COMMISSION
AGENDA MEMORANDUM

ACTION ITEM

Item No.	8b
Date of Meeting	September 24, 2019

DATE: September 5, 2019

TO: Stephen P. Metruck, Executive Director

FROM: James R. Schone, Director, Aviation Commercial Management
James Jennings, Senior Manager, Aviation Properties
Denise Trogdon, Senior Property Manager

SUBJECT: Request to Execute Management Services Contract for the Airport's Common-Use Premium Lounges

ACTION REQUESTED

Request Commission authorization for the Executive Director to execute a management services contract, for up to 10 years (a 5-year contract base with option(s) to extend for an additional 5 years), to operate the Port's common-use premium lounges at Seattle-Tacoma International Airport (SEA). The estimated contract cost to the Port is $60,000,000 over the 10-year contract term, which includes the management fee, incentive management fee and operating expenses.

EXECUTIVE SUMMARY

The management contract with the current operator of SEA's two common-use premium lounges expires on March 31, 2020. A solicitation of proposals and execution of a new contract is necessary now to ensure continuous operation of these lounges.

These lounges – one on Concourse A and one at the South Satellite - are an essential service for the international airlines that do not operate their own lounges at SEA or airlines that require additional lounge space outside of their own proprietary lounges. Having common-use premium lounge space is a requirement for most, if not all, of SEA's existing and potential international carriers. Of the 12 international carriers that began service at SEA during the last 5 years, 9 signed lounge-use agreements with the Port.

With the conversion of 12 narrow-body domestic aircraft gates on Concourse A to 8 wide-body international aircraft gates, as constructed by the International Arrivals Facility (IAF) project, demand by international carriers for lounge space is expected to increase over the next 5-year agreement term. In addition, the Port's two common-use lounges have become a popular destination for domestic travelers as well through the use of day passes or lounge membership programs. With the growing demand for use of these lounges, daily utilization has increased significantly, which has had a commensurate positive effect on SEA's non-aeronautical revenue.

JUSTIFICATION

For airlines, a premium lounge is a way to differentiate themselves from their competition; globally, many airlines have begun adding high-end amenities such as spas, full-service restaurants, and private sleeping rooms to win the business of high-margin international first and business-class travelers. At SEA, where the number of international passengers has increased by 50% over the last five years alone, most international carriers use the Airport-operated lounges.

For many passengers, the premium lounge has become an integral part of their travel experience. Once limited primarily to international first and business-class passengers, an ever-increasing number of today's domestic travelers expect to be able to wait for departing flights in a premium lounge that offers—at a minimum—complimentary beverages, hot meals, and a quiet place to relax and refresh. The proliferation of lounge membership programs has dramatically increased the percentage of passengers who are eligible for lounge access and represents a significant revenue generator for the Port. It is this revenue that enables SEA to reinvest in terminal services that benefit a wide range of passengers. There are many services now provided by airports – pet relief areas, nursing suites, enhanced accessibility services, power at seats – that are not only 'nice to have' but have become expectations of the traveling public. By maximizing the revenue from the lounge offerings, it enables SEA to offer a more diverse array of services to all types of passengers.

DETAILS

To provide a premium lounge experience to passengers, an operating model was implemented in 2014 whereby the Port contracted for management and operation of the lounges with a third party whose core competency was hospitality services under a Lounge Management Agreement. The Agreement for this third-party management service was structured to include a fixed base management fee as well as an incentive fee that is dependent on the profitability of the lounge operation. The third-party operator is responsible for staffing, procurement of food and beverage and management oversight. The Port reimburses the firm for those expenses. Each month, Port staff reviews the expenses and approves reimbursement.

The current lounge management operator launched a successful campaign to drive lounge use by non-international passengers through lounge membership sales programs which have filled the Port's two lounges to capacity on many days before and after the window of peak use by international passengers (10:00 am to 2:00 pm). The success of this effort resulted in a significant boost to non-aeronautical revenue, estimated to be $10.1M during the current agreement term.

PASSENGER VOLUME AND FINANCIAL PERFORMANCE UNDER CURRENT CONTRACT

	2014 Actual (Previous contract)	2015 Actual (Current contract)	2016 Actual (Current contract)	2017 Actual (Current contract)	2018 Actual (Current contract)	Total (Current contract)
Total Lounge Passengers		74,991 (Apr-Dec	104,514	187,411	284,577	576,502
Passengers from Third Party Sales Programs		15,738	31,796	112,409	184,286	344,229
Third Party Sales Program passengers as a percentage of total		21.0%	30.4%	60.0%	64.8%	59.7%
Gross Revenue	$ 1,517,770	$ 2,391,727	$ 3,027,597	$ 5,040,594	$ 6,801,648	17,261,566
Operating Expenses	$ 806,280	$ 1,141,887	$ 1,418,299	$ 1,959,294	$ 2,608,855	$7,128,336
Net Operating Income	$ 711,490	$ 1,249,839	$ 1,609,298	$ 3,081,300	$ 4,192,793	10,133,229
Base Management Fee	$ 87,600	$ 159,564	$ 186,000	$ 186,000	$ 186,000	717,564
Incentive Management Fee	$ 73,185	$ 25,643	$ 79,472	$ 99,336	$ 169,981	374,432

The Port's direct contracting of management services to support the common-use lounge facilities is unique across US airports. Most US airports approach their common-use lounges as a concession, with revenue to the airport based on a percentage of sales. This approach puts the burden of management and capital investment on the concessionaire, and usually translates into a smaller total amount of revenue for the airport owner. The Port's direct contracting approach requires more oversight and investment by the Port, but it has also translated into significantly more revenue than a traditional concession fee-based agreement.

As this significant non-aeronautical revenue stream has developed, it is important to note that the Port has had very little investment associated with the existing facilities which were previously occupied by airlines. Staff is working on a long-term airport-wide lounge strategy and will be returning in the future to discuss plans to invest in SEA's lounge facilities. Future improvements are required to ensure that the facilities remain competitive with products and services to meet the needs of SEA's international and domestic passengers. Additionally, Port staff are looking at opportunities to expand these facilities, to keep up with growing international demand, as well as capitalize on the increased demand by domestic travelers for premium lounge access.

Scope of Work

Manage the Port's common use lounges at South Satellite and Concourse A

- Manage world-class premium lounges to the growing numbers of international airline passengers that are not serviced by airline branded lounges at the SEA.
- Grow the Port's premium lounge business at SEA by developing non-airline business, through corporate users, walk-up passengers, third party memberships, etc.
- Interview all existing staff for positions in the operation of the two common-use lounges
- Comply with the City of SeaTac Ordinance 13-1020 (commonly known as Proposition 1)

- Ensure that the lounge service and amenities reflect the Airport, as well as the Pacific Northwest Region, and accommodate the broad spectrum of current and potential new airline customers. The premium lounges should have a marketable brand to be used in promotional and marketing materials. The current lounges, located on Concourse A and South Satellite, are branded as 'The Club at SEA'; however, this name is subject to change at any time at the sole discretion of the Port of Seattle.
- Provide industry expertise in any Port lounge facility planning efforts, as potential expansion of lounge capacity and facilities are considered, while also providing additional management and staffing capacity to support any potential future expansions.

Schedule

Activity

Commission authorization	2019 Quarter 3
Issue solicitation	2019 Quarter 3
Notice of selection	2019 Quarter 4
Execute agreement	2020 Quarter 1
Agreement start date	2020 Quarter 2

ALTERNATIVES AND IMPLICATIONS CONSIDERED

Alternative 1 – Enter into a concession-based agreement whereby revenue to the Port is derived from a percentage of sales (entry fee, including food and beverage) only.

Cost Implications: In 2016, Dallas-Fort Worth Airport conducted a survey of airports nationwide regarding management of airport lounges. The survey results provided an array of concession agreement terms. To evaluate the benefit of a concession agreement vs. a management agreement at SEA, as a basis for comparison, Port staff used the most beneficial concession terms from the survey.

Net Operating Income (NOI)	**Contract Year 1 (Apr 2015-Mar 2016)**	**Contract Year 2 (Apr 2016-Mar 2017)**
SEA Management Contract (Current)	$ 1,709,000	$ 2,010,000
OAK (9% of Gross)	$ 250,000	$ 294,000
CVG (4% of $100k, 6% of $100k+)	$ 165,000	$ 194,000

In comparison to the most generous concession agreement terms, SEA's management agreement was worth more than $1M in NOI in each contract year vs. the concession agreement.

For the concession agreement to breakeven with the management contract, the concession percentage would have to be 65%.

Pros:

(1) The concessionaire assumes most of the risk of the business.
(2) Significantly less Port staff time would be required to manage the concession agreement.
(3) No capital investments would be required by the Port.

Cons:

(1) The Port has less direct input and control of business decisions and, therefore, would have less ability to insure the needs of international airlines are fully met.
(2) The Port would defer to the concessionaire to make day-to-day operational decisions.
(3) Revenue to the Port would be far less than revenue realized under a management agreement.

This is not the recommended alternative.

Alternative 2 – The Port continues to manage the lounge business under a management agreement, with terms to include a Base Management Fee and Incentive Management Fee to be negotiated with the selected lounge operator.

Cost Implications: The Port's cost will be limited to a negotiated Base Management Fee for day-to-day on-site management, as well as an Incentive Management Fee calculated each year of the Agreement equal to a percentage of NOI.

Pros:

(1) The Port has direct control over business decisions in support of the needs of international airlines and the travelling public.
(2) The Port has direct contractual input as to the day-to-day operations of the lounge management.
(3) NOI far outweighs the cost of staff time expended.

Cons:

(1) The Port assumes the risk of failure of the lounge business.
(2) Port staff time dedicated to managing the agreement and operations of the lounge accounts for approximately 25% of two FTE's.
(3) The Port is responsible for lounge facility maintenance and capital renewal.

This is the recommended alternative.

FINANCIAL IMPLICATIONS

Based on the current lounge operation and anticipated demand for future lounge use, Port staff has created the lounge passenger activity and gross revenue forecast as shown below:

	2019 Forecast	2020 Forecast	2021 Forecast	2022 Forecast	2023 Forecast
Passengers (Estimated)	357,756	379,221	394,390	410,166	426,572
Forecasted Gross Revenue	$ 10,231,158	$ 10,845,027	$ 11,278,828	$ 11,729,982	$ 12,199,181

Growth in passenger volumes is based on new lounge users, including those resulting from agreements with airlines, third-party membership programs and walk-up customers and is generally tied to new forecasted international air service. However, even with new air service, the use of Port lounges is not guaranteed, as customers may elect to utilize alternate lounges. Staff intends to support the continued promotion of third-party membership programs and walk up customer business which, in addition to growth due to new air service, is the basis for the 4% increase per year in passenger volumes shown above.

Through the solicitation process, interested firms will propose amounts for both the base and incentive management fees included in total operating expenses, as well as lounge operating expenses. The final determination of the actual fees will be based on proposed amounts of operating costs and actual future lounge performance. Historically, total fees paid to the current operator have ranged from 5% of gross revenues (2014) to 9% of gross revenues (2018).

ADDITIONAL BACKGROUND

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

It is the policy of the Port to support participation of Airport Concession Disadvantaged Business Enterprises (ACDBEs), as defined in 49 CFR Part 23, and the lounge management contract is a concession subject to the requirements of 49 CFR, Part 23.

This lounge management contract also allows the Port 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 their own lounges. It also supports the Division's strategic goal of maximizing non-aeronautical net operating income.

ATTACHMENTS TO THIS REQUEST

- Common-Use Lounge Presentation

PREVIOUS COMMISSION ACTIONS OR BRIEFINGS

- November 25, 2014 – Commission approved execution of a contract for operation of common-use premium lounges at Seattle-Tacoma International Airport for a total contract cost to the Port not to exceed $2,000,000 and a term of three years with two, one-year options to extend.

- May 28, 2013 – Commission approved execution of the Second Amendment to the Management Agreement with VIP Hospitality LLC for operation of premium lounge services at Seattle-Tacoma International Airport effective March 8, 2013, to increase the contract cost for a five-year total not to exceed $500,000.
- October 4, 2011 – Commission approved an increase to the project budget for the remodel of Club International by $740,675 and to advertise and execute a construction contract for a total project cost of $1,061,000.
- March 1, 2011 – Commission approved funding for design of the remodel of Club International and competitive procurement of furnishings and casework in the amount of $320,325 of a total estimated project cost of $971,000.