

**Issues with Ground Lease Rent
As a Percentage of Revenue**

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Executive Summary

This paper identifies five significant challenges with the concept of rent being set as a percentage of revenues. Some airports have been dealing with these issues under their current leases, and have experienced the negative implications discussed above. Extending this concept to “all revenues at all airports” would promulgate a flawed concept.

In summary, adopting this concept at all airports would:

- Contribute significantly to the escalation of airline and passenger costs.
- Increase the fixed cost burden on airports, with potential rating agency implications.
- Not adequately address the equity issues regarding rent paid by individual airports.
- Lead airport authorities to restructure business relationships and not undertake roles that they should otherwise undertake.
- Creates significant issues regarding application, which are difficult to resolve.

The Canadian Airports Council official position is that rent be eliminated; our members have paid more that \$2 billion for assets that had an original book value of \$1.5 billion. However, if the federal government can not find a way to eliminate rent, the CAC has offered a second option and that is to reduce the current total value of rent paid by 50%, and distribute the total rent payment due to the federal government amongst Canada’s eight largest airports.

The CAC proposal dated March 22, 2001 set out a passenger based methodology.

The structure is set out as follows in Table.

Rent per Passenger Schedule

Tier	Rate per Passenger
0-2 million pax	\$0.00/pax
2-5 million pax	\$x/PAX
5-10 million pax	\$3.50/pax
10-15 million pax	\$4.00/pax
15-20 million pax	\$4.50/pax
20+ million pax	\$4.70/pax

Under this tiered structure, the rent schedule would be applied to each airport's passengers. For example, an airport with 8 million passengers would pay \$0 per passenger on the first 2 million passengers, and \$x per passenger between 2-5 million and \$3.50 per passenger on the remaining 3 million passengers.

The advantages of allocating rent on a per passenger basis are as follows:

- It ties an airport's rent to the primary economic driver of the airport, passengers.
- It provides for progressive "taxation", an accepted and long-used concept across industries and nations.
- It provides an equitable basis for allocating rent amongst airports, agreed to by airports.
- It allows an airport to allocate rent internally to allow more flexibility and equity in the pricing of their services.

The issue of timeliness of passenger data has been raised regarding this concept. This should not be a significant issue as airports have made arrangements with airlines who provide airport authorities with passenger statistics within 30 days of month end.

The CAC requests that the federal government give careful consideration to this proposal.

This paper discusses the following issues that arise under the concept of rent as a percentage of airport revenue.

- Impact on airline charges
- Rent differentials amongst airports
- No consideration of cost to earn revenue
- Impact on non-aeronautical services
- Application issues

1.0 Impact on Airline Charges

Airport authorities operate on the basis of cost recovery. In simple terms, airport authorities seek to recover the costs of their aeronautical operations through airline charges. Under this concept, revenue is determined by costs. Ground lease rent is a cost to airport authorities. Some or all of the rent costs are allocated to aeronautical services, and are therefore recovered through airline charges. The use of rent as a percentage of revenue contributes to an escalation in airline charges.

If rent is determined as a percentage of revenue, the costs of aeronautical services must be increased to recover the costs plus the rent amount. Assume that rent is set at 33% percent of revenue. To recover the costs of aeronautical services plus rent, the airport authority must mark up the costs by an amount greater than 33%. The formula for determining the exact markup is as follows:

$$x / (100\% - x) \quad \text{where } x = \text{ground lease rent as a percentage of revenue}$$

With ground lease rent as a percentage of revenue of 33%, the markup is:

$$\begin{aligned} & 33\% / (100\% - 33\%) \\ & = 33\% / 67\% \\ & = 49.25\% \end{aligned}$$

The mathematics of this formula lead to an ever-increasing markup as the percentage of revenue used to determine rent increases. For example, under the LAA ground lease formula, revenue is broken down into several categories. The ground lease rent payable as a percentage of revenue varies from 8% to 92%, depending on the type of revenue. Figure 2-1 below shows the markup required at various levels of ground lease rent as a percentage of revenue.

Figure 2-1
Required Percentage Markup versus Rent as a Percentage of Revenue

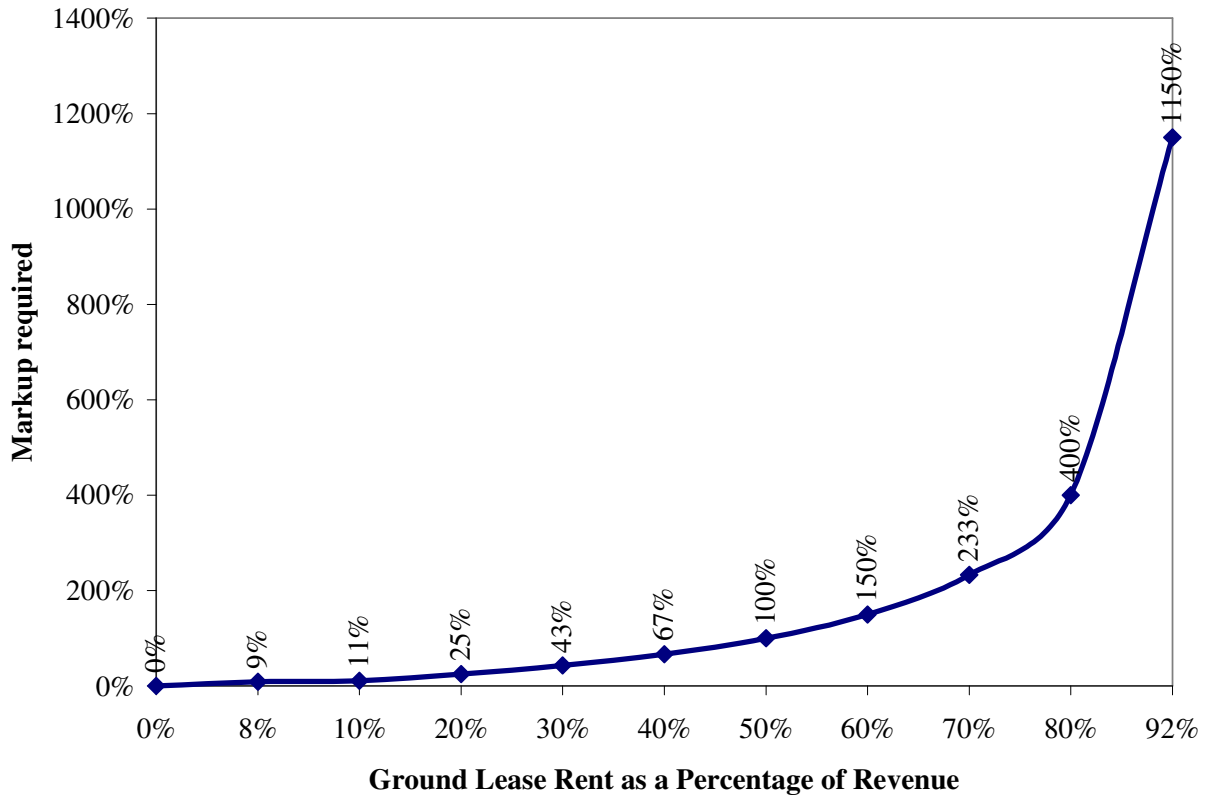


Figure 2-1 shows that as ground lease rent as a percentage of revenue increases, the markup required to recover costs plus rent increases at an exponential rate.

As a further example, assume an airport authority has \$100 million of operating and capital costs related to aeronautical services, excluding the ground lease rent. Because rent is a percentage of revenue, the airport authority would have to charge the airlines an additional 49.25%, or \$49.25 million, in order to come out “whole” on the recovery of costs, as shown below:

Total charges to airlines	\$149.25 million
<u>Less ground lease rent @ 33%</u>	<u>\$ (49.25) million</u>
Sub-total	\$ 100.00 million
<u>Less operating and capital costs</u>	<u>\$(100.00) million</u>
Net amount	\$ 0.0 million

The airport authority has recovered 100% of its costs but has had to mark up airline charges substantially more in order to recover the ground lease rent. Were the airport authority not to mark up its costs with the ground lease rent, it would not fully recover its operating and capital costs, as shown below:

Total charges to airlines with no markup	\$100.00 million
<u>Less ground lease rent @ 33%</u>	<u>\$ (33.33) million</u>
Sub-total	\$ 66.67 million
<u>Less operating and capital costs</u>	<u>\$(100.00) million</u>
Deficit	\$ (33.33) million

The problem will be exacerbated when, either, new capacity is added or operating costs are increased, without a commensurate increase in passengers. Using the example above, assume that operating and capital costs increased to \$110 million, due to capital investment, without an increase in passengers that year. The airlines charges to achieve 100% cost recovery would be as follows:

Total charges to airlines	\$164.18 million
<u>Less ground lease rent @ 33%</u>	<u>\$ (54.18) million</u>
Sub-total	\$ 110.00 million
<u>Less operating and capital costs</u>	<u>\$(110.00) million</u>
Net amount	\$ 0.0 million

In this case, ground lease rent increased by \$4.93 million, or 10%, while there was no increase in passengers. For various reasons costs may increase at a different rate than passengers. Setting rent without regard to passenger volumes disconnects rent from the key economic driver of airports, namely passengers.

In summary, this “tax on the top line” approach of using a percentage of revenue to calculate ground lease rent creates a circular escalation of costs and fails to reflect the key economic driver of an airport, passengers.

2.0 Rent Differentials Amongst Airports

For a variety of reasons, airport authorities have different capital bases and different operating costs. Airports also have different passenger volumes.

Under a system where ground lease rent is set as a percentage of revenue, airport authorities with higher capital bases and higher operating costs would pay higher rent. This could lead to inequitable rent on a per passenger basis. For example, Toronto has 1.75 times as many passengers as Vancouver. Toronto has an airline cost base excluding ground lease rent that is approximately 3 times as large as Vancouver's airline cost base. Under the percentage of revenue formula, Toronto would pay 3 times as much in total dollars of rent compared to Vancouver, yet it has only 1.75 times as many passengers. This means Toronto would pay a much higher per passenger rent than Vancouver.

The rent as a percentage of revenue approach would therefore lead to inequities in rent per passenger across airport authorities. Note that this is not meant to imply that all airport authorities should be paying the same dollar amount per passenger; rather that the basis for the differences in amounts per passenger should be an equitable formula for distributing the ground lease rent burden across airports. The cost bases of airport authorities do not seem to be an equitable basis for distributing the rent burden.

3.0 No Consideration of Cost to Earn Revenue

The determination of rent as a percentage of revenue gives no consideration to the cost to earn that revenue. Different revenue sources can have different costs required to earn the revenue. These costs can vary over time, even from year to year. Changes in costs may not always be matched by changes in revenue. An airport authority may have competitive reasons not to change its prices. An airport authority may be concerned about demand elasticity, in that an increase in prices to cover the cost increases may decrease demand for the use of the services it provides. Setting rent as a percentage of revenue gives no consideration to the variation in costs that an airport authority will experience on its different revenue sources from year to year.

Some of the LAA ground leases acknowledge and incorporate a cost to earn revenue, although the application of this concept is flawed through the inclusion of arbitrary fixed cost amounts for concession revenue.

Income tax policy in Canada acknowledges that there is a cost to earn revenue. Corporate income tax is determined by applying relevant percentages to income for tax purposes, which can be generally described as gross revenue less the costs of earning that revenue. To avoid abuses, the

Income Tax Act describes the costs allowed to be deducted for the purpose of earning income subject to tax.

4.0 Impact on Non-aeronautical Services

Airport authorities have other revenue sources aside from aeronautical revenue. Setting rent as a percentage of revenue means that airport authorities are unable to price these non-aeronautical services competitively.

For example, if an airport authority wished to lease out vacant office space, it would set the rental rates at minimum to cover its operating and capital costs. Possible tenants for the vacant office space could include concession operators or airlines. The airport authority might be competing with off-airport locations for office tenants.

The airport authority might be competitive with off-airport locations with regard to operating and capital costs. However, when the airport authority marks up these costs to include ground lease rent as a percentage of revenue, its rental rates will not be competitive with the off-airport locations. The mathematics would be the same as described in Section 2 above. The off-airport location operators will be paying tax on net taxable income, after consideration of the costs to earn that income. The off-airport operators do not have to mark up their costs by the same large amounts as airports, and can therefore offer substantially lower rental rates to tenants.

This example can also be applied to land development, where the airport authority is competing with off-airport developers to attract airport tenants with appropriate aviation-related land needs. The issue applies to all non-aeronautical revenue sources, including car parking and ground transportation.

In addition to the competitive issues, as with aeronautical charges, rent as a percentage of revenue drives up non-aeronautical charges and increases the burden on the ultimate end user who pays all airport costs, the air traveler.

Also of critical importance is the impact on the roles undertaken by an airport authority. While an airport authority may have strategic reasons to undertake certain roles, for example to ensure common use and equitable access, it may decide not to undertake a role due to the uncompetitive pricing it would be forced to impose under the percentage of revenue approach to rent.

This is not a trivial issue and airports will seek to restructure or rearrange business relationships to address this issue. Some roles that would be best performed by an airport authority may not be undertaken at all or may be performed by other entities. This may create unintended consequences for Transport Canada's airports policy.

5.0 Application Issues

Assessing rent as a percentage of airport revenue raises the following implementation issues which would need to be addressed.

- Would percentage rent apply to AIF revenue?
- Does one single percentage apply to all revenue sources?
- If not, what framework would be used to establish the appropriate percentage rent for each different revenue stream?

Conclusion

The Canadian Airports Council member airports do not believe that a gross revenue formula for establishing rent payment rates is fair or equitable. In closing, it would would:

- Contribute significantly to the escalation of airline and passenger costs.
- Increase the fixed cost burden on airports, with potential rating agency implications.
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