

This focus piece summarizes recent and proposed changes in federal policy related to airport privatization in the United States. With reauthorization of the Federal Aviation Administration (FAA) and its programs currently under consideration in Congress, policymakers are reviewing the provisions of the current Privatization Pilot Program (PPP). Given the successful privatization of infrastructure within and outside the airport sector since the last FAA reauthorization 4 years ago, the PPP is receiving renewed attention,¹ which raises a number of questions for airport sponsors:

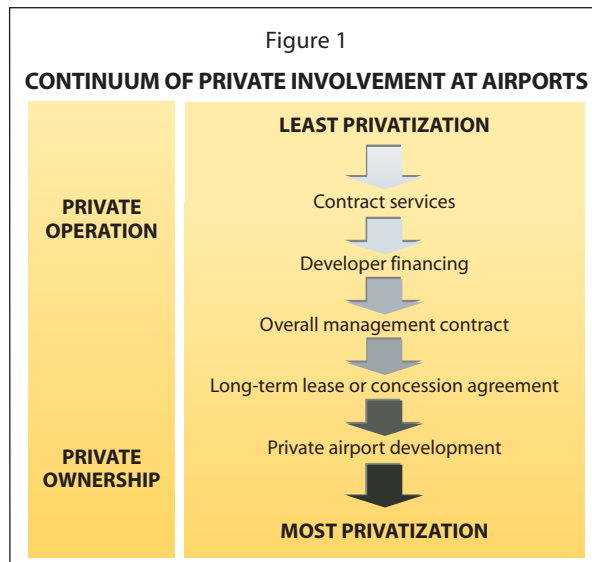
- How could the pending FAA reauthorization make it easier for airports to be privatized?
- What are the implications of the City of Chicago's potential privatization of Midway International Airport? What is behind the City's interest in privatizing one of its two large-hub airports?
- What can we learn from airport privatization in other regions?

THE PUBLIC-PRIVATE RELATIONSHIP AT AIRPORTS

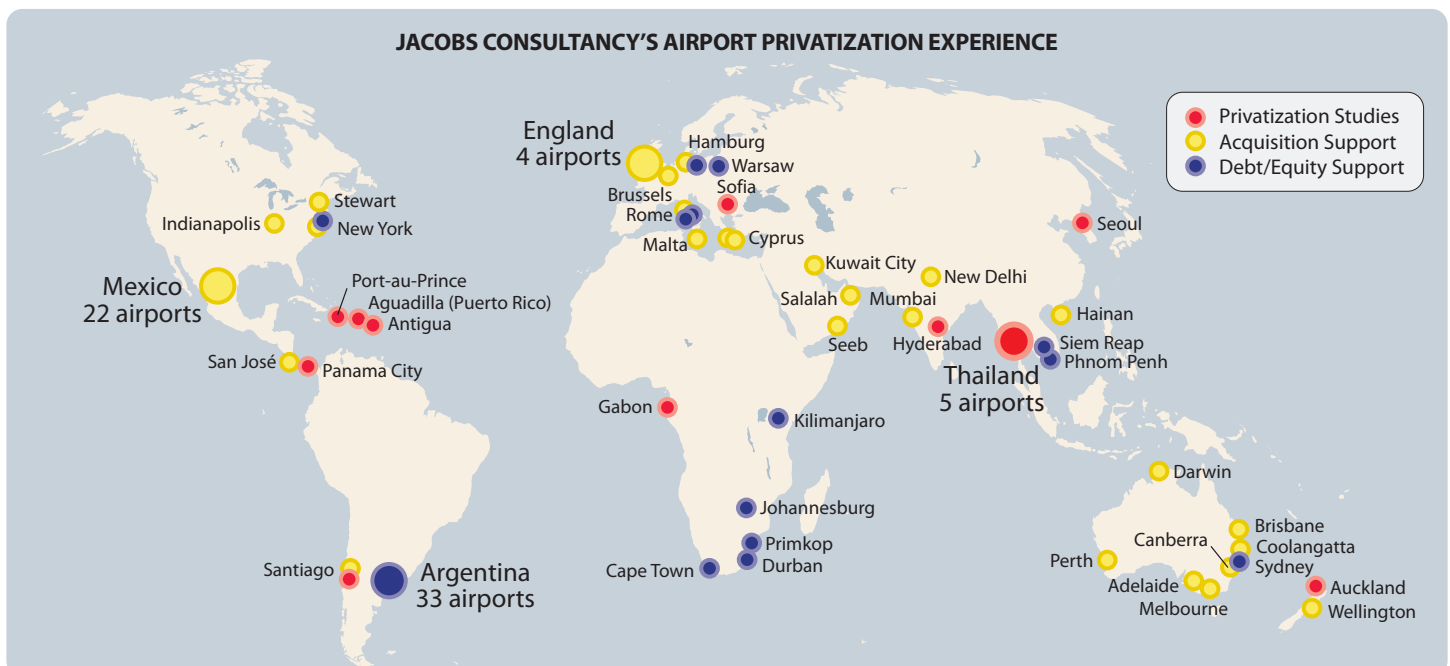
Privatization—used in this context to mean the transfer of airport ownership from the public sector to the private sector—has historically not generated much interest in the United States. Although private ownership of airports has not been met with enthusiasm,

private companies have played significant roles in the management and operation of airports. These companies include airlines, fixed base operators, rental car companies, in-terminal concessionaires, ground transportation providers, and providers of contract services, such as janitorial maintenance or shuttle bus operations.

Private businesses have been awarded master concessionaire agreements to oversee the development of terminal concessions, built and operated airport terminals (e.g., Terminal 4 at New York's John F. Kennedy International Airport), and been awarded contracts to manage and operate airports (e.g., BAA plc at Indianapolis International Airport).² Only one airport in the United States, Stewart International Airport in Newburgh, New York, has transitioned from public to private ownership.³ Figure 1 presents a continuum of private operation and ownership within the U.S. airport industry.



JACOBS CONSULTANCY'S AIRPORT PRIVATIZATION EXPERIENCE



¹ For a summary of the current FAA reauthorization process, see Jacobs Consultancy's December 2006 focus piece on the subject.

² Early this month, BAA plc and the Indianapolis Airport Authority agreed to terminate the management contract one year early, effective December 31, 2007.

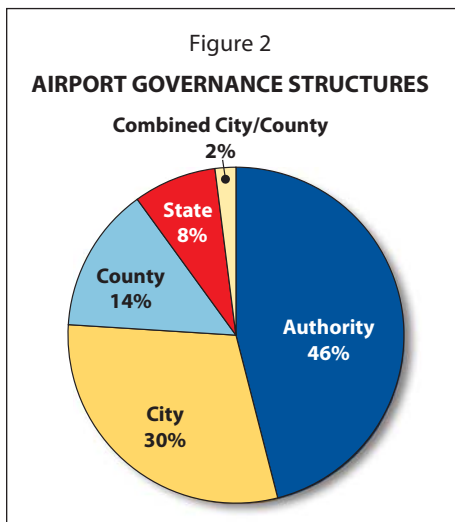
³ In early 2007, the National Express Group sold the remaining 93 years of the Stewart International Airport lease to The Port Authority of New York and New Jersey for \$78.5 million.

EVOLUTION OF AIRPORT OWNERSHIP

Since the expansion of commercial airline service in the 1920s, airports have largely been owned and operated by local governments. (Airlines and aircraft companies were also early developers of airports, such as Pan American Field in Miami, and United Airport—now Bob Hope Airport—in Burbank and Grand Central Airport in Glendale, both of which served greater Los Angeles before Los Angeles International Airport was constructed.)

Few private sources of capital were willing to invest in owning and operating an airport, given the immature nature of the industry (measured by traffic levels, facility use, or revenue generation).

The most typical owners of airports were municipal governments, followed by multipurpose port authorities and state governments. Single-purpose airport authorities became more common as the industry continued to mature and communities recognized that many airports generated enough revenues to be financially self-sufficient. Airport authorities generally have a more autonomous governance structure that helps insulate management from local politics and gives them control over salary, procurement, and budgeting systems, resembling the private sector more than local governments. Figure 2 shows the current distribution of airport governance structures.



INTERNATIONAL PERSPECTIVE

Historically, airports outside the United States were also publicly owned (most

often by national governments), but these public entities outside the United States did not benefit from the access to inexpensive revenue bond financing that was available in this country. Consequently, many airports had to compete for capital funding within the public sector, making it more difficult to secure the resources needed to expand and upgrade airport facilities.

For many governments, the next evolutionary step was corporatization of airports, wherein a corporation was created under the local laws governing businesses, with the governmental entity as the dominant shareholder. A corporate board and organizational structure were implemented, and financial statements and accounts were organized based on generally accepted accounting principles for businesses. The new corporation placed greater emphasis on generating profits to demonstrate its creditworthiness to potential lenders, thus reducing reliance on government subsidies.

With corporatization complete and a track record of profitable operation established, privatization of airport ownership emerged as an attractive next step.

Two approaches are typically used to transfer airport ownership. The first, flotation, involves listing shares of the airport corporation on a local stock exchange and selling shares to investors through an initial public offering. The second approach, a trade sale, involves selling shares of the airport corporation (or selling a long-term lease of the airport and its assets) to a single buyer or consortium through competitive bids.

The transfer of ownership is typically accompanied by a requirement to improve the airport's infrastructure and service levels, and the requirement that new capacity keep pace with demand. These requirements are in the best interests of the buyer as well, given that new capacity can accommodate additional flights (which generate increased landing and terminal revenues) and additional passengers (which generate increased concession revenue).

Airport privatization began in earnest in the United Kingdom in 1987, when the British Airports Authority (BAA), owner and operator of six major airports in England and Scotland, was floated on the

London Stock Exchange and became BAA plc. Airport privatizations then occurred elsewhere in the following sequence: Australia, New Zealand, Argentina, South Africa, Costa Rica, Mexico, and continental Europe.

The dynamic expansion of low-cost airlines in Europe also created substantial investor interest in the smaller, underutilized regional airports that are attractive alternatives to the more congested and expensive hub airports. Consequently, there has been strong private interest in the smaller regional airports in Europe, and many of these airports have been privatized.

Concern over the strong market position of airports and their potential to demand high user fees from airlines led governments to establish processes for regulating aeronautical (airline) charges. To provide stability for airline users, one widely used approach provides for the periodic adjustment of aeronautical charges considering the local rate of inflation (often referred to as a CPI-X formula, with CPI being the Consumer Price Index—a measure in the change of prices—and X representing an expected improvement in efficiency and economies of scale over time). Appeal processes are put in place to provide for user concerns to be heard and adjudicated.

Commercial revenues are largely unregulated, and are therefore a major source of profit for the private airport owner.

In the European Union, government policy favors airport privatization. Financing, developing, and operating airports are increasingly seen as private-sector activities, leaving governments to focus limited public funds on health care, social services, and other traditional government services. Even France, where the economy has a high degree of government involvement, intends to privatize (at least in part) Aeroports de Paris and the major French regional airports.

U.S. FEDERAL POLICY: CAPITAL SUPPORT WITH STRINGS ATTACHED

In contrast, U.S. airport sponsors not only have access to tax-exempt and AMT⁴ revenue bond financing, but also have access to capital support through the federal Airport Improvement

⁴ The interest earned on certain airport revenue bonds is subject to the Alternative Minimum Tax (AMT) for federal income tax purposes. Interest rates on AMT debt are, therefore, higher than on tax-exempt debt, but lower than on other, fully taxable debt.

Program (AIP). Since 1990, airports have also been able to generate federally authorized local revenue through passenger facility charges (PFCs)—a per segment use charge paid by passengers through the airline ticket. These funding sources, together with airline capital, were often used to construct dedicated airline facilities (including terminals, maintenance hangars, and crew bases) and provided sufficient revenue to upgrade and expand U.S. airport facilities. Receipt of AIP grants, however, is accompanied by extensive economic regulation by the FAA.

Through approximately three-dozen sponsor assurances, airport sponsors are required to abide by a series of federal rate-setting requirements and other rules. While some assurances have important public policy purposes and replicate other statutory requirements, they also provide airport sponsors with a narrow range of discretion regarding how users can be charged and how funds can be expended. Prior to 2000, these assurances also made it difficult, if not impossible, for communities to privatize their airports. The assurance that airport sponsors not divert airport revenues, for example, means that all revenues generated are to be used solely on the capital and operating costs of the airport, or on facilities that are directly and substantially related to airport activity. This requirement was designed to ensure that the money generated on an airport is reinvested in airport infrastructure and to deter local governments from raising fees on airport users for non-airport purposes. This arrangement—receipt of federal grants in exchange for assurances regarding a variety of financial practices—is one that most airport sponsors have accepted, but it remains an impediment to privatization.

THE 1996 FAA REAUTHORIZATION ACT AND THE PPP

Many public owners and operators of airports viewed the “money for regulation” deal as a favorable one. The *Federal Aviation Authorization Act of 1996*, which authorized the PPP, provided an alternative for a select number of airports.

The legislation:

- Authorized participation in the PPP by up to five airports, limiting participation to one large-hub

airport, and requiring participation by at least one general aviation airport.

- Limited the form of privatization for commercial service airports to a long-term lease (a general aviation airport could be sold).
- Gave the U.S. Secretary of Transportation the discretion to waive the revenue diversion restriction, permitting a necessary “reasonable rate of return” as an incentive for private investors. The Secretary was given the discretion to exempt a local airport operator or buyer from assurances that would have otherwise required the repayment of past federal grants and/or reimbursement to the government for the value of federal land acquired by the airport sponsor.
- Required that such exemptions had to be approved by 65% of the airlines serving the airport and by airlines representing 65% of landed weight.

In *Vision 100—Century of Aviation Reauthorization Act*, passed in December 2003, the PPP was changed to require that 65% of the airlines had to formally object within 60 days of the sponsor’s application if they wanted to block the sponsor’s application for a revenue diversion exemption.

Vision 100 also increased the share of AIP discretionary funding that private airports could receive, from the 40% set forth in the 1996 Reauthorization Act to 70%.

Airport sponsors interested in participating in the Privatization Pilot Program have to undergo an extensive application process that begins with the filing of a preliminary application. The FAA reviews the application, aiming to inform the airport sponsor within 30 days if the information is sufficient. If so, the airport is deemed to have encumbered one of the available slots, and the airport sponsor may issue a Request for Proposals, select a private operator, negotiate an agreement, and submit the final application to the FAA for approval.

OBTAINING APPROVAL TO PARTICIPATE IN THE PPP

To obtain FAA approval, applicants for privatization must demonstrate how they expect to meet a number of goals

designed to protect the public investment and interest in airports and to equitably treat the airlines serving them. Under the PPP, the private airport operator is mandated to:

- Continue to make the airport available on reasonable terms without unjust discrimination.
- Submit a plan that shows how the airport will be maintained, improved, and modernized.
- Keep rate increases under the rate of inflation unless a higher fee is approved by 65% of the airlines serving the airport.
- Mitigate the adverse effects of noise and other adverse environmental effects of aircraft and airport operations to the same extent as required of publicly owned airports.
- Retain any collective bargaining agreement with airport employees.

Initial interest in the program was limited, with Stewart International Airport the only airport to be successfully presented (i.e., the state of New York filed an application, issued a Request for Proposals, negotiated a deal, and had its application accepted by the FAA).

INITIATIVE TO PRIVATIZE MIDWAY INTERNATIONAL AIRPORT

In October 2006, the City of Chicago filed a preliminary application, which was accepted by the FAA, to privatize Midway International Airport, thereby taking the one available slot in the PPP for a large-hub airport. Given that no large-hub airport sponsors had applied for the PPP in the prior 10 years of the program, it is interesting to note the factors influencing the City of Chicago to file its preliminary application.

- In 2004, the City became the first U.S. local government to award a long-term (99 years) private lease of a toll road, obtaining more than \$1.8 billion for the 7.8-mile Chicago Skyway from Skyway Concession Company, LLC (owned by Cintra Concesiones de Infraestructuras de Transporte SA and Macquarie Infrastructure Group). The price was more than double the amount the City hoped to get from the sale, prompting discussion of the sale of other infrastructure assets.

- The State of Indiana followed suit and leased the Indiana Toll Road to a private company for \$3.8 billion for 75 years.
- Abroad, airport assets were commanding premiums as well. BAA plc accepted a takeover offer from Spain's Grupo Ferrovial SA for £10 billion (\$19 billion). Majority shareholdings in the airports serving Brussels, Budapest, Copenhagen, Sydney, Delhi, and Mumbai were also sold by government owners.
- Internationally (led by Australia and Canada), tens of billions of dollars have been allocated by private pension fund managers for infrastructure investment. Airports are particularly attractive investments for the managers of pension funds because of their history of long-term growth in airline traffic, inflation-resistant revenue streams, and track records of consistent profitability.

The FAA has determined that the City of Chicago's application to privatize Midway is complete and the City is expected to issue a Request for Qualifications to interested parties. A Request for Proposals would then be issued to a short list of qualified parties, who would then submit financial bids to the City.

For the City of Chicago, the tradeoff involves giving up control of Midway in return for substantial revenue that could be used for other capital projects and to reduce unfunded liabilities in the City's pension funds.

The premiums paid for airports by infrastructure companies and private equity firms, together with the possible lease of Midway, could usher in a new era of airport ownership, government

regulation, and airport-airline relations.

PPP ISSUES IN FAA REAUTHORIZATION

In February 2007, the Bush Administration introduced the Next Generation Air Transportation System Financing Reform Act of 2007, its proposed version of FAA reauthorization. The Administration proposed three significant changes to the PPP in this Act:

- Eligibility for privatization would be expanded from the current limit of 5 airports to 15 airports. This provision would also eliminate restrictions on participation by airport category, requiring only that the airports be in the National Plan of Integrated Airport Systems.
- The requirement that 65% of scheduled airlines at an airport approve exempting the airport sponsor from the revenue diversion assurance would be eliminated. Instead, the sponsor must show that it consulted with the airlines. In the case of a non-primary airport (one predominantly served by general aviation aircraft), the legislation would require that 65% of the owners of aircraft at the airport approve the exemption.
- The requirement that 65% of scheduled airlines approve fee increases higher than inflation would also be eliminated. Under this change, a private operator could recover a rate of return on all capital and operating investments in an airport except the lease or sales price it paid the public agency, which could not be added to the airline rate base without airline agreement.

Given the current partisan division in the U.S. government, with a Republican president and a Democratic majority in control of the House and Senate, the future of the Privatization Pilot Program is uncertain. While Republicans have been leading supporters of privatization, it is significant to note that the City owning the first large-hub airport to file a preliminary application to participate in the PPP is led by a Democrat, Mayor Richard M. Daley. Another issue that could arise in the debate is foreign ownership, considering the controversy that arose over the sale of a number of cargo terminals at U.S. seaports to Dubai Ports World, based in the United Arab Emirates.

Supporters of airport privatization will undoubtedly support the Administration's proposed elimination of the potential veto of the transaction by the airlines representing 65% of an airport's traffic. Replacing the veto with an enhanced consultation process and a regulatory approach could ensure that legitimate concerns about a change of ownership would be heard without eliminating the ability of local communities to decide the most appropriate airport ownership structure.

A TWO TRACK U.S. MODEL?

Ultimately, communities and airport sponsors will make privatization decisions based on the trade-offs between what are essentially two separate federal programs: the traditional model of airport operation, complete with higher levels of federal funding and extensive regulation, and the privatized model, which provides incentives for entry by private owners and their capital along with less federal funding and regulation. ■

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Please contact any of the following individuals for additional information:

Mark Lunsford, *Managing Director*

Bruce Boudreau, *Airport Privatization and Due Diligence Practice*

Cindy Nichol, *Business and Finance Practice*

Theresa Coutu, *Federal Practice*

Warren Adams, *Business Practice*

San Francisco area office:

555 Airport Boulevard, Suite 300
Burlingame, California 94010
Telephone: (650) 579-7722
Fax: (650) 343-5220

Washington, D.C. area office:

14900 Conference Center Drive, Suite 275
Chantilly, Virginia 20151
Telephone: (703) 961-9000
Fax: (703) 961-9318

www.jacobs-consultancy.com

E-mail: inquiry@jacobs-consultancy.com