

PORT OF SEATTLE
MEMORANDUM

COMMISSION AGENDA

Item No. 6f

Date of Meeting November 3, 2009

DATE: September 29, 2009

TO: Tay Yoshitani, Chief Executive Officer

FROM: James R. Schone, Director, Aviation Business Development
Deanna Zachrisson, Manager, Concessions Business

SUBJECT: Amendment to Extend the Lease and Concession Agreement of Smarte Carte, Inc., provider of airport luggage carts and other passenger services.

REQUESTED ACTION

Request for authorization for the Chief Executive Officer to execute an Amendment (Attachment A) to the Lease and Concessions Agreement – Attachment B (Agreement) of Smarte Carte, Inc. at Seattle-Tacoma International Airport (Airport) that would extend the term for an additional 5-year period as provided for in the current Agreement, under new negotiated terms.

SYNOPSIS

Smarte Carte has an Agreement at the Airport for the term February 1, 2005 - January 31, 2010 to sell luggage carts to the traveling public. A significant shock to that business occurred in May 2008, when the first air carriers began charging passengers a per-bag fee for checked luggage. Soon nearly every domestic carrier began charging between \$10 - \$15 for the first checked bag, and even more for second and third bags. Luggage cart rentals at the Airport dropped dramatically as passengers began shedding bags to save money. Smarte Carte quickly began to struggle in achieving enough sales to cover its minimum monthly guarantee to the Airport. Despite allowing Smarte Carte to raise its rental fee to \$4.00 in October 2008, Smarte Carte has not generated sufficient sales to cover their monthly guarantee payment to the Airport during 12 of the last 18 months.

While the Agreement provides an option for an additional five-year term, Smarte Carte notified Airport staff that the company was not interested in continuing to operate the luggage cart concession under the current terms. Thereafter, staff conducted an analysis of luggage cart concessions at major U.S. airports. Based on this analysis, staff recommends that it is in the best interest of the Airport to execute the option to extend the Agreement for another 5 years, but also to negotiate new terms reflective of current and probable future market conditions.

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BACKGROUND

The Airport issued a competitive Request for Proposals (RFP) for a luggage cart concession in mid-2004. At that time, the Airport was a very sought-after market in the luggage cart business. This was primarily due to the Airport's relative resilience in withstanding the swings of the aviation industry, the dominance of the leisure traveler in its passenger mix and also its distinction as an "origination and destination" airport. The core customer for a luggage cart is a leisure traveler with two or more bags. With such a large share of this type of passenger ending their trip in Seattle, the market was solid and profitable.

As an outcome of the 2004 RFP, the Airport was successful in negotiating a higher percentage rent than at any comparable airport (see chart below). The Airport negotiated 35% rent on luggage cart sales as well as sales of any supplemental services such as storage lockers and cell phone charging stations. Additionally, the Airport negotiated the free provision of luggage carts to international passengers in the South Satellite Federal Inspection Service (FIS) area. Smarte Carte agreed to re-stock the South Satellite international arrivals carts at no charge to the Airport. As a large airport, Sea-Tac also required significant new investment in luggage carts and luggage cart assembly stations. Smarte Carte invested approximately \$700,000 in new luggage cart infrastructure, and at the Airport's request, instituted a 25¢ cart return refund to address the problem of passengers abandoning luggage carts all over the Airport. While the 25¢ refund lowered revenues for Smarte Carte, it did solve this problem.

Examples of current Smarte Carte lease terms at comparable airports:

Airport	Length	% Rent	Minimum Annual Guarantee	Cart Price
Seattle (SEA)	5 yrs./one 5-yr. option (2005-10)	35%	90% of previous year's rent (\$542,00 in 2009)	\$4.00
Los Angeles* (LAX)	4 yrs. 11 mos. (2005-10)	55%	\$2.5 million	\$3.00
Las Vegas (LAS)	3 yrs./ two 2-yr. options (2005-10)	26%	None	\$4.00
San Francisco (SFO)	5 yrs./five 1-year options (since 01)	25%	\$450,000	\$4.00 ^SFO pays \$1.20 per cart to provide free in FIS
Salt Lake City (SLC)	5 yr. option extended (07-12)	20%	\$207,000	\$4.00
Denver (DIA)	Since 2002, expires 2010	25%	\$300,000	\$3.00
Portland (PDX)	Renegotiated new 5 yr term (2009-13)	15%	\$80,000	\$4.00
Minneapolis-St. Paul(MSP)	Renegotiated new 5 yr term (2008-13)	17%	\$179,000	\$3.00^MSP pays \$1.72 per cart to provide free in FIS

*LAX has 7,000 luggage carts compared to most airports having less than 2,000 carts.

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The Airport's luggage cart concession was very healthy until May 2008, when the first baggage fees went into effect. Smarte Carte's revenues began to decline as more carriers, including dominant carrier Alaska Airlines, began adding and/or raising baggage fees, as well as adding penalties if not paid online instead of at the Airport. Smarte Carte's sales dropped 8.4% in 2008 (with this drop occurring in the last 7 months of the year), and sales-to-date in 2009 are down an additional 12.4% - despite a 33% increase (\$3 per cart rental to \$4) in the cart rental fee in October 2008. On a month-by-month basis, Smarte Carte has only achieved adequate sales to support their minimum monthly guarantee to the Airport in the peak months of leisure travel.

The new baggage fees are consistent with the overall à la carte pricing model adopted by the airlines in recent years, which also includes fees for onboard food and entertainment and fuel surcharges. The U.S. Department of Transportation reports that the financial benefit to the top ten baggage fee revenue-generating airlines was more than \$1.1 billion for 2008, and 2009 revenues from baggage fees are expected to be close to \$3 billion for these carriers. Staff predicts baggage fees will continue and are likely to increase.

Normally, it would be to the Port's advantage to competitively re-bid any new concession. However, in this down economy, there have been compelling reasons to delay certain competitive RFPs. For example, the Port has delayed the competitive RFP for the Airport's duty free business for one year. In this instance, the concession concept is fundamentally sound, and the market is expected to improve in the short-term. Unfortunately, staff sees no such favorable turn-around for the luggage cart business in the short-term. The fundamentals of the luggage cart market are more likely to be even less favorable in one year, or even in 5 years.

Staff has considered carefully the likely outcome of a new competitive bid for the luggage cart concession. The two competitors who bid against Smarte Carte in 2005 (SafeSkies and Swissport) are both no longer in the luggage cart business. Of the top 50 U.S. airports, Smarte Carte holds the luggage cart concession in 45 airports. The remaining airports are divided between three providers. One German-owned, New York-headquartered provider holds the concession for Boston and Philadelphia airports, but has not bid on any new opportunities recently. Another provider is a parking garage management company that also offers a luggage carts at airports where they manage parking garages. This company has not bid on any luggage cart concessions in approximately the last six years. A third company holds luggage cart concessions at some smaller airports, and recently withdrew from competitive bid processes in Fort Lauderdale and John Wayne (Orange County), where both contracts were awarded to Smarte Carte.

In June 2009, Portland International Airport (Oregon) renegotiated a new five-year lease with Smarte Carte at lesser terms than their preceding contract (see above chart). There are no known local or regional luggage cart companies. Based on this market scenario, staff anticipates that the likely outcome of a competitive tender would be a lack of competition and ultimately less favorable financial terms than offered in this proposed negotiated extension. Staff believes that

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Smarte Carte is the only luggage cart vendor with enough resources and market position to be able to operate a robust and reliable luggage cart service at the Airport, and also provide the best possible financial returns in the marketplace.

In summary, three main factors suggest that a competitive process now, or in near future, is not in the Port's best financial interest:

- **Steep decline of the luggage cart business**
As stated above, the luggage cart business has declined dramatically since May 2008. Another measure of this decline is the average number of checked bags per passenger has declined 20% since 2007 (see Attachment C).
- **Smarte Carte's dominant position in the market**
Nearly all of the top 50 U.S. airports have Smarte Carte as their sole vendor. While there are some competitors, none has the scale or resources of Smarte Carte. It is a declining business that is not favorable for new entrants or small businesses.
- **Costly required infrastructure investment at Sea-Tac**
The requirements for new equipment, including approximately 2,000 luggage carts would be a significant investment for any new vendor, in excess of \$1 million. It is unlikely that a competitor to Smarte Carte would be interested in investing this level of new capital into a weak business model.

For any business that encounters a sudden and severe change to its basic business model, it is imperative for the survival of that business to find new market niches and other sources of income. Staff sees evidence that Smarte Carte is seeking to diversify its business model to include other supplemental services, as allowed in their current lease, such as cell phone charging stations and freestanding massage chairs. Under the extension, staff would encourage Smarte Carte to propose new sources of revenue, all of which would command the same percentage rent to the Port as the core luggage cart business. Such additions to their service mix would be subject to Port approval.

SCOPE OF AGREEMENT

The draft Amendment, as well as the Agreement, accompany this request for authorization. If approved, Airport staff will proceed to execute the Amendment.

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Below are the proposed new financial terms:

Seattle	% Rent	MAG*	Guarantee	Other
Current	35%	90% of previous year's rent	Monthly guarantee, no reconciliation	25¢ cart return, free FIS cart service
Proposed	22%	80% of previous year's rent – starting at \$317,000 in 2010	Annual guarantee, annual reconciliation	25¢ cart return, free FIS cart service

*Minimum Annual Guarantee

In comparison to other airports, it may appear that the new proposed percentage rent negotiated with Smarte Carte is less than currently found at many other airports. However, this is misleading because most of the percentage rents found at comparable airports are for contracts originated before the airline luggage fees came into effect. In other words, when many other airports received 25% percentage rent, the Airport had achieved a much higher percentage of 35%. As staff is beginning to see in evidence at airports in Portland and Minneapolis-St.Paul, it seems reasonable to expect that airports generally will receive much lower percentage rents once they also begin entering new contract cycles.

STRATEGIC OBJECTIVES

This proposal supports the strategy of “Ensuring Airport and Seaport Vitality” by ensuring viability for businesses at the Airport.

FINANCIAL IMPLICATIONS

The luggage cart concession already has been affected negatively by market trends, which will impact the financial return to the Port. Smarte Carte will pay the Port \$542,000 in 2009, which corresponds to 90% of 2008 rent paid to the Port. Smarte Carte will not achieve sales levels adequate to generate percentage rent above this amount. For 2010, Smarte Carte estimates that Port revenue at 22% of gross sales on luggage carts sales will reach at least \$316,827, which is the guaranteed annual minimum payment proposed for the first year of the amended Agreement. Smarte Carte will pay the greater of 22% of gross sales or the minimum annual guarantee.

ECONOMIC IMPACTS

The continuation of the Smarte Carte luggage cart concession will preserve eleven jobs based at the Airport.

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ALTERNATIVES CONSIDERED/RECOMMENDED ACTION

- **Alternative 1: Eliminate Luggage Cart Service at the Airport**

Passengers are traveling with fewer bags, which have greatly diminished the demand for luggage carts. In fact, luggage carts – at \$4 a cart – have become a very discretionary purchase. It would be possible to consider eliminating the service; however, the Airport has a significant number of international travelers who find a luggage cart more of a necessity than a luxury. In the interest of maintaining a level of customer service for travelers who require luggage carts, this is not a recommended alternative.

- **Alternative 2: Issue Competitive Request for Proposals**

Staff believes that a competitive RFP for the Airport's luggage cart business very likely will lead to one or both of two potential outcomes: Smarte Carte as the only bidder for the business, and less favorable financial terms than those proposed in this negotiated extension. This is due to Smarte Carte's ability to leverage its market dominance to propose a lower percentage rent in an RFP process. It also is highly unlikely that the luggage cart market will recover in the short-term to make a competitive RFP fruitful. This is not a recommended alternative.

- **Alternative 3: Extend the Smarte Carte Agreement under Proposed Terms**

Under any possible scenario, the financial terms the Airport previously commanded for its luggage cart concessions are unrealistic to achieve in the future. Due to the rise of airline baggage fees, it is necessary to adjust our revenue expectations to the current and future potential. Staff believes that this negotiated extension provides the best possible financial compensation, while also assuring the continuation of an appreciated (and often expected) customer service offering. This is the recommended alternative.

PREVIOUS COMMISSION ACTION

None.

ATTACHMENTS

Attachment A – First Amendment to Lease and Concession Agreement for Luggage Carts and Lockers

Attachment B – Lease and Concession Agreement for Luggage Carts and Lockers

Attachment C – Graph: Decline in Average Checked Baggage per Passenger.