3 Economic Issues

SUMMARY

The Metropolitan Airports Commission is expected to both promote competition and support locally based airlines. In general, MAC has balanced these two objectives reasonably well, although increased competition has been difficult to achieve at the Minneapolis-St. Paul International Airport due to factors beyond MAC's control. MAC's leases with the airlines are providing them with significant relief during the current financial crisis in the airline industry. Beyond that, MAC can best support the airlines by continuing to effectively operate the airport while keeping any operating cost increases to a minimum.

The main role of the Metropolitan Airports Commission is the efficient and effective operation of the Minneapolis-St. Paul International Airport (MSP). But, in operating the airport, the commission and its staff are also expected to perform other functions. For example, MAC is expected to help promote competition at the airport and thus help keep airfares reasonable for the traveling public. In addition, MAC is often expected to maintain a cost structure that enables Northwest Airlines, which has its headquarters and other facilities in Minnesota, to be economically successful and to maintain jobs in the state.

MAC is expected to support Minnesota-based airlines while fostering competition among airlines.

The Metropolitan Airports Commission faces a difficult task in trying to simultaneously achieve these somewhat contradictory goals. Promoting competition at the airport is likely to be detrimental to Northwest Airlines, while providing assistance to Northwest Airlines not available to other airlines may stifle competition at the airport and adversely affect the airfares paid by Minnesotans. In addition, MAC's task is made more difficult by the fact that its impact on competition at MSP and the success of Northwest Airlines is highly dependent on market factors beyond MAC's control. While MAC can provide access to the airport for competing airlines, other factors largely determine the success of those efforts in providing sustained competition. The impact of any efforts by MAC or the state to support airlines based in Minnesota is also limited. Factors such as the demand for air service, fuel costs, and airline management play a large role in determining the success of an airline.

This chapter examines MAC's role in promoting competition at MSP and maintaining airline jobs in Minnesota. In particular, this chapter focuses on the following questions:

- **What steps has the Metropolitan Airports Commission taken to promote competition at Minneapolis-St. Paul International Airport?**

What impact have MAC's efforts had on competition? What other factors affect the level of competition at the airport?

- **How have the state and the Metropolitan Airports Commission helped to maintain airline jobs in Minnesota? How are MAC's efforts restricted by federal regulations? What other factors affect the success of airlines and the retention of jobs in Minnesota?**

AIRPORT COMPETITION

Background

Studies at the national level have generally found that airfares are affected by the degree of competition at airports.[1] Airfares are usually higher at large airports dominated by one of the major airlines than they are at airports that are not dominated by a single airline.[2] Estimates of the "hub premium" paid by travelers at dominated hub airports range from less than 10 percent to more than 50 percent. The estimates of the premium have varied widely depending on the airport, the time period under study, the type of routes examined, and the study methodology.

Minneapolis-St. Paul International Airport is one of the airports that has been frequently identified as having higher airfares. In recent years, Northwest Airlines (NWA) has generally served more than 70 percent of the enplaned passengers at MSP. NWA has been the dominant airline serving MSP since the late 1980s, following the merger of Republic Airlines into NWA in late 1986.

More than 70 percent of the passengers at MSP fly Northwest Airlines.

Airports that serve as "hubs" for major airlines generally receive better service than other airports.

Northwest Airlines and other airlines that dominate other U.S. airports have pointed out that hub airports receive better service than other airports. Clearly, MSP has better air service than most other metropolitan areas, considering the relative size of the Twin Cities metropolitan area. In 2001, MSP had nonstop air service to 112 other cities. Compared with 20 other large airports, only three airports (Pittsburgh, Denver, and Atlanta) serve more airports

1 For example, see U.S. General Accounting Office, *Airline Competition: Higher Fares and Less Competition Continue at Concentrated Airports* (Washington, D.C., July 1993); U.S. Department of Transportation, *Airport Business Practices and Their Impact on Airline Competition* (Washington, D.C., October 1999), 30-32; and Severin Borenstein, "Hubs and High Fares: Dominance and Market Power in the U.S. Airline Industry," *RAND Journal of Economics* 20, no. 3 (Autumn 1989): 344-365.

2 An airport is generally said to be "dominated" by a single airline if that airline provides more than half of the passenger enplanements at the airport.

per capita with nonstop flights.[3] In addition, studies have found that the number of passengers per capita served at MSP ranks high relative to airports in similar metropolitan areas.[4]

Northwest Airlines and other airlines have suggested that the hub premium calculated in various studies is largely due to the better service provided at hubs and the greater proportion of business travelers in hub markets.[5] Business travelers generally have paid higher fares than leisure travelers since business travelers reserve tickets closer to the time of departure, are more likely to purchase tickets with fewer restrictions, and may demand a higher level of service.

But lack of competition at hub airports can lead to higher fares.

The United States Department of Transportation rejects the argument that airports like MSP have higher fares only because of their better service and their greater share of business travelers. The department concludes that a lack of competition has resulted in higher fares. Data indicate that fares are not higher simply because a single air carrier dominates an airport. Rather, airfares are higher at those dominated airports that lack a significant presence of low-fare carriers. Large airports dominated by a single airline may have lower fares if there is a strong enough presence of low-fare carriers. At MSP, the department has estimated that airfares are 55 percent higher in those markets in which low-fare carriers have less than a 10 percent market share than in similar markets nationwide in which low-fare carriers have a market share of 10 percent or more.[6]

The department also cites evidence that the share of high-price tickets purchased by business travelers decreases in a market when a low-fare airline enters the market. According to the department, dominant airlines without significant low-fare competition not only charge business passengers high fares but also severely limit the availability of low-fare seats. The entry of a low-fare airline can significantly reduce business fares and increase the availability of low-fare seats for business travelers.

MAC's Efforts to Spur Competition

As a result of the various studies of airfares, the United States Congress required the operators of certain large and medium hub airports—including MAC—to submit annual competition plans to the U.S. Department of Transportation. Airports are required to submit plans for review by the Federal Aviation Administration to receive federal grants or to impose or increase passenger

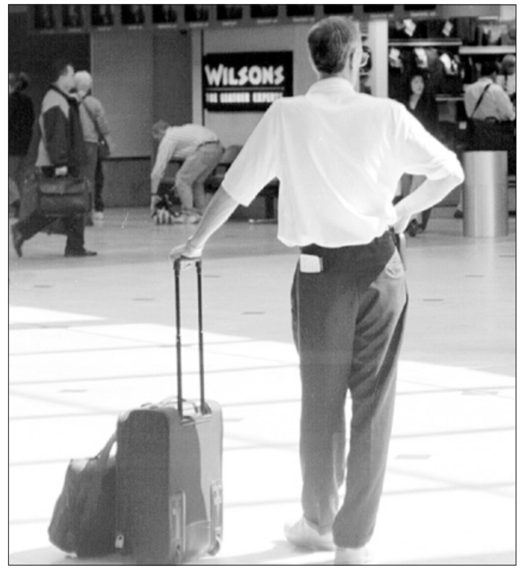
3 Metropolitan Airports Commission, *2001 Annual Report to the Legislature* (Minneapolis, April 2002), 12.

4 MSP ranked fourth highest of 13 airports examined in a Minnesota Planning report. The comparison excluded cities with more than one major airport and with high levels of seasonal or tourist travel. See Minnesota Planning, *Flight Plan: Airline Competition in Minnesota* (St. Paul, March 1999), 8.

5 One study estimated the average hub premium in the United States to be only 5 percent in 1993. This study concluded that most of the 33 percent difference between fares at dominated airports and other airports could be explained by differences among airports in the average trip distance, the typical number of plane changes, carrier-specific fare practices, the mix of business and leisure travelers, and the use of frequent flier programs. See Steven A. Morrison and Clifford Winston, *The Evolution of the Airline Industry* (Washington, D.C.: Brookings Institution, 1995), 44-49.

6 U.S. Department of Transportation, *Dominated Hub Fares* (Washington, D.C., January 2001).

facility charges. One of the main purposes of the plans is to provide information on the availability of airport gates and other facilities for airlines seeking to begin or expand service at an airport. Without gates or other facilities, a low-fare carrier would be unable to provide service.



To keep passenger fares at reasonable levels, the federal government has urged airports such as MSP to seek ways to encourage airline competition.

MAC has been criticized for the lack of available gates for new air service at MSP.

During the early and mid-1990s, MSP had the reputation of being a relatively difficult market for airlines to enter or expand in. According to a 1996 report from the General Accounting Office, MSP was one of the six airports that were most frequently cited by airlines as having competition limited by constraints in gaining access to gates.[7] Through 1998, all of the jet gates at the Lindbergh Terminal were leased using exclusive leases, which can restrict competition. Since then:

- **The Metropolitan Airports Commission has taken a number of steps to encourage competition at Minneapolis-St. Paul International Airport, but factors beyond MAC's control have limited the success of these efforts.**

Additional Gates

First, MAC has increased the number of gates at MSP, particularly by building the new Humphrey Terminal. The new terminal has 8 gates and could be expanded to 16 gates if additional gate capacity were needed.[8]

MAC has also expanded the Lindbergh Terminal, although that expansion has largely benefited Northwest Airlines and the commuter airlines that feed into Northwest flights. Table 3.1 shows that 101 of the 117 gates at the Lindbergh Terminal are leased to Northwest Airlines. Including the 8 gates at the new Humphrey Terminal, Northwest Airlines leases 81 percent of the gates at MSP.

Much of the additional capacity gained by building the new Humphrey Terminal was intended for use by Sun Country Airlines. But, as discussed in Chapter 2, Sun Country Airlines' scheduled air service was curtailed significantly within six months after the new terminal opened. The airline had lost considerable money and the effects of September 11, 2001 caused the airline to enter bankruptcy. The

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7 U.S. General Accounting Office, *Airline Deregulation: Barriers to Entry Continue to Limit Competition in Several Key Domestic Markets* (Washington, D.C., October 1996), 9-12.

8 The previous Humphrey Terminal had four aircraft parking positions. Three of these parking positions had fully enclosed bridges allowing passengers to board aircraft without being exposed to outside weather conditions.

Table 3.1: Gate Assignments at Minneapolis-St. Paul International Airport, December 2002

	Leased by Northwest Airlines	Leased by Other Carriers	Available for General Use	Total	Share Held by Northwest Airlines
Lindbergh Terminal					
Large and Regional Jet Aircraft	60	16	0	76	79%
Commuter Jets and Propeller Airplanes	41	0	0	41	100
Lindbergh Terminal Subtotals	101	16	0	117	86%
Humphrey Terminal					
Charter/Scheduled Service	0	0	8	8	0%
Entire Airport	101	16	8	125	81%

SOURCE: Metropolitan Airports Commission.

airline was sold and has reverted to offering charter service and limited scheduled service. As a result, the new terminal is greatly underutilized, and its operation is being subsidized by $2.5 million in revenues from the Lindbergh Terminal during 2002. The new terminal remains available for future expansion, but its location away from the main Lindbergh Terminal may make it less desirable for certain potential entrants into the Twin Cities market.

Lease Provisions

In recent years, MAC has added gates and changed lease provisions to promote competition at MSP.

Second, the Metropolitan Airports Commission has attempted to ensure that gate capacity would be available for new entrants through the provisions it has negotiated with existing airlines. As leases have expired, MAC has worked to reduce the number of *exclusive leases* at the airport. Federal authorities discourage exclusive leases, because a preponderance of exclusive leases at a large airport can make it difficult for other airlines to gain access to gates and compete with the dominant carrier. An airline with an exclusive lease generally has control of the gate and does not have to accommodate other airlines.

Ten gates at the Lindbergh Terminal are now leased to airlines using *short-term leases* that MAC can cancel and offer to airlines that are proposing to provide additional air service at MSP. These airlines may include new entrants not currently providing service at MSP or airlines providing service at MSP but not presently leasing a gate directly from MAC. Airlines that currently have a short-term gate lease may have the short-term designation removed by showing financial regularity and an average daily gate use of seven departures per day for the preceding 12 months.

In 1999, MAC took a short-term gate—formerly Gate 43 and now Gate 4 on Concourse E—from Northwest Airlines and gave it to United Airlines. MAC leased the gate to United because of pressure from the U.S. Department of Transportation and United's promise to increase service at MSP. According to officials at Northwest Airlines, MAC's decision forced Northwest to load and unload some passengers without a fully enclosed passageway to the terminal. In addition, the decision provided few benefits for airport passengers for some time, since United Airlines never increased service as promised.[9] MAC later took the gate back from United Airlines and leased it on a short-term basis to a low-fare carrier (American Trans Air) offering new service at MSP.

As Table 3.2 indicates, MAC now uses *preferential leases* for most of the gates for large jet aircraft at the Lindbergh Terminal. A preferential lease gives an airline the right to use a gate, but MAC may require the airline to accommodate another airline needing additional gate access. The accommodation can occur if the airline holding the lease is not fully using the gate and the proposed use of the gate by another airline is compatible with the lessee's flight schedule. MAC also requires that an airline subleasing its gate and certain other facilities to another airline may not charge a fee that is more than 15 percent higher than the airline pays MAC for the facilities.

Since 1998, MAC has significantly reduced the proportion of gates exclusively leased to one airline.

Table 3.2: Gate Leases at the Lindbergh Terminal by Type of Lease, December 2002

	Airlines	Exclusive Leases	Preferential Leases	Short-Term Leases	Totals
Jet Aircraft	Northwest	22	33	5	60
	American	0	3	1	4
	Delta	0	3	0	3
	United	0	3	0	3
	Continental	0	1	1	2
	US Airways	0	1	0	1
	American Trans Air	0	0	1	1
	Air Tran Airways	0	0	1	1
	America West	0	0	1	1
	Subtotal	22	44	10	76
Commuter Aircraft	Northwest	0	41	0	41
Totals		22	85	10	117

NOTE: Some additional airlines provide service at the Lindbergh Terminal. Continental Airlines hosts Frontier Airlines on its gates. Delta Airlines hosts Comair and SkyWest on its gates. United Airlines hosts Air Canada on its gates. In addition, Northwest Airlines hosts KLM Royal Dutch Airlines and IcelandAir on Concourse G.

SOURCE: Metropolitan Airports Commission.

The eight gates at the new Humphrey Terminal are *common use* gates—that is, they are not leased to any particular airline. MAC can assign the use of the gates on a temporary or short-term basis, depending on the needs of the airlines serving the terminal. As a result, gates would be available for use by airlines beginning or expanding service at MSP.

MAC continues to have 22 gates on Concourse G that are leased to Northwest Airlines under *exclusive leases* expiring in 2015. On 10 of the 22 gates under exclusive leases, however, Northwest Airlines is required to give regularly scheduled international flights priority over Northwest flights. These gates

9 According to MAC officials, leasing the gate to United Airlines may have benefited United's passengers by reducing crowding in its gate areas.

comprise the International Arrivals Facility that was built at the Lindbergh Terminal to replace facilities that used to be at the old Humphrey Terminal. Certain non-scheduled or delayed international charter arrivals are also permitted to use these gates but are not given preference over Northwest Airlines flights.[10]

Marketing

MAC has also attempted to attract new air service to the Twin Cities.

MAC has 1.6 full-time equivalent staff who promote the Minneapolis-St. Paul International Airport and work to attract domestic and international passenger and cargo service by full-service and low-fare airlines. MAC's efforts have helped to attract new international service by Icelandair, new domestic service by Midwest Express/Skyway, and domestic low-fare service from a number of low-fare airlines. Currently, MSP is served by four of the nation's six low-fare carriers and also has a relatively large number of charter passengers. The low-fare airlines are Frontier, AirTran Airways, American Trans Air, and Sun Country Airlines. Two of the low-fare carriers—AirTran Airways and American Trans Air—began serving MSP in 2000. Previously a charter airline, Sun Country Airlines began regularly scheduled service in June 1999 but entered bankruptcy and has considerably reduced its scheduled service. Two other low-fare carriers—Vanguard and Kiwi—provided service at MSP but left the Twin Cities market and have since gone into bankruptcy. Only two low-fare airlines—Southwest and JetBlue—do not serve MSP, although MAC staff have worked to attract service from these airlines.

Limitations

Although MAC has made numerous efforts to promote competition at MSP in recent years, the success of those efforts has been somewhat limited. While MSP has added international service from Icelandair and low-fare domestic service from AirTran Airways and American Trans Air, market factors have limited the success of other efforts. Kiwi provided service at MSP for less than three weeks. Vanguard provided service at MSP for close to six years but left MSP about five months prior to the events of September 11, 2001 and has since filed for bankruptcy protection. The expanded scheduled service provided by Sun Country Airlines lasted about a year and a half before the airline entered bankruptcy. While the events of September 11, 2001 may have helped to cause the carrier to enter bankruptcy, the airline incurred considerable financial losses prior to the terrorist attacks.

MAC's limited success has been largely due to market factors beyond its control. National studies indicate that it is difficult for airlines to enter and successfully compete in markets dominated by a single carrier. The dominant carrier may have marketing advantages—such as frequent flyer programs, travel agent incentives, or corporate incentive agreements—that other carriers cannot effectively duplicate. The flight frequency offered by the dominant carrier and its availability

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10 In addition, agreements between MAC and the airlines require Northwest Airlines to accommodate other airlines needing a gate large enough to meet the needs of a scheduled wide body or Boeing 757 aircraft. The requesting airline must have signed the airline operating agreement and terminal building lease at MSP and be physically unable to accommodate such large aircraft at its own leased gates.

of flights to many locations makes the dominant carrier's frequent flyer programs more attractive to travelers.[11]

In addition, a new entrant may be reluctant to enter a dominated hub market like MSP. The entrant may fear that competitive responses by the dominant carrier—including fare reductions, increased service, or a combination of both—may prevent the entrant from earning a profit. Faced with competition from the dominant carrier, the new entrant may sustain losses for an extended period of time and run out of funds to continue operations. Because a new entrant must announce its schedule and fares well in advance of providing service, the dominant carrier has an advance opportunity to adjust its fares and strategies to compete successfully with the new entrant. Fears that this scenario will occur have deterred airlines from serving airports like MSP that are dominated by a single airline.[12]

Finally, a high percentage of newly established airlines—or airlines new to the business of providing scheduled passenger service—fail for one reason or another. Sun Country Airlines may have failed because its top management lacked experience in providing scheduled service and had a business plan destined for failure. Sun Country instituted once per day service between MSP and a large number of airports. This strategy may have been unsuccessful because it tried to serve too many cities without providing customers with an adequate choice of flight times for any of the cities.

Market factors have limited the effectiveness of efforts to attract and retain new air service.

Overall, MAC has attempted to encourage more competition at MSP in recent years, but market factors have limited the effectiveness of those efforts. The experiences of the last few years with Sun Country Airlines and with Gate 43 have provided MAC staff and commissioners with some lessons about the difficulties in attracting and retaining new air service. Until the aviation industry rebounds from its current slump, MAC is unlikely to be making decisions about expanding gate space for new entrant airlines. Currently, MSP has excess gate capacity available at the new Humphrey Terminal. That excess capacity, and the potential for future expansion of the terminal, should provide new entrants with adequate space in the foreseeable future.

RETENTION OF MINNESOTA JOBS

Minneapolis-St. Paul International Airport is one of the largest generators of economic activity in the Upper Midwest region of the United States. It has been estimated that MSP helped generate close to $9 billion in business revenues and more than $4 billion in personal income in 1999.[13]

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11 General Accounting Office, *Aviation Competition: Challenges in Enhancing Competition in Dominated Markets*, Testimony before the Senate Committee on Commerce, Science, and Technology (Washington, D.C., March 13, 2001), 11-12.

12 *Ibid*., 11-12.

13 Martin Associates, *The Local and Regional Economic Impacts of the Minneapolis/St. Paul International Airport*, prepared for the Metropolitan Airports Commission (Lancaster, PA, June 2000).

Northwest Airlines is still one of the state's largest private employers despite recent reductions in its workforce.

Foremost among the employers at the airport is Northwest Airlines, which is headquartered in Eagan, Minnesota. In 2001, Northwest Airlines was the state's sixth largest private employer with approximately 18,000 employees.[14] The airline's number of employees in Minnesota declined from about 21,000 in 2000, when Northwest Airlines was the state's fourth largest private employer.

MAC has no direct statutory responsibility to ensure the financial well-being of Northwest Airlines. But there has generally been an expectation that MAC, while being fair to all airlines, should recognize the significant impact that Northwest Airlines has on the state's economy. In this section, we present information on the current and historical finances of Northwest Airlines and consider the impact airport operators like MAC can have on airline costs. We then discuss the federal regulations that govern the financial relationship between airport operators and airlines. Finally, we examine the ways in which MAC and the state have assisted Northwest Airlines.

Airline Finances

Since federal deregulation in the late 1970s, the U.S. airline industry has been a competitive industry with low profit margins compared with other industries. It has experienced financial losses during national recessions and periods of rising fuel prices. The industry, however, is currently experiencing its largest financial crisis ever. In 2001, the commercial passenger airline industry reported record losses of $7 to $8 billion. Some analysts are predicting similar losses in 2002 and continued losses for 2003.[15]

The airline industry experienced significant losses in 2001 and 2002, and losses are expected to continue in 2003.

The events of September 11, 2001 played a significant role in these losses, but the industry had already begun to incur losses earlier in 2001 due to a general downturn in the national economy. The number of passengers has fallen, and business travelers have resisted paying the higher fares they have typically paid. The recession and security delays at airports have had an adverse impact on airline revenues. In addition, some believe that the availability of discount tickets on internet web sites has reduced airline revenues from business travelers.

The financial performance of Northwest Airlines has been near the top of the industry. Northwest has lower costs than most of the large carriers, has aggressively implemented technological improvements like e-ticketing, and finished 2001 with the largest cash balance relative to its size among the six largest airlines.[16] In contrast, US Airways filed for Chapter 11 bankruptcy protection in August 2002, and United Airlines filed for similar protection in December 2002.[17] Nevertheless:

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14 CityBusiness, *Fact Book: 2002 Edition* (Minneapolis, 2002), 23.

15 Anthony L. Velocci, Jr., "Chapter 11 Stalks Airlines as Sector Fights for Recovery," *Aviation Week & Space Technology* 157, no. 21 (November 18, 2002): 55-56. The losses in 2001 and 2002 even include the $5 billion in pre-tax grants given to airlines by the federal government.

16 Northwest Airlines Corporation, "Salomon Smith Barney Investor Meetings" (March 2002); http://media.corporate-ir.net/media_files/NSD/NWAC/presentations/roadshowpresentation mar02/sld001.htm…sld021.htm; accessed October 15, 2002.

17 Other smaller airlines such as Vanguard and National have also filed for bankruptcy during 2002. Flights on US Airways and United Airlines are continuing, while Vanguard and National discontinued scheduled service.

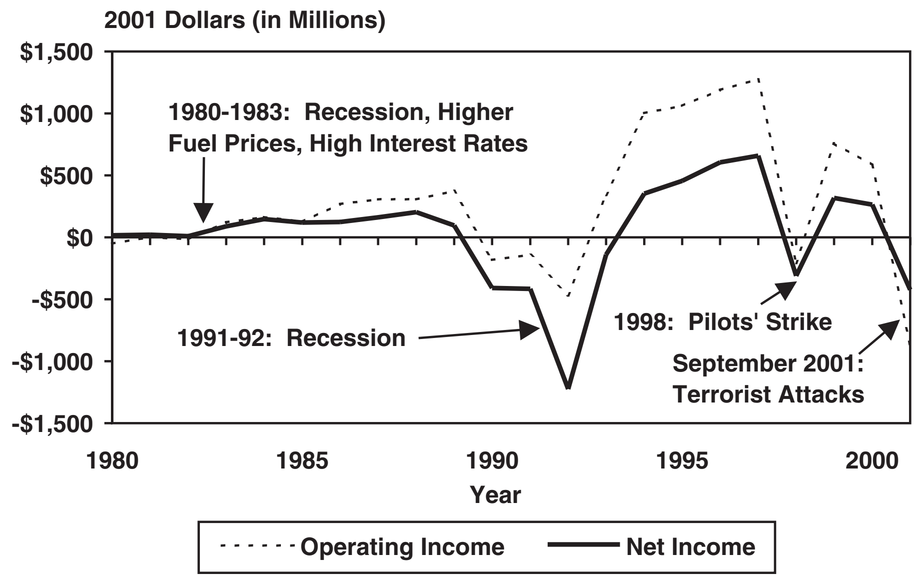
- **Like the rest of the airline industry, Northwest Airlines has experienced significant losses during 2001 and 2002.**

In 2001, the airline had operating losses of $868 million on revenues of $9.9 billion. Northwest's net loss—after adjusting for non-operating income and expenses—was $424 million. The major reason why its net loss was less than its operating loss was that it received $461 million in grants from the federal government. These grants were part of the $5 billion aid package that the U.S. Congress approved for the airline industry following the events of September 11, 2001.

Figure 3.1 shows that Northwest's operating loss during 2001 was greater (in 2001 dollars) than the loss experienced in 1992 when the company was close to bankruptcy. Its net loss in 2001, however, was less than the net loss in 1992, due in part to the financial assistance received from the federal government.

Northwest Airlines incurred significant losses in 2001 despite cost cutting and financial assistance from the federal government.

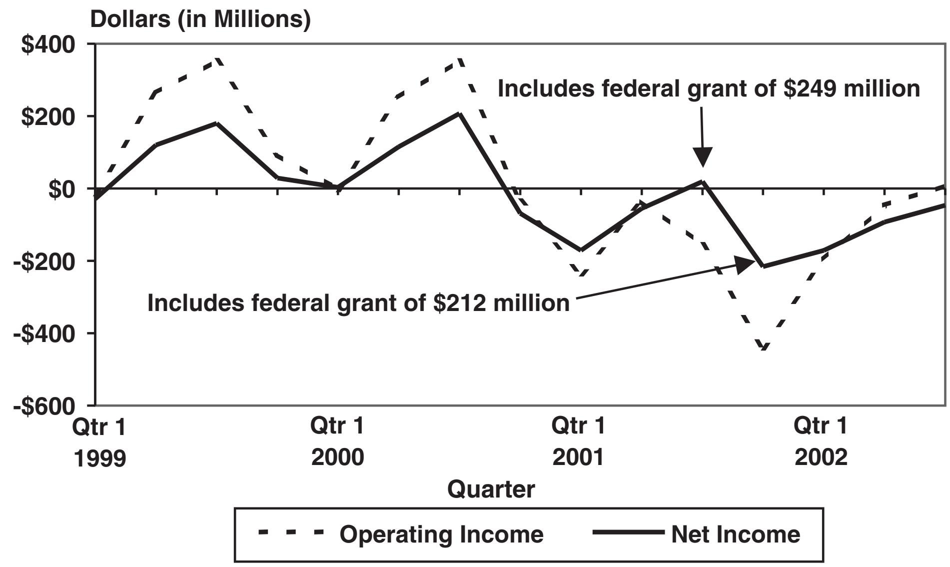
Figure 3.1: Northwest Airlines' Operating Income and Net Income in 2001 Dollars, 1980-2001



SOURCE: Northwest Airlines Corporation.

As Figure 3.2 indicates, Northwest Airlines continued to incur losses during 2002 although there has been improvement since the fourth quarter of 2001. Through the first nine months of 2002, the airline had an operating loss of $234 million and a net loss—after adjustments for non-operating revenues and expenses—of $310 million. During the third quarter of 2002, Northwest Airlines had operating income of $8 million, although it had a net loss of $46 million due largely to interest expenses. The small operating gain represented a significant improvement but came during a quarter that is typically the airline's best quarter from a financial standpoint. Travel during the summer months is usually much higher than during the rest of the year.

Figure 3.2: Northwest Airlines' Operating Income and Net Income, 1999 Through Third Quarter 2002



SOURCE: Northwest Airlines Corporation.

Most airlines will likely need to reduce their costs even further in order to survive.

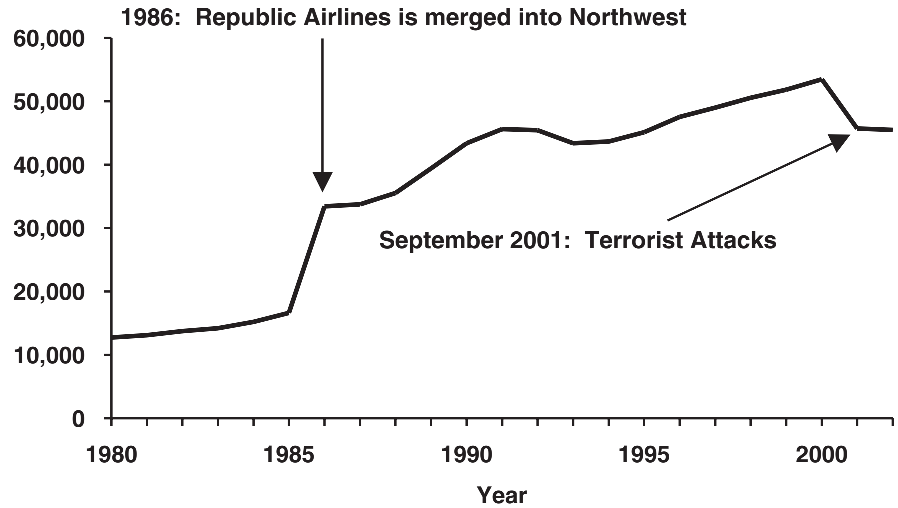
Industry experts generally believe that the airline industry will need to cut costs in order to survive financially. A national economic recovery may also help to restore the industry to profitability—as it has following previous recessions. But, some analysts believe that the large airlines may never again be able to charge business passengers the premium fares they once paid. In that case, the nation's large airlines would need to rely primarily on cost cutting to restore themselves to profitability.

Northwest Airlines has been aggressively cutting its costs and adjusting its air service. The airline reports that by next year it will have trimmed $2 billion in costs from its projected expenses. Northwest's costs have been below most other large airlines. But they have been significantly higher than those at Southwest Airlines, which is one of the few airlines that has been able to record profits.

Figure 3.3 shows that Northwest Airlines reduced its number of employees worldwide by the end of 2001. The year-end number of employees at Northwest had grown from about 33,400 at the end of 1986 following its merger with Republic Airlines to about 53,500 at the end of 2000. But Northwest Airlines reduced its workforce by about 15 percent to 45,700 employees at the end of 2001. At the end of September 2002, the airline's workforce included 45,500 employees—slightly fewer than at the end of 2001.

Given the continued financial stress in the airline industry and at Northwest Airlines, there is considerable concern among some policy makers at the national and state levels. Much of the interest in financial assistance has been focused at the national level. But questions have been raised in Minnesota about the role that

Figure 3.3: Full-Time Equivalent Employees of Northwest Airlines at Year End, 1980-2002



NOTE: Data for 2002 is based on the number of employees on September 30, 2002.

SOURCE: Northwest Airlines Corporation.

the state and the Metropolitan Airports Commission should play in assisting the airline industry and, in particular, Northwest Airlines.

It should be pointed out, however, that:

- **Any assistance MAC could provide to the airlines, including Northwest Airlines, would be small relative to the airlines' need to cut costs.**

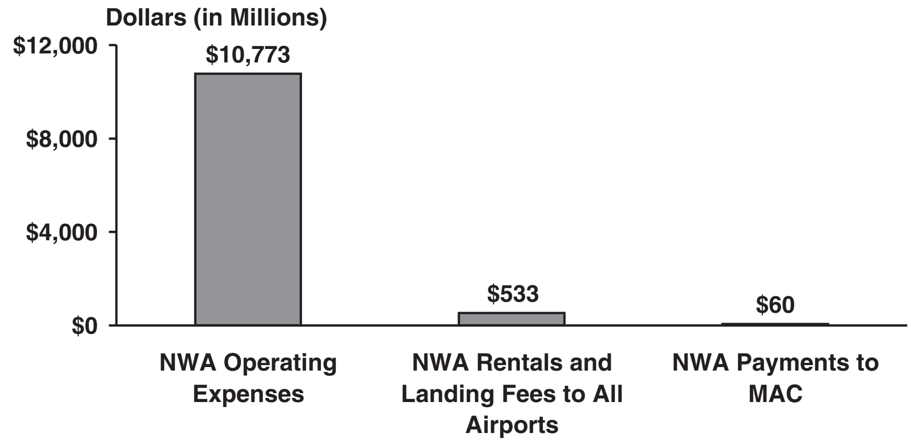
Cost reductions at MAC can help the airlines but are only a small part of the solution.

Figure 3.4 shows that Northwest Airlines had operating expenses of $10.8 billion in 2001. The airline paid landing fees and rents to airports throughout the world totaling $533 million—or less than 5 percent of its expenses. Northwest's total payments to MAC were $60 million—or less than 0.6 percent of expenses.

MAC's role in reducing airline costs will be somewhat limited since airport costs are a small portion of overall airline costs. In addition, operations at MSP are running only about 4 percent lower than during 2000. Also, MAC has continued, with support of the airlines, to implement much of the 2010 plan, so terminal and other facilities have increased in size and cost at MSP.

Nevertheless, as we pointed out in Chapter 2, it is important for MAC to keep cost increases to a minimum during this time when airlines are struggling financially. The MAC staff's proposal for a 12 percent increase in airport operating expenses during 2003 seemed out of step with conditions in the airline industry and was not adequately justified. Ultimately, the commission decided to keep estimated airline charges from increasing during 2003 by using $3.3 million from 2002 parking and concession revenues to offset the impact of the 6 percent increase in expenses

Figure 3.4: Northwest Airlines' Annual Operating Expenses Compared With Annual Payments to Airports, 2001



NOTE: NWA payments to MAC exclude lease payments related to the 1992 special bond issue.

SOURCE: Northwest Airlines and Metropolitan Airports Commission.

included in the adopted budget. The airlines serving MSP have supported the commission's decision, although we question whether MAC staff provided adequate information to support even a 6 percent increase in operating expenses. Commissioners and staff have said that they will continue to look for cost savings during 2003.

Federal Restrictions

The federal government restricts the type of financial assistance that airports can provide to airlines.

Federal laws and rules impose some restrictions on the degree to which airports can assist airlines. Airport operators are prohibited from directly subsidizing air service. An airport may offer fee waivers or discounted fees during a promotional period during which a new service is being provided. But the airport must offer that waiver or discount to all users of the airport willing to provide the same type and level of new services.

In addition, an airport receiving federal assistance is required to charge airlines fees and rents that make the airport as self-sustaining as possible. Generally, the fees and rents charged to airlines should reflect the costs of providing facilities and services. But, a fee schedule that recovers less than the costs of services to airlines is permitted if the airport's total revenues are sufficient to cover its total costs.[18] MAC's lease agreements with the airlines at MSP are designed to recover revenues sufficient to cover the costs of facilities and services used by the airlines.

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18 Policies and Procedures Concerning the Use of Airport Revenue, 64 *Fed. Reg.* 30, 7720-7721 (1999). Federal rules also state that an airport operator should establish long-term goals to make an airport as self-sustaining as possible, if market conditions or demand for air service do not permit the airport to be completely self-sustaining.

In most years, MAC's operating revenues have exceeded its operating expenses.[19] The agency's excess revenues have generally been used for construction projects at MSP and MAC's reliever airports.

MAC Assistance

Perhaps the most important thing that an airport can do for the airlines is to effectively and efficiently operate the airport. An airport operator needs to effectively run the airport so that airline operations are facilitated and airplane delays are kept to a minimum. Northwest Airlines and others acknowledge that MAC has performed well in this regard. MAC has effectively performed snow removal and other maintenance at MSP so that airline operations can proceed as smoothly as possible. As we saw in Chapter 2, MAC has generally been an efficient airport operator as well. The costs of operating MSP compare favorably with most other airports. Despite the airport's lower than average operating costs, MAC has been recognized for its effective operations at MSP. The International Air Transport Association has named MSP the best large North American airport in overall customer satisfaction for the last three years, 1999-2001.

The airlines have legitimate concerns about the increasing costs of operating MSP. But it should be recognized that:

- **The state and the Metropolitan Airports Commission have provided significant financial assistance to the airlines, particularly Northwest Airlines, in the past.**

Northwest Airlines benefited from state-authorized bonds issued in 1992 and MAC's refinancing of those bonds in 2002.

The 1991 Legislature authorized MAC to issue general obligation revenue bonds to assist Northwest Airlines during an earlier financial crisis. The $270 million in bonds were used to finance the purchase of certain flight training facilities and related real and personal property owned by Northwest Aerospace Training Corporation, Northwest Airlines, and NWA Inc. The properties and equipment were then leased back to these parties with lease payments equal to the debt service on the bonds. This bond issuance provided Northwest Airlines with a capital infusion at a time that it needed cash. As part of the deal negotiated with the Legislature, Northwest agreed to build an aircraft maintenance base in Duluth and reservation center in Hibbing.[20]

In January 2002, MAC refinanced the bonds issued in 1992 at a lower interest rate. The refinancing will save Northwest Airlines $37 million over the 20-year life of the bonds.[21] In addition, MAC agreed to delay reappraising the facilities and equipment that Northwest Airlines put up as collateral. The real property and fixtures were last appraised in March 2001, while the personal property was last appraised in 2000. MAC felt that appraisals of the collateral property should not be conducted for a period following September 11, 2001. The impact of

19 At MSP, MAC's revenues have generally exceeded expenses, but some of that excess revenue is used to subsidize the operation of MAC's reliever airports. In 2001, MAC's operating revenues at its reliever airports covered only about one-third of its operating expenses, including depreciation.

20 The location of the reservation center was later changed to Chisholm.

21 MAC staff calculate the amount of savings to Northwest Airlines to be about $53 million over the life of the bonds. Using a 6.6 percent discount rate, they estimate the savings to be about $37 million on a present-value basis.

September 11 would make it difficult to appraise the property until the future status of the airline industry was more apparent.

To help the airlines, MAC agreed to depreciate construction projects over a longer than usual time period and defer the start of cost recovery for certain projects until 2006.

In addition, prior to the current financial crisis in the airline industry, MAC negotiated new airline operating agreements and terminal building leases with airlines serving MSP. These agreements, which became effective in 1999, provide the airlines with significant current relief from increased rates and charges that would otherwise have occurred due to MAC's implementation of the 2010 plan. The agreements require that charges for certain construction costs that would have been added to airline rates after January 1, 1999 be depreciated over a longer period than would generally be the case. For example, the costs of terminal building projects involving building or structural changes are being depreciated over 30 years rather than the usual 20 to 25 years. Ramp and runway projects are similarly being depreciated over 30 years.

Besides lengthening the period over which costs are being recovered, MAC agreed to defer the recovery of any costs associated with certain construction projects in the 2010 plan. Specifically, MAC deferred starting its recovery of about $50 million in costs involved in constructing the North/South runway until 2006. MAC was originally planning completion of the runway for 2003, but completion has been delayed until 2004. In addition, MAC is deferring until 2006 the start of the recovery of about $122 million in project costs from the extension of Concourse C and the construction of Concourses A and B. These areas opened in mid-2002 and are leased to Northwest Airlines.

The airlines will pay the full cost of these construction projects, including interest for the deferral or extended depreciation periods. But the airlines—particularly Northwest Airlines—are receiving some significant relief during the current financial crisis. Some of the fees they would otherwise be paying are being deferred to future years when observers hope the industry will be in better shape.

The start of the cost recovery for new terminal facilities built for Northwest Airlines is being deferred until 2006.

It should be noted that these lease provisions are not without risk to MAC and airport users, and even potentially to taxpayers. Some of the charges are being deferred and will not be fully recovered until 2035. At some point in the future, MSP may cease to be a viable airport if demand for travel increases like it did during the 1990s. The state may need to consider building a new airport if the existing one can no longer meet the demand with acceptable delay times. The further into the future that obligations on the existing airport are deferred, the more difficult it will be for MAC and the airlines if a new airport needs to be built and financed. In addition, deferring the charges may increase the risk that MAC will not be fully paid for these construction projects should Northwest Airlines, or other airlines serving MSP, go out of business.