

Making Overheads Fly

By Louis D. Wollinetz

Much has been written about aviation's financial health as air carriers struggle to cope with economic difficulties. Airports are not immune to the downturn in revenues and need to be creative in reducing costs and generating new income sources wherever possible. A potentially significant and often overlooked area is overhead expenses.

Airports typically have a keen understanding of their direct costs, such as for personnel, maintenance, and utilities. A significant amount of the cost of airport operations, however, is often lumped under "administrative" or "overhead expense." According to the 2002 AAAE Rates and Charges Survey, a typical medium hub airport spends 24 percent of its operating expenditures (OPEX), or \$2.23 per enplaned passenger (EPAX), on administrative/overhead costs (the survey combines these two cost categories because, as discussed below, they are difficult to separate). Smaller and non-hub airports generally pay more by both measures (see Figure 1).

At many airports, administrative/over-

head expenses are difficult to link to specific activities, and thus difficult to reduce. In particular, airports that are departments of local governments (government sponsors) are often assessed lump-sum costs that include the cost of services provided by their government sponsor and an allocation for overhead expenses. Since the overhead allocation is usually not itemized, it is very difficult for airports to fully understand and control these costs. The purpose of this Measure of the Month is to both discuss the typical range of overhead expenses assessed by government sponsors and to consider methods to better understand and perhaps reduce these costs.

What am I paying for?

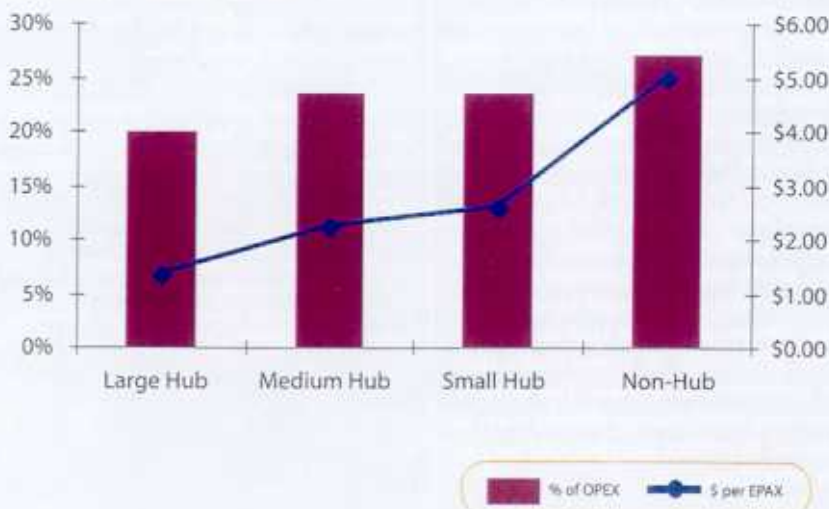
Government sponsors may be able to offer airports economies-of-scale savings for services such as legal, payroll, security and IT/MIS. Smaller airports, in particular, may not have the resources to pay full-time staff to handle these duties, making it practical for them to obtain them elsewhere.

Yet the cost of these services is often problematic. For one, the unit costs airports pay may be a multiple of the sponsoring government's direct costs. One airport with whom Infrastructure Management Group has worked was facing legal hourly rates from their government sponsor that were comparable to rates of the leading law firms in that state—completely unacceptable given the routine nature of the services they were receiving. Secondly, in addition to covering the direct cost of services provided, airports typically share in the general overhead costs of their government sponsors. Depending on the method of allocation, some airports may be assessed a greater share of these costs than their use of services warrants. Overpayments to government sponsors not only make it even more difficult for airports to make ends meet, it also potentially constitutes a diversion of revenue for non-aviation activities prohibited by the Airport and Airway Improvement Act (49 U.S.C. Section 47107). For instance, in a 1998 audit of the Augusta-Richmond County Commission, the U.S. DOT Office of Inspector General found that some \$2.6 million of airport revenue was being improperly diverted, including more than \$94,000 for indirect administrative costs of government.

How much should I pay?

To examine overhead expense allocations more closely, we analyzed 36 city- or county-owned airports that are divisions of municipal or county governments. Figures 2 and 3 show the range of payments made by the airports to their government sponsors for both services and overhead combined, excluding costs for police, ARFF and utilities on a per EPAX basis and as a percentage of the airports' operating expenditures. Unfortunately, since each airport purchases different services from its sponsoring government, this information suffers from not being a true apples-to-apples comparison. Still, the data provides a guide of whether these costs are out of line. As might be expected, smaller airports rely signifi-

Fig. 1 MEDIAN ADMINISTRATIVE/OVERHEAD COSTS AS A PERCENTAGE OF TOTAL OPERATING EXPENDITURES AND PER EPAX



cantly more on their government sponsors than larger airports. The median large hub airport pays only \$0.33 per EPAX to its government sponsors, while small hubs and non-hub airports pay \$0.80 and \$1.07, respectively. Measured as a percentage of OPEX (exclusive of capital expenditures and depreciation), large hubs pay somewhat less (5.6 percent) than medium, small and non-hub airports (7.8 percent, 6.9 percent and 7.3 percent, respectively).

Specific data on overhead payments to government sponsors (as opposed to total payments to sponsors for services and overhead) were available for 10 of the 36 airports included in this study. Overhead costs comprised 44 percent of total payments to the government sponsor at the median airport of these 10, a significant portion of their costs. The data also show that overhead costs are highly variable, as demonstrated by Bangor and Kalamazoo, two small hub airports that enplane a similar number of passengers (260,788 and 272,833, respectively, in 2000). Both airports paid their government sponsors similar amounts (\$307,000 versus \$338,000) for that year. However, Bangor paid nearly twice as much in indirect overhead costs as Kalamazoo.

How Do I Account for This?

In order to reduce overhead cost allocations, airports must calculate how much they are paying for each service provided by their government sponsor. Many governments (and businesses) use traditional cost accounting, assigning overhead costs based on the relative size of each department, often in terms of full time equivalent staff or total operating costs. Since many airports work independently of their government sponsors and often use central services to a lesser extent than typical government departments, they pay more than their true share of overhead costs under this accounting method.

Activity-based costing more realistically assesses the costs of each activity an organization conducts. For example, it takes no more effort for the purchasing department to order \$100 worth of paper than it does to order \$500 worth. Traditional cost accounting, however, would charge higher overhead expenses to the larger purchase order, even though both cost the same amount in overhead staff time. Activity-based costing measures the actual cost of completing a task, enabling the organization to assign the true overhead cost to each department and thereby helping airports determine if overhead charges are reasonable.

Fig. 2 RANGE OF AIRPORT PAYMENTS TO GOVERNMENT SPONSORS FOR SERVICES AND OVERHEAD PER EPAX

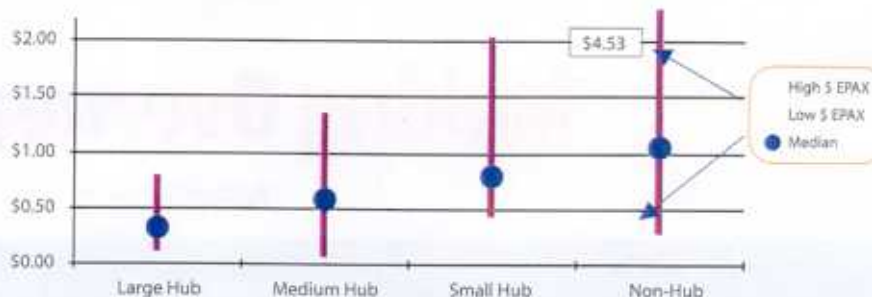


Fig. 3 RANGE OF AIRPORT PAYMENTS TO GOVERNMENT SPONSORS FOR SERVICES AND OVERHEAD AS A PERCENTAGE OF OPERATING COST



If an airport determines that it is overpaying and the government sponsor is unwilling to adjust overhead costs, the airport may have two options:

- It may internalize the activity. For example, after determining that the government sponsor was allocating too high a cost for property management services, a small southern hub recently hired a full-time employee to handle development and management of landside, airport-owned property.
- It may outsource the activity. If maintenance services are determined to be too large a portion of overhead expenses, for instance, a private contractor may be hired at a guaranteed rate to perform the service. Because their profit will be determined largely by controlling overhead costs, a private company may be able to operate more efficiently in some tasks than the government sponsor. The government overhead charge should then be reduced to reflect the reduced service it is providing.

Flying Overhead

A significant and varying portion of operating costs, administrative and overhead costs provided by government sponsors is often overlooked when airports seek ways to improve their bottom line. Probing into these costs may result in opportunities to reduce overall operating costs if reasonable cost allocation methods can be applied. Otherwise, if overhead costs don't fly, the rest of the airport won't, either.

How does this experience compare to your airport? If you would like to share your ideas and information, please e-mail hwolinetz@IMGgroup.com.

Infrastructure Management Group (IMG) is a family of U.S. companies providing management consulting, investment banking, development and technology services to airports and other infrastructure industries.