



# The impact of airline lease agreements on the financial performance of US hub airports



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## ABSTRACT

This paper employs benchmarking analysis to examine the financial implications of the different types of airline lease agreements used by US airports. Five key financial performance areas relating to cost effectiveness, revenue generation, commercial performance, financial profitability and capital investment are analysed using financial data from 2011/12 for 23 of the 29 large-hub airports. The results show that compensatory airports are the most financially efficient, particularly in terms of debt efficiency, revenue generation and profitability while the vertical airport airline relationship that is common at residual airports delivers higher levels of commercial performance and cost efficiency.

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## 1. Introduction

At most commercial airports in the United States, the conditions for utilising airport facilities are established in legally binding contracts between airport operators and airline users (Gillen and Lall, 1997). These agreements comprise two distinct elements; 'leases', which govern an airline's occupation of land and buildings, and 'use agreements' which define an airline's use of airport facilities (AAAE, 2005). Together, they form what is collectively known as an airport's 'use and lease agreement'. These agreements set out the terms and conditions for the use of airport facilities by airlines and specify the method used to calculate airline rates (Graham, 2014). Since they specify how the risks and responsibilities of running the airport will be shared, they also serve as the foundation for the financing of airport facilities (Richardson et al., 2013).

There are three types of agreement in use at US commercial airports: residual, compensatory and hybrid (AAAE, 2005). Each one uses a different method to calculate airline charges and presents a different level of financial risk to the airport (Beckers and Fuhr, 2007). As airline rates, fees and charges remain the largest contributor to an airport's operating revenue (ACI, 2011; Hamzaee and Vasigh, 2000), the choice of lease agreement is a fundamental part of an airport's business model and corporate strategy (TRB, 2010). Crucially, 83% of current airport agreements in the US are due to expire within the next five years (ACI-NA, 2012a) and airport managers are increasingly seeking advice and empirical

evidence of the financial implications of each agreement type to inform future agreement negotiations (TRB Report 36, 2010). The aim of this paper, therefore, is to establish the impact different types of airport lease agreements have on the financial performance of large-hub airports which are defined as facilities which handle 1% or more of total US passenger enplanements (FAA, 2012a). At the time of writing in 2013, 29 large-hub airports, which are owned by a variety of different organisations (see Fig. 1 and Table 1) collectively handle 70% of all US passenger traffic.

In order to address this issue, our paper is divided into five principal sections. In section two, we introduce the extant literature on airport lease agreements and document the three different types of agreements that are currently used in the US. A detailed description of the data and the methods used is provided in section three. Section four presents the findings of the benchmarking analysis and discusses their significance in light both of the existing literature and the current challenges facing US airports. The fifth and final section draws together key insights and suggests avenues for future research.

## 2. Airport performance and leasing agreements

At present, three distinct types of airport leasing agreements are used at US airports. These are: residual agreements, compensatory agreements and hybrid agreements. In a residual agreement both non-aeronautical and aeronautical revenues are considered when setting aeronautical charges (Forsyth et al., 2004). This enables airlines to guarantee an airport's solvency by agreeing to pay any deficit or 'residual operating costs' that are not covered by non-aeronautical revenues (AAAE, 2005). By ensuring airports operate

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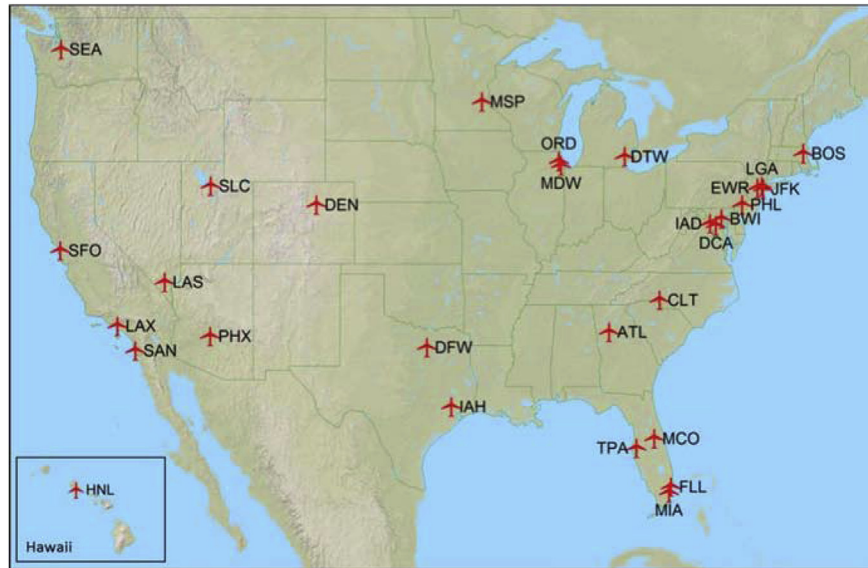


Fig. 1. The geographical distribution of large-hub US airports, 2012.

Source: FAA, 2012a.

on a break-even basis, the airlines assume all of an airport's financial risk (Ashford and Moore, 1999). In return, airlines receive a proportion of control and a share of the airport's non-aeronautical revenue (Oum et al., 2004). The residual approach can be described, therefore, as being somewhat akin to the European 'single-till' approach (see Forsyth et al., 2004), which considers revenues from all airport activities when setting aeronautical charges. This

residual pricing structure encourages 'hubbing' (Richardson et al., 2013), in which airlines concentrate routes and operations at a limited number of strategically important airports in order to reduce average unit costs through improved connectivity, enhanced economies of scale, and higher passenger load factors. In 2012, 36% of large-hub US airports operating a formal lease agreement, including Chicago O'Hare International (ORD), Dallas-Fort Worth International (DFW) and San Francisco International (SFO), operated a residual agreement.

Under a compensatory agreement, however, no cross-subsidisation exists. Airports retain all aeronautical and non-aeronautical revenues but also assume all the financial risk associated with the airport's operation (AAAE, 2005). This approach divides all revenue and expenses between two, financially independent, landside and airside cost centres (Richardson et al., 2013). Thus, contrary to a residual agreement, airlines are charged for the actual cost of both the landside and the airside facilities and services they use (Graham, 2014). A compensatory agreement is therefore akin to the European 'dual-till' approach in which only aeronautical costs are considered when setting charges (Forsyth et al., 2004). In 2012, 28% of large-hub airports, including Boston Logan International (BOS), George Bush Houston Intercontinental (IAH), and John F. Kennedy International (JFK), employed a compensatory agreement.

The third and final agreement type, hybrid schemes, combines elements of both residual and compensatory agreements to suit the needs of a particular airport (Graham, 2014). Although every hybrid agreement is unique, they typically combine residual principles to airside facilities such as runways and compensatory elements to landside services such as car parks (Ashford and Moore, 1999). Here, the airport–airline relationship falls in the middle of the risk/reward spectrum. Additionally, most hybrid airports often incorporate some form of non-aeronautical revenue sharing clause into their agreements. 36% of large US hub airports employed a hybrid agreement in 2012. Examples include Denver International (DEN), Los Angeles International (LAX), and Seattle–Tacoma International (SEA).

Interestingly, there is no legal requirement for an airport to enter into a use-and-lease agreement, nor are these agreements

Table 1  
Ownership structure and identifier codes of large-hub airports in the US.

Airport Code	Airport name	Ownership
ATL	Hartsfield-Jackson Atlanta International Airport	City
BOS	Boston Logan International Airport	Port Authority
BWI	Baltimore–Washington International Airport	State
CLT	Charlotte Douglas International Airport	City
DCA	Ronald Reagan Washington National Airport	Airport Authority
DEN	Denver International Airport	Region
DFW	Dallas-Fort Worth International Airport	Airport Authority
DTW	Detroit Metropolitan Wayne County Airport	Airport Authority
EWR	Newark Liberty International Airport	State
FLL	Fort Lauderdale–Hollywood International Airport	County
HOU	Honolulu International Airport	City
IAD	Washington Dulles International Airport	Airport Authority
IAH	George Bush Houston Intercontinental Airport	City
JFK	John F. Kennedy International Airport	State
LAS	McCarran International Airport	County
LAX	Los Angeles International airport	City
LGA	LaGuardia Airport	State
MCO	Orlando International Airport	Airport Authority
MDW	Chicago Midway International Airport	City
MIA	Miami International Airport	County
MSP	Minneapolis–Saint Paul International Airport	Airport Authority
ORD	Chicago O'Hare International Airport	City
PHL	Philadelphia International Airport	City
PHX	Phoenix Sky Harbor International Airport	City
SAN	San Diego International Airport	Airport Authority
SEA	Seattle–Tacoma International Airport	Port Authority
SFO	San Francisco International Airport	County
SLC	Salt Lake City International Airport	City
TPA	Tampa International Airport	Airport Authority

Data Source: ACI-NA 2012 Benchmarking Survey.

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