key variables, and develop the initial calculation. The rate counsel will provide opinions on the feasibility of implementing certain options, such as inclusion of debt service coverage, reasonableness of cost allocation, fairness of rate results, to name a few.

Construct a Robust Financial Model

The financial modeler will proceed to build the third scenario, the negotiation scenario, or to modify the existing ratemaking into the negotiation scenario, and to complete other parts of the financial model. The financial model is a sandbox, built based on the knowledge of airport finance using Excel skills, and provides key financial metrics for evaluation. There are three fundamental requirements of building a good model, as discussed in this link:

1. User-friendly, which provides an easy way to change all key variables and to examine the results.
2. Accuracy, which faithfully translates assumptions to projections.
3. Transparency, which allows any user to easily track the logic and calculation.

There are two sets of variables to test: basic inputs such as operating expense growth rates, capital cost escalation, PFC level, or bond borrowing rates, and rate options such as recovery of hard coverage, split of common use requirements, or per-turn fee calculations. A financial modeler must consider the interactions among variables, such as reducing debt service under the resolution rates by applying collected coverage, if any, vs. no such adjustments under a residual ratemaking, which requires a deep understanding airport finance and a high level of Excel skills.

Suggest Rates and Charges Options

There is no bad airline ratemaking methodology, but there are bad airline agreements. It is saddening to see a residual agreement without addressing equipment and capital outlay needs, or to see a compensatory agreement without recovery of cash-funded assets. A financial modeler can make a key contribution by identifying potential improvements to the existing ratemaking, providing alternative rates and charges options available in the industry, and making suggestions if requested. This requires the financial modeler to know many airports in order to serve one. Our industry lacks a repository of related document and reference, which I have been attempting to address in the articles in this section.

In addition, the ACI-NA business term survey will be a great resource available to all airports for airline negotiation. Your input to the survey will form a solid foundation for your colleagues to conduct further research and to equip themselves for airline negotiations, and will be greatly appreciated!