

# Airport Beacon Report



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## SATISFYING THE REGIONAL AIRLINE MARKET: PART ONE

*By Mark R. Davidson A.A.E., Vice President*

They're coming! They're coming! The Regional Airline Representatives are coming! If you manage an airport with regional service, which happens to be the majority of the airports offering commercial service, you are probably going to start noticing them at your annual airline budget review meetings and lease negotiations. In fact, if you have a couple of different regional airlines servicing your airport, you will probably hear them chanting the same phrase in unison "Lower your costs!"

For years the "Regional Reps" have remained relatively silent at these meetings, since they have been profitable while the legacy carriers have lost billions attempting to avoid or recover from bankruptcy. According to the FAA, the regional airline industry enjoyed an aggregate operating profit of \$1 billion and net earnings above \$400 million in 2004. In addition, regional airlines now represent about 37% of commercial traffic at the 35 busiest U.S. airports, up from 30% in 2000. The FAA's annual forecast for the aviation industry advised that the regional airlines will continue to grow beyond the estimated 129 million passengers carried in 2004, which was up 19% over 2003.

But if things are so well for the regional airlines, why are they going to start demanding airports to reexamine their rate structure and revenue sources all of a sudden? Simply put, they are being squeezed by the legacy carriers. As a result, at a recent Regional Airline Association (RAA) Meeting in Cincinnati, the underlying theme was to work with airports to lower costs.



***And you thought your Airport had a Wildlife Problem!***

The majority of regional flying is done on behalf of hub-and-spoke airlines under agreements through which the legacy carriers assumes much of the operating cost risk in return for a guaranteed level of service. The financial relationships are primarily done through "fixed fee" or "cost-plus" contracts, which can also be called "revenue-guarantee" and "pro-rate" agreements. These agreements have the attraction of minimizing earnings risk for the regional airlines through pre-determined target margins, while protecting the brand and ensuring the availability of capacity for the majors.

Generally under these agreements, network carriers are responsible for commercial planning, revenue management, sales, distribution, branding and marketing. It is also customary to assume fuel and insurance risks. The contracted regional carrier handles labor, maintenance and operation of the aircraft, as well as station and ground requirements. Target operating margins range between 10 and 15% in most agreements, and are usually re-priced annually to ensure revenues and costs are in line with targets.

Specifically, under a revenue-guarantee arrangement, the major airline generally pays a fixed monthly minimum amount, plus certain additional amounts based upon the number of flights flown and block hours performed. The contracts also include reimbursement of certain costs incurred by the regional in performing flight services. These costs, known as “pass-through costs”, may include passenger and hull insurance, aircraft ownership cost, aircraft property taxes, landing fees, catering and fuel. The contracts also include a profit component that may be determined based upon a percentage of profits on the regional flown flights, a profit margin on certain reimbursable costs, as well as a profit margin based on certain operational benchmarks. The regional primarily recognizes revenue under its revenue-guarantee agreements when the transportation is provided. The majority of the revenue under these contracts is known at the end of the accounting period and is booked as actual. A regional airline usually performs an estimate of the profit component based upon the information available at the end of the accounting period. All revenue recognized under these contracts is presented at the gross amount billed.

Under a pro-rate agreement, the regional receives a percentage of the passenger’s fare based upon a standard industry formula that allocates revenue based upon the percentage of transportation provided. Revenue from pro-rate agreements and independent operations are recognized when transportation is provided. Often tickets sold, but not yet used, are included in air traffic liability on the consolidated balance sheets.

As a whole, regional airlines are well operated and maximize their resources. Aircraft and crews are highly utilized and generally fly routes that are within 100 to 300 miles of their destination. They also fly at lower altitudes than flights of the long-haul carriers and pride themselves with fast turn-arounds at each airport they operate from. Regional airlines are becoming more profitable with the development of newer, smaller jets that are faster than turboprop planes and have greater ranges. The new regional jets have also made operating in previously underserved

markets more cost-efficient. Today, 9 out of every 10 airports in the United States receiving scheduled air transportation are served by a regional air carrier, and 1 out of 4 domestic airline passengers now travel on regional airlines. In 2004, regional airlines provided frequent and timely air service to 654 airports, with 479 of these communities depending exclusively on regional airlines for scheduled air transportation. By contrast, the major airlines served approximately 38%, or 253 airports.

Despite the regional airlines efforts to operate as efficiently as possible, the majors are determined to lower their costs and are placing heavy pressure on them. As a result, the regional airlines are putting pressure on the airports to assist them remain competitive and profitable, since 5 to 10% of their costs are directly related to airport rents and fees.

Next month, Part Two will address a few of the options your airport might have to reduce the financial impact on regional airlines, such as non-aviation land development and innovative business practices.



### **THINK FUNCTIONALITY**

*By Michael A. Hodges, MAI, President/CEO*

Often while negotiating leases and/or determining the value of a leasehold, an airport or tenant will neglect to recognize and appreciate the “function”. Functional utility is defined as: “The ability of a property or a

building to be useful and to perform the function for which it is intended according to current market tastes and standards, as well as the efficiency of a building's use in terms of architectural style, design and layout, traffic patterns, and sizes and types of rooms." As a result, this is a vital variable of comparison for various components of a leasehold, to include hangars, office/terminal areas, cargo facilities, and even ramp/apron areas.

The utility of a hangar is related to its ability to accommodate a variety of aircraft types. However, a more important factor in the utility analysis is a hangar's ability to accommodate the most prevalent type of aircraft and meet the consumer demands in a particular market. Obviously, a hangar which can only accommodate smaller aircraft is less valuable than one able to accommodate a variety of aircraft types including larger corporate jets, especially in a market that caters to larger aircraft. Along similar lines, an insulated and/or heated hangar is demanded in colder climates. The revenue potential of an unheated hangar in the Northeast and portions of the Midwest is significantly less than that of a comparable heated structure.

A functional design and layout is crucial in the value of an FBO leasehold. The utility of the office/terminal area is essential to attract high-quality corporate users and may affect the ability to sublease office space to other tenants within the facility. A quiet location for a pilot's lounge and/or sleeping quarters is important to many users and should not be adjacent to a high traffic, high-noise area. Furthermore, the location of the office for aircraft servicing personnel needs to offer a clear view of the ramp area used for operating aircraft.

In cargo facilities, the changing environment of cargo handling has changed the requirements in many areas. Moreover, the mechanization of freight storage and transfer has created the need for more high-bay facilities and truck docks in many markets.

Utility is also an important issue for the ramp area of a leasehold. The size and type of aircraft that can be accommodated is significant in the successful

operation and value of a facility. Ramp strength can be influenced by many factors; type and depth of the base; age and condition; and even weather conditions. In basic terms, the key issue is once again the ability to accommodate the prevalent types of aircraft using the airport and its facilities.

Therefore, always assess the functionality of the leaseholds and leasehold improvements when addressing their value. The aviation market is constantly changing as technology advances. Make sure your airport and tenants are constantly evolving as well!



### ***Redneck Birthday Cake!***

#### **PRICE VS. PERCEPTION**

*By: Michael A. Hodges, MAI, President/CEO*

I recently read an article that addressed the issue of product pricing and the importance of market perception. The example given was one of two guys out on the beach, and they decide they want a beer. They could either go to the store and buy a six-pack for \$4.00, or go to the beach bar and get a single beer for \$4.00. They have no problem in paying the \$4.00 at the beach bar, because that is the perception and expectation of what it costs, while they would never pay that for a single beer at the grocery store.

I bring this up because this scenario is played out every day at FBOs. FBOs too often consider themselves as the grocery store instead of marketing

themselves as the beach bar. Perception is everything! FBOs are a service industry first and foremost. The focus of an FBO must be on providing value and creating the perception that the price they are charging for fuel and services is justified because of the amenities offered and the overall positive experience of customer service. Too many FBOs fall victim to price, and undercut their ability to be reasonably profitable.

This does not mean that price is not an issue, but rather it does not have to be the issue. Airplanes are not cheap to own and operate, neither are FBOs. It is important for an FBO to help the customer understand what it costs to provide the facilities and services they demand, and make them feel guilty (indirectly) about not buying fuel or complaining about an extra \$0.05 to \$0.10 per gallon. FBOs have to realize that their primary business must be to sell themselves, not fuel. Fuel is just part of the package.

*Note: I recognize that most of you reading this are airport people, so you might wonder why I address this topic. It is important that airport management not only knows their tenants, but also knows their tenant's business. The more you know about your tenant's business, the better equipped you are to negotiate a lease, assess infrastructure needs, plan for unexpected issues, etc. In addition, some of you may be considering taking over FBO activities (or do already), and you need to understand how they work.*

### **ASK ABS**

In the past few issues, we have included a section called "Ask ABS", where we request aviation-related questions from our readership. Each month we publish one question that we receive from our readers with a joint reply from our professional consulting team. Even if your question is not selected, all questions submitted will be responded to via e-mail. Please submit a question by e-mailing Mark Davidson at the following: [mdavidson@airportbusiness.net](mailto:mdavidson@airportbusiness.net)

This month's question comes from Lee Rimmel at the DeKalb Peachtree Airport in Atlanta, Georgia. Lee asks the following "hypothetical": "A general

aviation airport is considering the implementation of landing fees based on FAA certificated gross landing weight. The local jurisdiction collects ad valorem taxes on based aircraft based on the tax code. Other local "fees" collected include personal property taxes, excise taxes, and sales taxes that go into the general fund. Therefore, believing these based aircraft already pay their "fair share", can they be exempted in the landing fees ordinance from having to pay landing fees?"

There are several airports that exempt based aircraft from landing fees, just like many exempt flight school operations or other small aircraft operations on the airport. The key issue is justification. Be able to justify why you elect to exempt any entity or aircraft from landing fees, or any other fee on an airport. It kind of goes back to the FAA's use of the term "unjust discrimination". It is okay to discriminate in certain circumstances, as long as you can justify why you are making the distinction between two entities.

However, I would caution you about exempting all based aircraft on the airport. What about charter aircraft based on the field. Most general aviation airports that have landing fees only impose them on Part 135 operations. As such, even if they are based on the airport, I would suggest that they should not receive an exemption. I hope this helps!

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