
**IMPACT OF AIR CARRIERS
EMERGING FROM BANKRUPTCY
ON HUB AIRPORTS, AIRPORT SYSTEMS
AND U.S. CAPITAL MARKETS**



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Over the last two years, the airline industry's financial condition has deteriorated significantly. Several air carriers have either failed or have been forced to file for bankruptcy. During this period, a number of factors have contributed to the dramatic financial losses for an important component of the industry, the large network airlines. The events of September 11, 2001, stand out, but these airlines were already experiencing record financial losses due both to rapid cost escalation and a decline in business traffic.

In response, major network carriers have had to reduce their operating costs, restructure their operations, and adopt new business strategies to counter unsustainable financial losses and to achieve long-term financial viability. A core part of each network carrier's recovery strategy has been to cut back on seat capacity, in some cases by reducing or withdrawing service from a market altogether, in others by reducing frequency of service, and in some markets by replacing large aircraft with smaller aircraft. It is important to note that in contrast, several low-fare carriers have continued to rapidly expand service after only a brief reduction in capacity immediately following the terrorist attacks of September 11th.

Many airports served by major network carriers have also experienced a decline in their financial health, and some face significant financial challenges. After September 11th, airports were compelled to incur additional safety and security costs while suffering a decline in revenues due to the decline in air travel. Moreover, because airports have substantial fixed costs (often including debt issued through general airport revenue bonds) and limited leeway to cut certain operating costs quickly, they are financially stressed when faced with a substantial, prolonged drop off in passenger traffic or air carrier operations. Further, because airport revenues are generated primarily from airline operations (landing fees and terminal rents) and the rents charged concessionaires, the majority of airports have seen a decline in operating revenues and profits since September 11th. Other airports, however, have seen their revenues recover.

The primary objective of this study is to examine the financial health of airports where the airlines serving the airport have emerged from bankruptcy or are currently undergoing bankruptcy proceedings. A secondary objective is to analyze the impact of air carrier bankruptcies on airport operations and airport capital development.

Background analyses conducted in connection with the Department's study¹ provide information on recent airline industry trends, including the growth and subsequent contraction of hub-and-spoke route networks, the essential role hub airports play in the nation's air travel system, the development and importance of low-fare air carriers, and how the adoption of large numbers of regional jet aircraft by some air carriers could affect airport operations and capital needs. The background analyses also:

- Review the financial requirements of connecting hub airports and their business and financial practices;
- Present information about the changing nature of the business relationship between airlines and airports, including the role of the bankruptcy code, the vulnerability of connecting hub airports to potential traffic diversion of their connecting traffic (i.e., traffic that does not originate or terminate at the hub airport), and how airport rates and charges affect airline costs;
- Examine airport operations, including sources of funds for capital-improvement projects, methodologies for establishing airport rates and charges, the financial obligations of air carriers with respect to airports, the ability of airports to meet their financial obligations, and the actions airport managers have taken to reduce costs and increase revenues over the past two years; and
- Provide an overview of recent actions taken by the credit ratings with regard to different financing practices, such as general airport revenue bonds (GARBs), bonds financed with passenger facility charges (PFCs), single-tenant special facility bonds, and multi-tenant special facility bonds, as well as bond insurance and letters of credit.

The Department's study was undertaken in response to a directive contained in the 108th Congress's conference report, *Making Emergency Wartime Supplemental Appropriations for the fiscal year 2003, and Other Purposes* (April 12, 2003). The report stipulated that the Secretary of Transportation "examine the impact that airlines emerging from bankruptcy could have on hub airports, as well as the ramifications on airport systems and U.S. capital bond markets."

The Department's study was the joint responsibility of the Federal Aviation Administration (Office of Airport Planning and Programming) and the Office of the Secretary of Transportation (Office of Aviation and International Affairs).

¹ The Department retained the services of the John F. Brown Company, an airport management consulting firm to conduct some of these analyses, including case studies of four airports. The Department also solicited public comment through a *Federal Register* notice. The case study reports and a summary of the comments have been included in the public docket.

RESULTS IN BRIEF

As directed by the conference report, the Department's study focused on two basic questions:

- What are the financial implications for a hub airport when a tenant airline emerges from bankruptcy?
- What are the financial ramifications of an airline emerging from bankruptcy on the airport system and the U.S. capital bond markets?

Financial Implications for Connecting Hub Airports

The nation's largest hub airports, as a group, are not in immediate financial distress.² For all categories of hub airports, operating profits as a percentage of revenues dropped from 6 percent in 2001 to 3 percent in 2002.³ Some individual airports are nonetheless facing significant financial stress. Although the factors noted below tend to increase financial stress, not all the airports listed as sharing these characteristics are facing significant stress at this time:

- (1) Status as secondary hubs of weak carriers, especially those with a high share of connecting traffic, such as St. Louis or Pittsburgh; and
- (2) High costs per enplaned passenger, such as San Francisco or Newark; or
- (3) Competition from alternate regional airports, especially alternates with a strong low-fare carrier presence. Examples are San Francisco, with nearby Oakland and San Jose airports; Dulles, with Baltimore-Washington International Airport; Boston Logan, with Manchester and Providence airports; and Los Angeles International, with Ontario, Burbank, John Wayne and Long Beach airports.

Many airports, but especially those that face significant financial exposure, have taken reasonable and prudent actions to reduce their operating expenses, defer capital projects and, when possible, raise revenues. These actions, plus the slow rebound in air

² While definitions vary as to what constitutes a "hub" airport, according to the FAA there are 31 large hub airports, 37 medium hub airports, and 66 small hub airports. Under this classification scheme, large hub airports enplane 1.0 percent or more of total U.S. passengers enplaned annually, medium hubs enplane between 0.25 and 0.99 percent, and small hubs enplane between 0.05 and 0.24 percent. These statistical definitions are largely unrelated to the use of the term to describe a connecting hub airport. For the purpose of this study, we refer to a hub airport as one dominated by at least one air carrier that operates a network of flights at that airport. A "primary" hub airport is one that is very important to a dominant airline's network operations (American Airlines at Dallas); a "secondary" hub is one that is less important to an airline's service network (American at St. Louis).

³ FAA Form 5100-127 financial data submitted by small, medium, and large hub airports.

travel now underway, will result in an improving financial picture for the nation's airports. Moreover, despite the financial pressures they have confronted, most large hub airports have solid financial reserves and adequate liquidity. Indeed, since the U.S. domestic airline industry was deregulated in 1978, no airport has defaulted on its general airport revenue bonds, a period when more than 130 airlines filed for bankruptcy.

Financial Ramifications for the Airport System and Bond Markets

Structural changes are underway in the airline industry. Large network carriers are attempting to reduce their costs so they can compete more effectively against low-fare air carriers. Low-fare carriers, whose business strategies do not rely upon charging high prices to business travelers, but, instead, focus on more price sensitive travelers, have been successful in profitably expanding service and increasing their market share. Traditional network carriers have responded by reducing employment, cutting seat capacity, and pursuing a number of other strategies. For example, many traditional carriers are substituting regional jet flying for large jet operations, including operations in new markets that could not sustain large jet operations. Some of these carriers are implementing additional point-to-point operations.

The implications of this restructuring process for the nation's airports are not yet clear. However, it could mean that large network air carriers will (1) retrench to primary hubs, (2) downsize secondary hubs, (3) convert secondary hub service from an overwhelming reliance on large jet aircraft to a fleet comprised primarily of regional jet aircraft, or (4) eliminate some network hubs. How the restructuring process evolves will depend upon a number of factors, including the extent to which airline demand eventually recovers, and the success the network airlines have in getting their operating costs under control. If large network airlines achieve adequate reductions in their operating costs relative to demand, pressures to reduce seat capacity or shrink or eliminate hubs will be lessened. Otherwise the pressures to reduce seat capacity will intensify, and the restructuring process will then depend more on the success low-fare airlines have in achieving airport access to accommodate their expansion preferences. In this regard, it is noted that to the extent that network airlines downsize or eliminate network hubs, opportunities are created for low-fare carriers to expand. AirTran, for example, has been able to develop a successful network around its Atlanta hub because of the airport capacity freed up by the failure of Eastern Airlines.

What is clear is that for virtually all airports, the cost of future airport financing will be higher than in the past. As the finance industry takes a fresh look at the risk of airport debt, we are seeing a general upward movement in the cost of bond insurance and other credit enhancements. In addition, for some airports, especially secondary hubs and high-cost airports that have lost or could lose substantial air service, financing costs will rise even more. This may occur because of lower credit ratings, which translate

directly into higher interest charges, or indirectly through higher costs for bond insurance and other credit enhancements (which also reflect bond ratings).

Recent events have caused capital markets to reevaluate their traditional approach to relying on the strength of a hubbing carrier and its long-term commitment to an airport as a critical element of risk. Today, the capital markets are placing greater emphasis on certain airport characteristics, including mix of traffic, number of competing carriers, and costs per enplaned passenger. Bond ratings historically have clustered in a narrow range. However, because of the change in emphasis, one credit rating agency has predicted that we will see wider variations in the ratings of individual airports' bonds.

Capital markets now have a better understanding of the risks that accompany airline dominance, including the likelihood that gates and other critical airport assets may be tied up for an extended period of time if an airline attempts to reorganize under the bankruptcy code. Moreover, because of recent pronouncements and actions taken by bankrupt airlines, the long-term contractual agreements that govern airline-airport finance may be less secure than they were once thought to be.

In addition to GARBs, PFC and special facility bonds are two other forms of airport bond financing that have come under increased scrutiny by credit analysts. For the most part, PFC stand-alone financing has not been affected by airline bankruptcies or even the sharp declines in traffic after September 11th. This is due in large part to the larger than average debt service cushion requirements used with PFC stand-alone bonds and rigorous stress tests reviewed before bonds are issued. Nevertheless, because they are supported by a single revenue stream dependent on traffic levels, PFC stand-alone bonds are more vulnerable to passenger traffic decreases than GARBs. Under special facility bond financing, the indebtedness is backed solely by an airline corporate pledge to repay. This form of airport bond financing has come under great scrutiny as a result of recent airline bankruptcies.

Pittsburgh International has excellent facilities and a substantial base of local traffic. Regardless of what actions US Airways takes in the coming months -- and US Airways has recently stated its intention to operate a hub at Pittsburgh at least until September 2004 -- other carriers, both established and new entrants alike, could find Pittsburgh an attractive place to do business. American Airlines, for example, recently has announced plans to expand service at Pittsburgh. And press reports indicate that a new low-fare carrier is considering Pittsburgh as a base for future operations. Thus, while not denying the importance of US Airways to the long-term financial viability of Pittsburgh International, new competitive service at Pittsburgh could stimulate additional passenger traffic and also make the airport's financial condition less dependent on US Airways.

The Department expects that airport managers will continue to seek ways to reduce operating costs and increase revenues in their on-going efforts to achieve greater

financial stability. The Department also notes that our suggested “best practices” provide airport managers with a set of business practices that have successfully improved the competitive environment at airports, thereby facilitating air carrier expansion and making it less likely that an airport will be dominated by a single carrier in the future.⁴ In addition, the FAA reauthorization legislation (H.R. 2115) includes provisions intended to strengthen the financial position of airports.

⁴ FAA/OST Task Force Study, *Airport Business Practices and Their Impact on Airline Competition*, October 1999.

SCOPE AND METHODOLOGY

The study was based on a review of available data on airport finance, public comments, and four airport case studies.

Financial Data

This report draws upon publicly available data to develop estimates of the financial condition of large and medium hub airports and the status of airport credit practices since September 11, 2001. It also incorporates information on recent trends in the level of costs per enplaned passenger at each large and medium hub airport.

Public Comments

The Department also reviewed the submissions filed by interested parties in response to a Federal Register notice, published on June 26, 2003, that requested comments on important economic, financial, and policy issues raised by the study.⁵ A summary of the comments submitted is being placed in the docket.

Case Studies

The contractor prepared case studies of four major connecting hub airports: Pittsburgh International, St. Louis International, San Francisco International, and Minneapolis-St. Paul International. These airports were selected for the reasons outlined below. In the course of preparing these case studies, a representative of FAA met with the management of two case study airports (Pittsburgh and St. Louis) to discuss the financial impact of the decline in airline traffic at their airports, the nature of changing patterns of air service on airport operations and costs, the actions they have initiated to respond to the financial challenges they face, to review past actions and lessons learned from previous airline bankruptcies (usually from the early 1990s), and to better understand the implications of airline bankruptcy, or potential bankruptcy, on their long-term financial viability and credit worthiness. The information presented in the case studies is from publicly available sources. Copies of the case study reports are being placed in the public docket.

Pittsburgh International Airport. Just before it emerged from chapter 11 reorganization, US Airways rejected all of its leases and contractual agreements with the Allegheny County Airport Authority, effective January 5, 2004, subject to renegotiation of a new long-term lease agreement that would result in substantially lower airport rates and charges for the carrier. Unless it receives substantial

⁵ Docket No. FAA-2003-15481, *Request for Public Comments on the Impact of Airline Bankruptcy on Hub Airports, Airport Systems and U.S. Capital Bond Markets.*

financial concessions, US Airways' officials have threatened to significantly downsize its operations at Pittsburgh, alleging that Pittsburgh is not competitive on a cost per enplaned passenger basis with Charlotte, another US Airways' hub. Charlotte has invested in new facilities on a smaller scale than has Pittsburgh and, to date, has not levied a passenger facility charge.

St. Louis International. This airport is a secondary hub for American Airlines, which has announced significant reductions in operations at the airport. But, unlike most other secondary hubs, Southwest Airlines, a major low-fare carrier, has a significant market presence at St. Louis. Nevertheless, the American Airlines service cutback is requiring the airport to adjust its financing plans for the new air carrier runway currently under construction, which is projected to cost \$1.1 billion.

San Francisco International. This airport is a secondary hub for United Airlines and a major international gateway. The decline in traffic at San Francisco has been especially severe. United recently announced that it will not emerge from chapter 11 reorganization before March 2004.

Minneapolis-St. Paul International. This airport is a major hub for Northwest Airlines, a carrier that has remained financially stable, at least compared to other large hub-and-spoke network air carriers.

AIRPORTS REMAIN FINANCIALLY HEALTHY

Despite the financial challenges airports have faced since September 11th, airports remain financially sound. Indeed, the three major credit rating agencies (Moody's Investor Services, Fitch Ratings, and Standard & Poor's) have concluded that, on the whole, the airport system has performed well under difficult circumstances. In fact, since September 11th, airports have not been denied access to credit markets.

Some airports, of course, have seen their financial condition and credit ratings deteriorate over the last two years (*see Exhibit 1*). The rating agencies also agree that there is substantial variation among airports in terms of their financial performance, and, in the future, some airports could present investors with substantially more risk than others.

There are four major reasons for why most airports have been able to weather the financial storm since September 11th:

- First, prior to September 11th, most hub airports were in excellent financial condition, in part because of the rapid increase in passenger traffic and airline operations that occurred in the late 1990s; indeed, prior to 2002, airports had

enjoyed excellent credit ratings. As a result, most airports had, and retain, substantial financial reserves.

- Second, while the nature of airport operations makes it difficult to cut costs deeply, especially in the short term, airport managers took decisive action to reduce operating and capital costs, including staff reductions, hiring freezes, work-rule changes, reductions in employee benefits, the closure of unnecessary facilities, and the deferral, and in some cases the suspension, of capital projects. When not precluded by law from doing so, airport managers also refinanced their existing debt to take advantage of historically low interest rates. It is important to note that, in addition to reducing costs, many airports assisted their airline tenants directly, by suspending or reducing airport rates and charges for a period of time, contributing discretionary funds to help reduce airport fees, or providing air carriers with additional time to pay their assessed rates and charges.

Exhibit 1. Recent Rating Activity – U.S. Airports

Airport / Authority	Hub	Fitch		Moody's		S&P	
	Airports	09/11/01	08/27/03	09/11/01	08/27/03	09/11/01	08/27/03
GENERAL AIRPORT REVENUE BOND – DOWNGRADES							
Boston Logan International Airport		AA	AA-	Aa3	n.c.	AA-	A+
Corpus Christi International Airport		BBB+	n.c.	Baa1	n.c.	BBB	BBB-
Dallas Love Field Airport		--	--	A1	n.c.	A	A-
Denver International Airport	X	A+	A	A2	n.c.	A	n.c.
Erie International Airport		--	--	--		BBB-	BB+
Guam International Airport	X	--	--	--		BBB	BBB-
Lambert St. Louis International Airport	X	A-	n.c.	A3	n.c.	A-	BBB+
Miami International Airport		A+	A	A1	n.c.	A	A-
Pittsburgh International Airport	X	A-	BBB	Baa1	Baa2	BBB+	n.c.
San Francisco International Airport	X	AA-	A	A1	n.c.	A+	A
Tulsa International Airport		--	--	A2	A3	A	A-
Washington Dulles / National Airports	X	AA-	n.c.	Aa3	n.c.	AA-	A+
GENERAL AIRPORT REVENUE BOND – UPGRADES							
Colorado Springs Airport		A-	n.c.	Baa2	A3	BBB+	A-
Fort Lauderdale-Hollywood International Airport		A+	n.c.	A1	n.c.	A	A+
Manchester Airport		A-	A	A3	n.c.	BBB+	A-
Oklahoma City Airport -- Senior Lien		--	--	Aa2	Aa1	A+	n.c.
Oklahoma City Airport -- Junior Lien		--	--	A3	A2	--	--
Orange County-John Wayne Airport		A+	n.c.	Aa3	n.c.	A	A+
Sacramento County Airport Junior Lien (PFC)		A+	n.c.	A2	A1	A+	n.c.
Tampa International Airport		A	A+	A2	A1	A	A+
PFC AND SPECIAL FACILITY BOND DOWNGRADES							
Boston Logan Intl Airport (Delta Terminal Project)		--	--	Baa3	B1	BBB+	BBB-
Boston Logan Intl Airport (PFC)		A	n.c.	A2	n.c.	A	A-
JFK International Air Terminal LLC		A	BB+	Baa2	Ba1	BBB+	BB+
JFK International Terminal One Group Assoc LP		A-	n.c.	A3	n.c.	A-	BBB+
San Francisco Intl Airport (SFO Fuel Corp Special Facilities)	X	A-	n.c.	A3	n.c.	A-	BBB+

Sources: Moody's "Global Airport Sector" published November 2002 and "Why the Airport Downgrades" published May 2002; Fitch "Airline Bankruptcies and Airport Bonds: 2003-2006" published July 21, 2003; "Unexpected Turbulence" published January 29, 2002; "U.S. Airport Debt – The Sky's the Limit" published February 9, 2001; S&P "The U.S. Airport Sector: Fundamentally Sound, Yet Potential for Credit Erosion Persists" published July 17, 2003, all as updated by Fitch, Moody's, and S&P on August 28, 2003. Compiled by the John F. Brown Company.

Notes: "n.c." means no change.
 "--" means the rating agency does not currently rate the debt or entity.

- Third, airports took actions to raise revenues. For example, reductions in airline traffic following September 11th reduced an important source of airport revenues--funds collected through the imposition of PFCs on airline passengers. A number of airports did raise their PFC from \$3.00 per enplaned passenger to \$4.50 (as permitted by the existing statute), thereby partially offsetting the decline in traffic. Other airports, however, deferred plans to increase their PFCs because of concerns that, in combination with other airline, airport, and security fees, it would further reduce airline traffic and thus hurt their airline tenants. Also, while concession revenues declined with reductions in passenger traffic, such revenues did not fall as sharply as the decline in traffic because of higher spending levels per passenger and minimum annual guarantees from concessionaires.
- Fourth, the nature of the contractual agreements between airports and tenant airlines establishing airport rates and charges serves to protect airports by generating a reliable source of revenue. Under a compensatory methodology, airlines pay for the costs of the facilities and services that they occupy and use; they do not receive credit for non-airline revenues, nor do they assume any of the risk of ensuring that an airport covers its costs. Under a residual agreement, tenant airlines guarantee to cover the airport's costs; they also receive credit for any non-airline revenues earned by the airport. And while many airports employ a combination of these methods, the end result is the same: airports have a source of revenues that, barring extraordinary circumstances, is reasonably secure and predictable. Moreover, airports can adjust the fees they charge their airline and non-airline tenants periodically in response to changing market conditions and their financial needs. Additionally, to compensate for the decline in airline operations, some airports initiated marketing programs to attract new air service. That said, some airports are nevertheless facing extraordinary challenges. The elimination or significant reduction of service at Pittsburgh by US Airways, for example, could result in a large increase in landing fee rates and terminal rental charges for those carriers that continue to serve the airport. St. Louis may face a similar challenge.

CERTAIN STRUCTURAL FACTORS INCREASE AN AIRPORT'S FINANCIAL RISK

The current financial uncertainties facing the nation's airports are closely linked to the financial condition of large air carriers that operate extensive hub-based route networks. These carriers have incurred billions of dollars in losses during the past 3 years, and have focused on cutting operational costs by reducing capacity, retrenching to their primary hubs, downsizing their secondary hubs, converting operations to regional jets and, in some cases, terminating service. The carriers have also cut internal costs through wage concessions. Although the hub airports served by these network carriers vary in their overall financial performance, and the credit worthiness of any single

facility depends on its specific economic circumstances, the following conditions characterize those airports that face increased financial risk:

- Airports dominated by one carrier are more vulnerable to economic downturns, and are thus inherently riskier, than are airports that have many competing airlines with more balanced market shares. If the dominant airline encounters financial difficulties and responds by cutting flights, the hub airport faces increased economic and financial risk. An example is Pittsburgh International Airport, where US Airways' announced prospective rejection of all its lease agreements, effective January 5, 2004, resulted in the downgrading of the airport's credit rating by the major rating services. In 2001, US Airways controlled 67 percent of the airport's jet gates and was responsible for 78 percent of its revenues.
- Airports that are secondary hubs of financially weak air carriers, especially those with a high share of connecting traffic (e.g., St. Louis and Pittsburgh), are generally more vulnerable than are primary hubs (*see Exhibit 2*). Secondary hubs are generally more vulnerable because their operations are more easily reduced or eliminated by hubbing carriers during periods of retrenchment.

Exhibit 2. Changes in Scheduled Departing Seats by Hubbing Carriers
At Primary vs. Secondary Hub Airports
(August 2000 vs. August 2003)

Airline ¹	PRIMARY HUBS		SECONDARY HUBS	
	Airport	Percent Change	Airport	Percent Change
American	Dallas-Ft. Worth	-11.4%	St. Louis	-39.2%
	Chicago O'Hare	13.3%	Miami	-4.4%
Delta	Atlanta	-6.7%	Salt Lake City	-9.1%
	Cincinnati	-5.9%	Dallas-Ft. Worth	-17.5%
United	Chicago O'Hare	-7.8%	San Francisco	-27.4%
	Denver	-22.6%	Los Angeles	-38.1%
Continental	Houston Intercontinental	-2.5%	Dulles	-20.6%
	Newark	-13.0%	Cleveland	-17.2%
Northwest	Minneapolis-St. Paul	-2.0%	Memphis	-7.5%
	Detroit	-5.2%		
US Airways	Charlotte	-5.0%	Pittsburgh	-34.7%
	Philadelphia	-6.7%	Baltimore-Washington	-76.6%
America West	Phoenix	-2.9%	Las Vegas	-2.6%
			Columbus OH	-83.1%

Source: Official Airline Guide and John F. Brown Company.

Note 1: Includes codesharing domestic feeder carriers in each case.

- Airports located in multi-airport regions can be vulnerable to diversion of local origin-and-destination (O&D) traffic from the hub to alternative regional airports. Local residents and visitors may choose alternatives to the hub airport based on considerations of service, fare, or ground access. Because hub airlines depend on the fare premium derived from local O&D passengers, such diversion can erode the economics of a hub, especially if the diversion is primarily attributable to the availability of lower fares at an alternative airport. To the extent the hub proves less economically viable, the hub airline will likely reduce service. Furthermore, traffic declines have been most dramatic at the primary metropolitan airport in a region that has one or more alternative airports with competing low-fare air service. Low-fare carriers benefit consumers, often stimulating substantial new traffic in a market. Indeed, it is the low-fare carrier segment of the industry that is showing the most resilience to the negative factors affecting the airline industry. Metropolitan areas where low-fare carriers have increased traffic significantly at alternative airports include Boston, Washington, D.C.-Baltimore, Miami, Chicago, Los Angeles, and San Francisco.
- Airports with high costs per enplanement (CPE) are more financially vulnerable than are lower-cost airports. High levels of traffic activity at an airport will cause its CPE to decline. A reduction in traffic or high capital costs will cause an airport's CPE to rise. However, when a major hub airline chooses to reduce service, other air carriers may be required to pay additional fees to ensure that the airport recovers its costs. For these remaining carriers, their CPEs will increase. Examples of airports with high CPEs include San Francisco and Newark. Additionally, the high CPE at Pittsburgh compared to Charlotte is one of the factors US Airways has cited as a reason for its decision to prospectively reject its Pittsburgh leases.

AIRPORTS AND BOND MARKETS ARE REASSESSING THE RISK OF RELYING ON A DOMINANT AIRLINE

As indicated above, the bankruptcies of the hub carriers United and US Airways and the weaknesses of other major airlines have magnified the risk of relying on a dominant airline at a hub airport. Traditionally, hub airports have issued tax-exempt (and insured) GARBs, which typically are secured by a lien on the net revenues of the airport, to finance the facilities constructed for its hub airline's peak operations. Airports have sought to manage their financial risk through long-term agreements and residual rate-setting methodologies that spread the airport costs over all users in exchange for allowing airlines majority-in-interest control over airport investment decisions and exclusive control over their leased space. Such airports also generally agree not to insist on a substantial discretionary cash flow account for the airport.

The relationships between hub airports and their tenant airlines enabled hub airports to position themselves as connecting hubs for their dominant carriers, often making it more difficult for competing carriers to establish themselves in the market. Hub airports relied on business practices and policies that left them vulnerable to airline decisions to de-hub or reject leases in bankruptcy. Similar structures have been used in connection with special facility revenue bond financing by a hub airline, where the airport acts as the tax-exempt conduit and the bond obligations of the airline are without recourse to the airport. Some observers have suggested that airline financial leverage over an airport could be reduced through local infrastructure financing, including general obligation bonds or general funds. However, this type of funding would represent a major shift in the traditional division of cost responsibilities that have emerged since deregulation, could strain the bonding capacity of some communities, and could weaken efforts to prevent diversion of airport revenues to general municipal functions.

The bankruptcy laws equip a carrier in chapter 11 reorganization with a significant amount of leverage over its leased airport facilities in order to facilitate the carrier's re-emergence as a viable economic entity. A carrier under bankruptcy protection has the right to assume or reject its airport leases and to pay a relatively small amount in damages to the airport (an unsecured creditor because airports do not provide the carrier capital assets) for breach of its unexpired leases. Airlines reorganizing under bankruptcy also have considerable leverage to negotiate reductions in leased space and facilities and place considerable pressure on their hub airports to reduce costs. The unprecedented decision of US Airways as it emerged from bankruptcy protection, to announce a prospective rejection of its long-term, exclusive use leases at Pittsburgh International Airport (unless the airport significantly reduces its charges) exposed the vulnerability of that airport to the business decisions of its dominant carrier. This action was termed "the shot heard round the industry" by one of the rating agencies because it eroded investor confidence in the reliability of the leasing and GARB agreements and the adequacy of the remaining airport revenues to service the debt.

Even without a bankruptcy, an airline sometimes find it economically advantageous to terminate service and bear the remaining costs of the lease agreement, which typically run between four and six percent of the carrier's total costs, rather than to continue to serve an unprofitable market or one that no longer fits the carrier's strategic objectives. American Airlines (not in bankruptcy) has decided to substantially reduce its hub presence at St. Louis International Airport while continuing to honor the remaining two-year term on its lease commitment. Other carriers have expressed concerns about the performance of some of their secondary hub airports and whether they will continue their operations there.

Capital markets increasingly recognize that hub airports are exposed to greater credit risk than airports with high levels of origination passenger traffic. Credit rating agencies have downgraded or placed on “negative watch” hub airports with the following characteristics: secondary airport dominated by a financially weak hubbing carrier, a high cost structure, large amounts of outstanding debt, and a high share of connecting traffic. A prominent rating issue has become the willingness of airlines under financial stress to continue to honor key leases and contracts, such as US Airways' future lease rejections at Pittsburgh and United's uncertainty about lease rejections at its hub airports.

Lowered credit ratings can affect an airport's cost to issue debt, amount of reserves required for guarantors, and ability to access the bond market for more GARBs. Rating agencies also are concerned that airports may not have the leverage to recapture and re-lease facilities financed through special facility revenue bonds at which the airline continues to operate, paying ground rent but refusing to make debt service payments. In this regard, the bankruptcy courts are considering the legality of United's novel arguments that United's missed debt service payments to special facility bondholders should be treated as "disguised financing" and not as a violation of its lease obligations, which would permit the airport to take back the facilities. In the past, airlines in bankruptcy generally vacated special facilities as required.

AIRPORTS ARE WORKING TO SUSTAIN FINANCIAL STABILITY

Airports have taken a variety of actions to sustain their financial stability by reducing the costs they impose on air carriers and by raising airport revenue. Key actions have included:

- (1) Refinancing debt at lower interest rates when possible under the existing tax code, evaluating opportunities to restructure debt to take advantage of lower interest rates, and redirecting PFC revenue to pay for debt service to reduce airline charges.
- (2) Altering staffing and benefits and reducing expenditures on non-essential operations.
- (3) Raising additional revenue by applying for reimbursement for security costs, maximizing contract security, and increasing parking rates.
- (4) Reducing or refunding the effective rates that air carriers pay for airport facilities by suspending or reducing airline rates and charges, under-recovering certain costs allowable under airline agreements, contributing discretionary cash flow to reduce airline charges, adjusting the income-sharing formula to enlarge the

airline share, offering airlines additional time to repay any underpayments of prior rates and charges, and consolidating unspent construction fund amounts to refund to airlines.

Airports can continue to look for opportunities to implement such measures. In addition, during this time of financial uncertainty and industry restructuring, it is important that airports collaborate with the FAA and their airline users to review and reassess their capital development plans to adjust them to evolving industry conditions.

“BEST PRACTICES” ALSO CAN HELP TO STABILIZE AIRPORT FINANCES

In October 1999 the Department published a report that examined the impact of airport business practices on airline competition. That report cited specific business practices used at some of the nation’s airports to encourage access to gates and related airport facilities by new air carriers and promote competition among individual airlines. The report concluded that access to airport facilities was a requirement for successful entry or expansion. Given the new reality in the restructuring process now underway in the U.S. domestic airline industry, it is more important than ever that airports and communities take the actions necessary to enable access for the growth part of the airline industry.

Among specific “best practices,” the report noted that a pro-competitive management philosophy on the part of airport executives is one way to minimize the chances that an airport will be dominated by a financially weakened or bankrupt airline that could expose the airport to increased financial risk. Adoption of this and other best practices can help an airport overcome substantial service cuts by making it easier for new entrant or incumbent carriers to gain access to the facilities they need to fill the service voids engendered by hub carrier retrenchments. In addition, by promoting competition and diversity of services, airport management can reduce the airport’s vulnerability to the actions of a hubbing carrier.

Airport managers can, for example, promote new entry and become advocates for competition, a step now being taken by the management of San Francisco International Airport. Similarly, the management team at Minneapolis-St. Paul International Airport has used marketing initiatives to attract low-fare carriers and has created short-term gates with preferences for new-entrant carriers. Meanwhile, management at Chicago’s Midway Airport monitors gates on a per-gate basis to better target opportunities for new-entrant access and relies on leasing arrangements that include provisions on shared usage of airport gates. Likewise, the Newark Liberty International Airport management team initiated a review of its master airline leases that identified provisions allowing the airport to gain more control over the use of its gates, including recapturing a gate subsequently used by a new entrant carrier.

LEGISLATION COULD FURTHER ASSIST AIRPORTS

H.R. 2115, 108th Cong., 1st Sess., (2003), (Vision 100 – Century of Aviation Reauthorization Act) contains provisions that are intended to help airports, especially smaller airports, maintain financial stability. Key provisions include:

- Reductions in restrictions on the use PFCs for debt service at airports when necessary due to financial need;
- Extending a special provision that preserves the level of entitlements for an airport that goes from a small hub to a medium hub (otherwise, the airport would lose entitlements due to its ability to collect PFCs);
- Extending the use of Airport Improvement Program (AIP) funding for pavement maintenance to non-hub primary airports;
- Extending the provision that preserves an airport’s entitlements if it falls below 10,000 passenger enplanements annually; and
- Increasing the Federal share of AIP grants to 95 percent for small airports.

CONCLUSION

The nation’s largest hub airports, as a group, are not in immediate financial distress. For all categories of hub airports, operating profits as a percentage of revenues dropped from 6 percent in 2001 to 3 percent in 2002. Some individual airports are nonetheless facing significant financial stress.

The Department expects that airport managers will continue to seek ways to reduce operating costs and increase revenues in their on-going efforts to achieve greater financial stability. The Department also notes that our suggested “best practices” provide airport managers with a set of business practices that have successfully improved the competitive environment at airports, thereby facilitating air carrier expansion and making it less likely that an airport will be dominated by a single carrier in the future. In addition, H.R. 2115 includes provisions intended to strengthen the financial position of airports.