



Memorandum

TO: Public Safety, Finance, and
Strategic Support Committee

FROM: Sharon W. Erickson,
City Auditor

SUBJECT: *First Review of Airport Concessions*

DATE: October 12, 2010

RECOMMENDATION

We recommend that the Public Safety, Finance and Strategic Support Committee accept the City Auditor's *First Review of Airport Concessions*.

BACKGROUND

At the request of the Airport's Director, we performed the first in a series of Mineta San Jose International Airport (Airport) concessions audits. This first report covers the Airport's food, beverage and retail concessions pricing, and includes three recommendations to improve the pricing process. The Airport has reviewed the report and concurs with the audit results and recommendations. The Airport will be working with the concessionaires to ensure compliance with the requirement of maximum product pricing of street plus ten percent.

Respectfully submitted,

Sharon W. Erickson
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City Auditor

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Memorandum

TO: Bill Sherry
Airport Director

FROM: Sharon W. Erickson,
City Auditor

SUBJECT: *First Review of Airport Concessions*

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SUMMARY

At your request, the Office of the City Auditor has performed the first in a series of Mineta San Jose International Airport (Airport) concession audits. This audit covers food, beverage and retail concession pricing. We found that the current price-setting process is burdensome and can be streamlined. We also found overpriced items at all five of the concessions that we reviewed. As you have said, reasonable pricing of products and services rank high in airport customer service surveys and could affect Airport patron experience and passenger levels. We recommend that the concession agreements be amended to refer to a clear pricing policy and a less burdensome process for pricing items, and that you work with the concessions to lower prices as noted.

AUDIT OBJECTIVE, SCOPE, AND METHODOLOGY

In accordance with the City Auditor's 2010-2011 Workplan, we audited the Airport's food, beverage, and retail concessions. Our audit objective was to determine whether the Airport's food, beverage, and retail concessions are in compliance with the concessions agreements' pricing provisions. To determine compliance, we reviewed the concessions agreements' pricing provisions for the four major concessionaires, and reviewed pricing at the following subconcessions: the Sharks Cage, Gordon Biersch, CNN Newsstand, Sunset News, and The Brit. Specifically, we reviewed the price comparisons submitted by the concessions to the Airport and verified the subconcessions' product prices at the Airport. To determine "street pricing" we reviewed and verified prices at similar businesses. We also contacted San Francisco International, Phoenix International, and Dallas/Fort Worth International airports to obtain best practices information.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

BACKGROUND

With the completion of Terminal B in June 2010, the Airport significantly increased the number of food, beverage, and retail concessions from 25 to approximately 48 under four concession agreements. Of these, 12 concessions are planned to open soon. The Airport's Property Unit administers the agreements which have terms through June 30, 2020. The agreements are with the following three companies:

- Host International, Inc. (Host) has operated food, beverage, and retail businesses at airports since 1954 and reported \$2.3 billion in revenues. It has two of the agreements with a total of 24 concessions in San Jose that include Gordon Biersch, Sunset News, and Starbucks.
- AMS-SJC JV (Hudson) is a joint venture of Airport Management Services, LLC dba Hudson Group, JR Lester Associates, Ltd. and Marilla Chocolate Company, Inc. The Hudson Group serves major North American airports and reported total average annual revenues of over \$200 million. It has 10 concessions in San Jose that include CNN Newsstand, Hudson News and Discover San Jose.
- Areas SA, the parent company of Areas USA SJC, LLC (Areas), provides a wide array of services at major avenues of transportation and reported annual revenues of almost \$1 billion. It has 14 concessions in San Jose that include Peet's Coffee and Tea, The Brit, and Le Boulanger.

Concession Agreement Pricing Provisions

To ensure reasonable product pricing, the Airport structured its concession program Request for Proposal (RFP) to require that with the exception of pre-priced items such as magazines, that products be made available to the public up to a maximum of street pricing plus 10 percent. The RFP was attached and incorporated into the agreements as an exhibit and included the following:

Section IV. Tenant Mix and Concession Plan

Item d) Describe your pricing management policy and methodology for maintenance of the Airport's pricing program as required by the City and described in the Agreement. The City recognizes the benefit of "Street Pricing" but will allow pricing methodologies that include pricing up to a maximum of "Street Pricing" plus 10%. Successful Proposers must adhere to the pricing methodology as presented in their Proposal...

The four primary concessionaire agreements have the same pricing provisions, with the exception of the references to price comparisons to either food or retail businesses. If concessionaires do not comply with the agreement pricing provisions, the Airport can assess liquidated damages of \$200 per day. The concession agreement Section 4.16 includes the following key provisions and takes precedence over other pricing-related information in the exhibits attached to the agreements.

***4.16.3** Prices shall be posted or displayed prominently at all locations where Product is sold. ...*

***4.16.4** Concessionaire is required to submit, prior to the opening of any concession, a complete list of items to be offered by each Concession Location, including Subconcession Concession Locations, and the prices suggested to be charged. The Director shall have the right to request adjustments to these charges based on the pricing objectives outlined in this Agreement. No Concession Location shall open without a City approved price list.*

*...**4.16.7** Concessionaire agrees to perform price surveys once each year, at the reasonable request of the Director. The Concessionaire shall select five (5) local retail concessions deemed similar to Concessionaire's Operations for comparison for Director's Approval. Concessionaire shall survey all of Concessionaire's Products,*

*excluding promotional items and shall provide a written report of the results of its pricing survey to the Director using the method for maximum price calculation described in this **SECTION 4.16.7**, on a form provided by or in a manner prescribed by the Director. If less than five (5) retail concessions carry identical Product, the maximum price which may be charged for an item shall not exceed the average of the prices for similar Product.*

The Airport's Tenant Guidelines are also attached as an exhibit to the agreement and include the following pricing guideline:

*3a: Pricing Policy: Airport tenants participate in either market-basket or street-pricing; programs in which merchandise, goods and/or services at the Airport are priced within a permissible range of tenant's other locations or comparable products at **other non-Airport** locations. All tenants must have a current pricing list of merchandise and services on file with the City as part of its original proposal and subsequent agreement with the City. [Emphasis added]*

THE CURRENT PRICE-SETTING PROCESS IS BURDENSOME AND HAS RESULTED IN OVERPRICED ITEMS

The concession agreements which govern the pricing of food, beverage and retail items include ambiguous and conflicting provisions and guidelines which have resulted in concessions pricing some of their products above the maximum street pricing plus 10 percent. These concession agreement requirement issues have also created a burdensome process. Reasonable pricing of products rank high in airport customer service surveys and could affect Airport patron experience and passenger levels.

The Pricing Method is Burdensome

The Current Agreements Require Concessionaires to Obtain Price Comparisons from Too Many Businesses

As noted above, the agreements require that the airport concessions perform annual price surveys. To complete the survey, the concession is to obtain prices on comparable products from five similar local businesses. If the concession is unable to obtain five comparable prices, the concession can simply charge the average price for the comparable products they were able to obtain, but without adding the 10 percent mark-up. This offers some leeway to the concession when the price comparisons become too burdensome. However, we noted that some concessions selected many more than five similar businesses. For example, we noted that a food and beverage concession selected 37 businesses to obtain five price comparisons for each product. This concession surveyed 18 businesses for its restaurant food menu; an additional 15 businesses for its "to go" menu; and 4 businesses for its alcoholic beverages.

In our opinion, the method used at Phoenix International Airport, AZ, (Phoenix) offers more flexibility to its concessions when the price surveys become too burdensome. Phoenix allows its airport concessions to obtain only three price comparisons and to use different businesses for different menu sections, for example, breakfast and dinner. However, because San Jose requires price comparisons from five businesses, many more businesses are surveyed. Surveying a high number of businesses creates a burden for both the concessionaire as well as the Airport. To lessen this burden, we

recommend reducing the required number of price comparisons to three. This will require an amendment to the concession agreements.

Some concessions sell products which are unique or less common, making it difficult for the concessions to obtain five price comparisons. As a result, Airport concessions compare prices on products from an additional number of businesses and in one instance compared prices from a dissimilar product. Phoenix allows for its concessions to use the most similar product if the exact product cannot be located during price surveys. In order to limit the number of businesses surveyed for price comparisons on unique or less common products, we recommend that the Airport amend the agreements to allow concessionaires to use the pricing for a similar product or the manufacturers suggested retail price if the similar concession does not carry exactly that product, and perhaps limit the number of price comparisons to fewer than three.

Some of the Airport's concessions are national or regional brand stores. As stated in the Airport's Tenant Guidelines shown above, prices can be set within a permissible range of tenant's other locations. Given that the other location provides the street pricing, we recommend that the Airport amend the agreements' provisions to conform to the Tenant Guidelines and allow for concessions with their local or closest off-airport locations to charge a maximum of the prices charged at their other location(s) plus 10 percent. For example, the major concession Host operates the Gordon Biersch subconcession at the Airport, which operates a stand alone restaurant within five miles of the Airport. If the off-airport location does not carry all the products, then additional price comparisons will be needed. For example, one of the sports bar/restaurants we reviewed does not carry breakfast items at their off-airport locations as they do at the Airport.

The Current Agreements Require Concessionaires to Obtain Price Comparisons for Too Many Products

The concession agreements require that the annual surveys include price comparisons of all products. During our review we noted that some of the concessions, such as the retail concessions, carry many products. Also, we noted that two food and beverage concessions carried approximately two hundred alcoholic beverage products. In our opinion, obtaining price comparisons for so many products creates a burden on the concessionaire.

The Airport's tenant guidelines make reference to market-basket pricing. In a market-basket approach, the concessionaire obtains price comparisons for a sample of products instead of all products. For example, in Phoenix where not all products are surveyed, concessions select five to ten items of each of the following: 1) highest dollar sales volume; 2) highest number of units sold; and 3) randomly selected items.

According to the Airport Property Unit, a market-basket pricing approach should include best selling items from the various categories of products. For example, one of the retail stores we reviewed included a sample of products in food, health and beauty, souvenirs, apparel, electronics, luggage and eyewear categories. Also, a sample of alcoholic beverages should include liquor, beer, wine and cocktails product categories.

Two retail concessions we reviewed used the market-basket price comparison approach. Although one of the exhibits attached to the agreement allows for market-basket surveys, the agreements require the concessions to perform price comparisons for all products.

In order to limit the number of products surveyed by concessionaires and monitored by the Airport, we recommend that the Airport allow concessions that have a large number of products overall or a large number of products in a certain category, to use a market-basket type approach. Specifically, concessions would obtain price comparisons for a sample of five to ten items in each product category so long as that sample includes items with the highest dollar sales volume and highest number of units sold. This will require an amendment to the agreements.

A Clear Pricing Policy Is Needed

The Current Agreement does not Provide Guidelines on What Constitutes a Similar Business for Pricing Comparison Purposes

We found that neither the Airport nor the concessionaires had a clear understanding of the types of similar businesses that could be used in the price comparisons surveys. For example, some concessions make price comparisons to hotel restaurants and shops. But according to the Airport Property Unit Manager, hotels may not be good comparisons for certain concession products because their pricing may be in excess of typical street pricing. Nonetheless, Airport Property Unit staff approved some of the surveys that included hotel comparison prices.

We also noted that some concessions have made price comparisons with other concessions at the Airport, even though tenant guidelines attached as an exhibit to the agreement do not allow this because those prices have already been marked up by 10 percent.

Ambiguous and Conflicting Pricing Provisions and Guidelines

Furthermore, we found inconsistencies between the agreements and the exhibits attached to the agreements. For example, the requirement for street pricing plus 10 percent was described in the Request for Proposal which was attached and incorporated into the agreements. However, this was not included in the agreement provisions and neither the agreements nor the exhibits define street pricing.

Phoenix incorporates a pricing policy with its concession agreements which clarifies its pricing provisions. The pricing policy incorporates specific policies such as the types of similar businesses to use for price comparisons by product categories. For example, the Phoenix policy explicitly indicates that hotels cannot be used for certain product categories. In our opinion, use of such a pricing policy could increase consistency in adherence to the agreement provisions.

Recommendation #1: To provide guidance to concessions and obtain consistency in compliance with the agreements, as well as preclude unnecessary and burdensome price comparisons, we recommend that the Airport develop a pricing policy. The Airport should consider including the following items in the policy:

1. Definition of street pricing.
2. Requirement of pricing of a maximum of street pricing plus 10 percent, excluding products with pre-printed prices such as magazines and books.
3. Use of a sample of products for price comparisons when a high number of products within product categories need to be compared.
4. Use of similar products, manufacturer's suggested retail prices, or fewer than three comparisons, for price comparisons of products which are unique or less common.
5. Specific pricing policies on the types of acceptable businesses to use for price comparisons by product categories.
6. Reduction in the number of businesses to be used in the price comparison process to three, or, if needed, three comparable businesses by product category. For concessions with an off-airport location, reduce the number of businesses to be used in the price comparison process to one or two of the local off-airport locations.
7. The required frequency of price comparisons.
8. Airport and Concession roles/responsibility in the price comparison process.
9. Reference to the liquidated damages agreement provisions regarding non-compliance with the policy.

Recommendation #2: To ensure that concessionaires comply with the Airport's pricing policies, we recommend that the Airport amend the concession agreements by replacing the agreement sections specifying the price comparison process with a reference to the Airport pricing policy, and eliminating the provision that if fewer than the required five price comparisons are obtained, that only street pricing can be charged.

Many Products are Overpriced at the Five Concessions We Tested

We tested compliance with pricing provisions for five Airport concessions: the Sharks Cage, Gordon Biersch, CNN Newsstand, Sunset News, and The Brit. We reviewed the price comparison surveys submitted by the concessions to the Airport. Given that some of the businesses selected by the concessions were not similar, when applicable, we identified other similar businesses for price comparisons. We found that some of price comparisons performed by the concessions to hotel, high end restaurants, and other airport concessions resulted in pricing that exceeded street pricing plus 10 percent. We also found other pricing exceptions, such as prices for alcoholic beverages were not posted or prominently displayed. In Exhibit I, we note the pricing exceptions we found. Furthermore, we recommend streamlining the pricing process by comparing prices to off-airport locations as described earlier in this report.

Exhibit I: Concession Agreements Price Exceptions

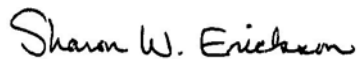
Concession/Sub-Concession	Exception	Comment	Recommended Action
Host/Sharks Cage and Gordon Biersch	Five Sharks Cage and six Gordon Biersch breakfast menu items exceed the maximum pricing provision.	Concession used hotels in comparison.	Decrease prices for these items.
	Four other Sharks Cage menu items exceed the maximum pricing provision.	The Sharks Cage compared a salmon sandwich to salmon meals for two of its five price comparisons. It compared the other three items to a hotel restaurant.	Decrease prices for these items.
	Ten other Gordon Biersch menu items exceed the maximum pricing provision.	We compared Gordon Biersch appetizer and meal prices with its off-airport downtown San Jose location only.	Decrease prices for these items.
	Comparison to hotels and high end restaurants likely to result in high alcoholic drink prices. We verified one drink that exceeds maximum pricing provision.	Both the Sharks Cage and Gordon Biersch alcoholic drink prices use the identical pricing.	Gordon Biersch has an off-airport location. We recommend Host submit to the Airport a market-basket list of alcoholic drink prices at the off-airport location prices and to establish pricings per the street pricing plus 10 percent at both Gordon Biersch and the Sharks Cage.
	Premium and regular bottled water and bottled sodas significantly exceed maximum pricing provision.	Concession compared these to other airport concessions and hotel restaurants.	Decrease prices for these items.
	Prices for alcoholic drinks and served beverages not posted or prominently displayed.		Post or prominently display alcoholic drinks and served beverages prices as required in the agreement.
Host/Sunset News	<p>1. Over 70 percent of the 33 items we selected for testing from the concessions' market-basket exceed the maximum pricing provision; 14 items were priced at more than 35 percent above street-level prices.</p> <p>2. The sample of products surveyed did not include souvenirs, apparel or electronics.</p>	The concession included hotel shops in its price comparisons.	<p>1. Decrease prices for these items.</p> <p>2. Include souvenirs, apparel, and electronics products in price comparisons.</p>
Hudson/CNN Newsstand	Almost 70 percent of the 26 items we selected for testing from the concessions' market-basket exceed the maximum pricing provision; 10 items were priced at more than 35 percent above street-level prices.	The concession included hotel shops and a movie theater in its price comparisons.	Decrease prices for these items.
Areas/The Brit	<p>1. 19 of the 30 market-basket meal items we selected for testing exceed the maximum pricing provisions.</p> <p>2. 32 of the 48 alcoholic drink prices we selected for testing exceed the maximum pricing provisions.</p> <p>3. Alcoholic drink prices are not posted/proximately displayed.</p>	We compared The Brit prices with its off-airport locations only, The Downtown Brit and Britannia Arms.	<p>1. Decrease prices for these items</p> <p>2. Post or prominently display alcoholic and non-alcoholic drink prices.</p>

Recommendation #3: In order to ensure pricing of street plus 10 percent, a streamlined process, and compliance with the concession agreements, we recommend that the Airport work with the concessions to lower prices and implement other actions such as posting/prominently displaying prices.

CONCLUSION

Based on our audit of concession pricing, we recommend that the Airport streamline the burdensome price setting process by implementing a pricing policy and to also work with the concessions to lower pricing. Thank you for your assistance and cooperation during this audit.

Respectfully submitted,



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City Auditor

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