PORT OF SEATTLE
MEMORANDUM

COMMISSION AGENDA
ACTION ITEM

Item No. 5b

Date of Meeting May 28, 2013

DATE: May 21, 2013

TO: Tay Yoshitani, Chief Executive Officer

FROM: James Schone, Director, Aviation Business Development
James Jennings, Manager, Aviation Properties
Jess Qunell, Aviation Property Manager

SUBJECT: Amendment No. 2 to the Port's Management Agreement with VIP Hospitality for Club International at Seattle-Tacoma International Airport

Amount of this Request: $500,000 **Source of Funds:** Airport Development Fund

ACTION REQUESTED:

Request Commission authorization for the Chief Executive Officer to execute the Second Amendment to the Management Agreement with VIP Hospitality LLC for operation of premium lounge services at Seattle-Tacoma International Airport, substantially as drafted in the attached exhibit, effective March 8, 2013, to increase the contract cost for a five-year total not to exceed $500,000.

SYNOPSIS:

VIP manages and staffs the Port's common use premium airline lounge named Club International, which is located at the South Satellite (See Exhibit 1). The agreement pays VIP a base management fee to oversee the facility and staff the operation and offers an incentive management fee based on annual profitability. The term of the current agreement is for three years with two one-year options. Staff has determined that execution of the first option year would require Commission approval due the expectation that management fees under the current agreement would exceed $300,000 after September 2013. The amendment is written to be retroactive to March 8, 2013, in order to align with the beginning of the first option year of the original agreement.

Staff is seeking authorization for the full implementation of both option years, which if approved by Commission, will enable the current agreement to continue through the fifth year.The amendment includes the following changes to the underlying agreement: 1) an increase to the base management fee; 2) modification of the incentive management fee schedule for year four and five of the agreement; and 3) added administrative duties that VIP will perform on a regular basis to streamline some processes.

BACKGROUND:

A premium passenger lounge is an essential component of the services offered by airlines that target high margin first- and business-class-passengers on international flights. A premium lounge offers a quiet place for passengers to relax prior to boarding their flight and offers services including complimentary food and beverage, computer access, newspapers, magazines and televisions. The Port's provision of a common-use lounge, which accommodates multiple airlines in the international terminal, is key to ensuring that both existing and prospective international airlines serving the Airport can meet their business plan objectives, specifically, route profitability. The Port's Club International meets a critical market need for those airlines that cannot justify building or leasing their own facility and that cannot be accommodated as sub-tenants in the existing airline branded lounges. Many international carriers would view the lack of a common-use lounge at the Airport as a barrier to successful entry into the market. Therefore, it is important that such an option be maintained for current lounge users as well as prospective new entrant airlines. Strategically, having a viable common-use premium lounge in the South Satellite is critical to meeting the Port's Century Agenda objective to double the number of international flights in the next 25 years.

The Port markets Club International as a premium passenger lounge directly to carriers operating at the South Satellite of the Airport. Club International first began on the Mezzanine level of the South Satellite decades ago as a no-frills common-use lounge where airlines would provide their own staffing, food, and beverages. In May 2010, the Port changed the operating and business model in an effort to improve the level of service. Port staff solicited and selected a third-party company (VIP Hospitality) to provide a full service lounge inclusive of staff, food and beverage services, as well as management oversight. Additionally, the fee model was changed from a fixed per-flight charge to an individual per-passenger charge applied to airlines' passengers who visit the facility.

The lounge agreement with VIP was executed on March 8, 2010. On June 17, 2011, the first amendment to the agreement was executed that clarified accounting processes, record keeping responsibilities and asset ownership. In March 2012, Club International moved into a remodeled facility on the concourse level that was vacated by Delta Airlines. Since opening the doors at the new location, our partnership with VIP Hospitality has been quite successful in attracting new airline customers and achieving profitability in their management of the facility.

The basic terms of the amended management agreement include the following:

- Hire, staff, manage, maintain and operate the Club International lounge
- Manage direct operating expenses and budgets on behalf of the Port
- Compensation of a monthly Base Management Fee for the full-time manager and Incentive Management Fee based on percentage of Net Operating Income

VIP has done an excellent job in managing the staffing and expenses of Club International. The club now provides service to five international airlines and the operating hours have been extended to meet the needs of these airlines. Per their contract, VIP has accommodated this growth without any escalation to the original base management fee or incentive management fee as compensation. It is important to note that the original agreement did not come before Commission because the term, including the option to extend, did not exceed five years and the estimated costs to the Port were not anticipated to exceed the CEO's spending authorization. Previously, it was the objective of staff to conduct a new request for proposals (RFP) process prior to the end of the three-year term. However, this objective was not met. Accordingly, Port staff determined that execution of the first option year allowed in the agreement would be necessary. This will lead to expenses associated with this contract exceeding the CEO's spending authorization limit of $300,000 by September 2013.

In order to streamline administrative responsibilities for management of the club, Port staff requested and VIP has agreed to take on additional duties that have been performed by Port staff for the past three years. These duties include invoicing airline customers and collecting payments. In recognition of these additional duties as well as the significant increases in lounge traffic and the lack of a built-in fee escalation clause in the original agreement, Port staff has negotiated an increase to the base management fee. Also, changes to the incentive management fee have been included in this amendment to ensure VIP is working to improve profitability during the remaining term of this management contract. Based on these factors , VIP's strong performance, and the importance to the Port to have uninterrupted service for our current Club International airline customers, the Port has agreed in principle to the following terms:

- A $14,450 increase to the annual base management fee, from $73,150 to $87,600.
- An increase in the incentive management fee schedule, resulting in a 1% to 4% increase in the share of net operating income that VIP would receive if certain gross operating profit margin thresholds are met.

Port staff is working on an RFP process that would change the lounge operating model from a management agreement to a more traditional concession-based agreement model. In the meantime, staff hopes to maintain the flexibility for the Port to exercise the second option year (through March 7, 2015) if the market doesn't adequately respond to the RFP.

FINANCIAL IMPLICATIONS:

The costs incurred by the Port under this agreement are included in the Airport's annual operating budget, and thus funded by the Airport Development Fund. These costs are more than offset by revenues generated by this agreement to produce a positive net operating income (NOI). The lounge generated $98,000 NOI in 2012, and the budgeted NOI for 2013 was $215,000. It is anticipated that, in light of the proposed changes to the base management fee and incentive management fee, the revised 2013 NOI would be $199,000. This assumes no change in revenues for the year. Through April of 2013, revenues are running 56% above budget, so projected NOI for 2013 will likely exceed budget.

STRATEGIC OBJECTIVES:

This request supports the Port's Century Agenda objective to advance the region as a leading tourism destination and business gateway. Specifically, this amendment ensures that the Port has high quality and uninterrupted premium lounge services that will provide a key amenity in support of making Sea-Tac Airport the West Coast "Gateway of Choice" for international travel and support the goal to double the number of international flights and destinations.

BUSINESS PLAN OBJECTIVES:

This amendment supports the Aviation Division's strategic goal of operating a world-class international airport. It allows the Port to continue to provide a high level of customer service to airlines and their passengers and to keep airlines' cost per enplanement low by ensuring that they have existing lounge service opportunities available to them without the need to construct and operate exclusive lounges.

ALTERNATIVES CONSIDERED AND THEIR IMPLICATIONS:

Alternative 1 - Do nothing. Continue into year four of the agreement with no changes. This would require the Port to terminate the agreement later this year prior to exceeding the $300,000 spending authorization limit for the Port's CEO. This would not be in the best interest of the Airport or participating airlines as it would cause an operational disruption in lounge service while the Port attempts to procure a new service provider and negotiate a new agreement. This is not the recommended alternative.

Alternative 2 – Approve the current agreement to exceed $300,000, without making any other changes to the agreement as have been negotiated between Port staff and VIP. Rejection of the negotiated terms may place the lounge operation in jeopardy as VIP could elect not to continue as the lounge operator upon providing 90 days' notice to the Port. This is not the recommended alternative.

Alternative 3 – Approve retroactive changes to the agreement through the execution of Amendment No. 2, with changes to the base management fee and incentive management fee with the intent of ensuring continued and profitable service for Club International. **This is the recommended alternative.**

OTHER DOCUMENTS ASSOCIATED WITH THIS REQUEST:

- Exhibit 1 – Club International Map
- Amendment No. 2 to Management/Concession Agreement with VIP Hospitality L.L.C. for Operation of Lounge Services at Seattle-Tacoma International Airport
- Original management agreement available electronically

PREVIOUS COMMISSION ACTIONS OR BRIEFINGS:

- None