

## Pick Your Price, Pick Your Service Level

By Sasha N. Page

On June 8, the *New York Times* ran a picture of the back of an airline seat with a price list attached. It read: “Blanket \$2, Extra Legroom \$33, Pillow \$5, Reading Light \$3, Soda \$3, Snacks \$4, Toilet \$1, Tray Table \$2.” While some airlines’ measures to charge for every service appear extreme, the industry’s continued poor health justifies some of these actions. Airlines, like many consumer companies, have offered a range of services and prices for years: non-stop versus connecting flights, walk-up versus 14-day advance purchase tickets, and business versus tourist class seats. Service differentiation has been a pillar of consumer marketing for decades.

Can and should airports do the same? Should they offer different services to airlines and passengers at various price levels? Should they deliberately position their entire facilities with peer or competitor airports in mind? Our analysis in this Measure of the Month is that airports do already offer differentiated services and should consider more to better meet the aviation marketplace’s needs.

### Differentiated services

Airports provide some differentiated services: they offer stand-up bistros and sit-down restaurants; parkers often have a choice of valet, close-in, and economy lots; in larger airports, airlines can choose to lease older, less expensive terminal space. And because of location or other factors, some airports as a whole are known as lower-cost facilities—Oakland is considered low-cost to San Francisco’s better located, full-service operations; St. Petersburg Clearwater fashions itself as a very low-cost airport compared with its low-cost neighbor across Tampa Bay, and Houston’s

Hobby and Chicago’s Midway are lower-costing airports, primarily serving point-to-point business, within airport systems.

But can an airport go further and proactively decide on the operation it wants to be and price itself accordingly? As written in past columns, we do not believe that an airport’s airline charges (landing fees, terminal rent, apron charges) per enplaned passenger (CPEP) has a major, if any, impact on most airlines’ decisions to provide service. At current levels of \$4 to \$8 for many airports, these costs represent around 5 percent of airlines’ expenses (recently declining due to high fuel prices). Yet a CPEP of over \$12 may begin to influence passenger choices. CPEP also matters for airports demonstrating to the public that they are trying to provide airlines financial relief.

### Net assets and CPEP

To test whether airports are offering differentiated services, we analyzed the relationship between net assets per enplaned passenger (EPAX) and CPEP. High net assets/EPAX is one proxy for higher levels of service. Net assets are the value of an airport’s facilities—runways, buildings, and equipment—after depreciation as reported on financial statements. This “book value” is a very crude measure, however, since airlines and passengers may put up with inadequate, decades-old facilities that an accountant might consider having little or no “value.”

For data, we used the FAA Form 5100-127 from the “Airport Financial Reporting System” database from 2003. It yielded information on 145 airports with from 1,000 to 39,700,000 EPAX.

As Figure 1 (Fig. 1) indicates, there is a very weak relationship between

net assets/EPAX and CPEP. We expected an upward sloping set of points, but a regression analysis showed no statistical relationship between the two. In some ways this makes sense: airports do not necessarily charge airlines for the true cost or the market value of facilities whose debt has been repaid, or which were funded with grants or concession revenues.

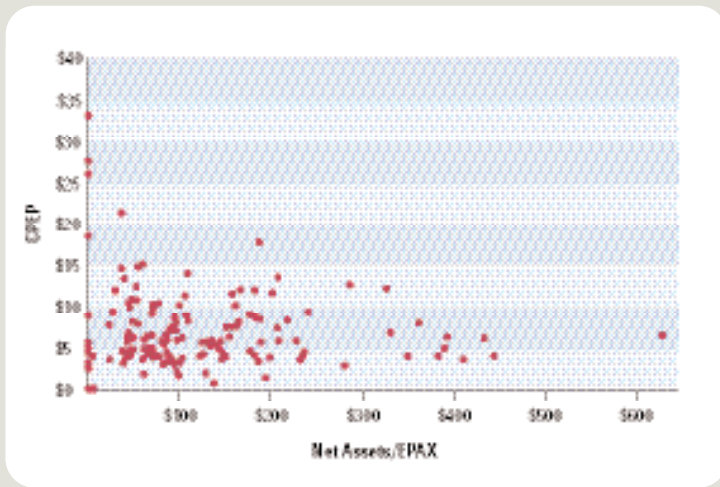
Perhaps, however, something else is at play: not all of the “value” in an airport property is valuable. Many of the facilities built in the last 10-20 years do not conform to today’s requirements, such as jetways that handle regional jets (RJs) and gates that allow quick turns. Airports cannot justify fully charging for them.

### Debt/EPAX and CPEP

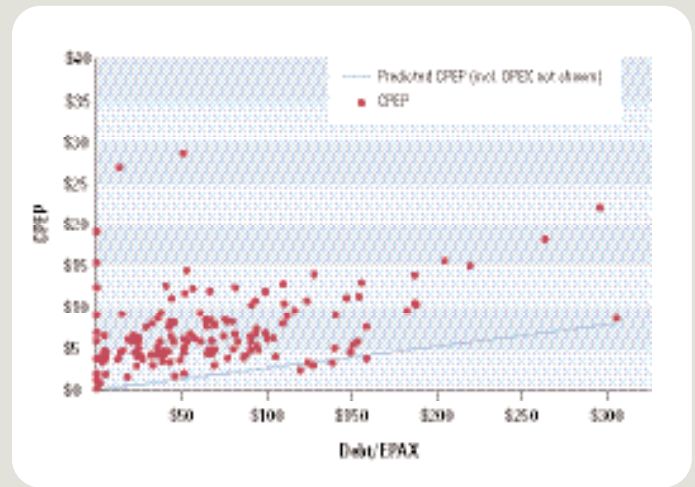
Using the same data source, we examined the relationship between debt/EPAX and CPEP. Debt consists of long-term financial obligations, including revenue bonds and loans. As Fig. 2 shows, there appears to be a clear relationship between debt/EPAX and CPEP. A regression analysis (that included operating costs as discussed below), suggests that for every \$100 of debt/EPAX, an airport’s CPEP increases by \$2.50. The debt service that non-aviation revenues and PFCs do not cover must be made up by airline charges. No wonder airlines cherish strong majority-in-interest (MI) clauses giving them a veto over projects that increase their costs.

Debt/EPAX is not the only airport cost driver. Operating expenses (OPEX) per EPAX also determines CPEP. For every dollar of OPEX/EPAX, CPEP increases by \$0.93 (The complete equation is:  $CPEP = \$3.84 + (\$0.025)(DEBT/EPAX) + (\$0.093)(OPEX/EPAX)$ ). It had an  $r^2$  of 0.66 and all of the coefficients and the intercept were

**Fig. 1** NET ASSETS/EPAX VS. CPEP: UNCLEAR RELATIONSHIP



**Fig. 2** DEBT/EPAX VS. CPEP: UNAMBIGUOUS RELATIONSHIP



statistically significant at the 95 percent confidence level.) No surprise that salaries, janitorial costs and overheads all determine CPEP, although we have found that airports tend not to change OPEX levels much.

It is also important to note that CPEP is not static; it changes as EPAX fluctuates with growth, airline bankruptcies or the shifting of service from mainline to commuter carriers. CPEP also differs depending upon whether the airport has adopted a more residual or compensatory rate-making methodology.

**Further differentiating services**

So should airports choose their price point and orient their cost strategies—capital programs, operations—for their entire operations or individual services, accordingly? Internationally, some airports talk of building low-cost terminals; in the U.S. this has not yet come to pass, although some airports have become de facto low-cost operations as discussed. Can an airport consciously pick a level of terminal congestion or of runway delays and market the corresponding cost of that service? Boston Logan’s congestion pricing program, for instance, will be a step in that direction.

Choosing a price point, or CPEP, does not have to be a constraining exercise that prevents airport planners from

building the facilities they feel are most appropriate; it can be liberating by overcoming well-founded—but sometimes short-sighted—fears that funding anything but the barest capital program is frivolous. By selecting a position other than low-cost, airports and their boards draw attention to higher service levels they intend achieve.

Right now, CPEP is set by: 1) financial feasibility tests such as debt service coverage ratios, 2) airline consensus, 3) the orientation of most airport boards and stakeholders to keep costs low, and 4) unfortunately, simply by what other funding sources do not cover—an output, not an input, and based on a specific position in the aviation marketplace.

Safety and security are costs that should not vary based on marketplace strategy. Either an airport meets (or exceeds) standards or it does not. In addition, there are many, often smaller, hub airports that are simply trying to stay aloft, doing anything possible to maintain airline service. Their challenge is not finding a competitive position but keeping any position at all.

Yet for many airports seeking a market position, as a car manufacturer developing its next model or a hotel seek a certain rating, can help them define what they want to be and, in part, how to go about doing it.

Funding changes necessitate that airports better assert how they serve their markets: it is likely that there will be fewer Airport Improvement Program monies in the future; airlines are less reliable as long-term lease partners; and, at least until Wall Street forgets, few airlines will be developing special facilities. This means that airports have to take more control of their facilities and seek their livelihoods more independently from airlines and grant sources.

So, perhaps pilots and passengers will some day read signs at each gate offering the following: “Faster Runway \$1,500, Terminal with Four Walls \$500, Terminal with Air Conditioning \$250, Super-Clean Rest Rooms \$5/Passenger, Escalator Service \$50, Extra Pick-Up Lane For Your Passengers \$75.”

*How does this experience compare to your airport? If you would like to share your ideas and information, please e-mail [spage@imggroup.com](mailto:spage@imggroup.com).*

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