Airport Privatization

(August 25, 2017 by Dafang Wu; PDF Version)

Airport Privatization or public-private partnership (PPP or P3) for airports refers to cooperation between public and private sectors in operating, maintaining, renovating or improving airport facilities. As described in Airport Cooperative Research Program (ACRP) Report 66, *Considering and Evaluating Airport Privatization*, airport privatization includes various degrees of cooperation, ranging from the simplest form of service contracts to long-term leases or sales. This article includes discussions of the long-term lease of primary airports provided under 49 U.S.C 47134, *Pilot Program of Private Ownership of Airports* (the Pilot Program), referred to as airport privatization throughout this article. A primary airport is defined as a commercial service airport that has more than 10,000 enplaned passengers every year.

Motivations

The essence of airport privatization is access to private sector capital and expertise, which may lead to a better managed and maintained airport that provides additional benefits to the local community. Among many stated goals and objectives are the following:

1. The current airport operator, typically a city or county government, expects to receive a large payment that is more than enough to retire all existing debt. According to 49 U.S.C 47107(b) and 47133, and better described in the *1999 Revenue Use Policy*, an airport operator cannot spend airport revenues outside the airport except for very limited exceptions. Therefore, the existence of a financially profitable airport operation does not benefit the general fund unless the airport is privatized under the Pilot Program.
2. The bidders / potential private operators want to realize a long-term stable return on their investment. Compared to the current airport operator, which requires no return on its investment, a potential bidder must generate a profit high enough to recover the lease payment over the lease term.

Key Regulations in the Pilot Program

The Pilot Program provides the exemption from the revenue use policy in 49 U.S.C. 47107(b) and 47133. Without the Pilot Program, the current airport operator would not be able to move the lease payment received outside the airport system, and a private operator would not be able to recover its investment.

This exemption is contingent upon the approval of at least 65% of scheduled or nonscheduled air carriers that accounted for at least 65% of landed weight in the previous year for any primary airport.

Therefore, air carriers have the ultimate bargaining chip. A transaction cannot proceed without air carrier support.

The Pilot Program also includes the following key regulations:

1. Exemption from grant repayment obligation.
2. Requirement that the airline fee cannot increase faster than inflation except as approved under the 65% rule described above. This is not an additional burden, since the 65% rule must be satisfied to allow the transaction.
3. Requirement that general aviation fees cannot increase faster than the air carrier fee increases.

The Federal Aviation Administration (FAA) has reserved a section of its website for the Pilot Program, including all airports that have applied under the Pilot Program.

Business Case

An airport privatization transaction is feasible only if the bidder believes it could generate adequate revenues to at least recover its investment. In addition, a private operator must fund the capital expenditure at an airport using internal equity or taxable bonds, compared to a public operator that could issue tax-exempt bonds. The weighted cost of capital is substantially higher than that of a public operator. Nevertheless, a private operator expects to:

1. Enhance air service through marketing. Due to the revenue use policy, a public airport operator has limited tools for providing air service incentives. A private airport operator has much more flexibility in using its profits or external fund to conduct market research, develop market campaigns or subsidize airline operations. Those activities may lead to a higher level of air service, which brings more revenue to the airport.
2. Improve operation efficiency. Although a majority of airport staff are typically included in a union agreement, a private operator still has opportunities to improve operation efficiency and optimize operating expenses, such as adopting technology or undertaking preventive maintenance.
3. Develop nonairline revenue. A private operator expects to generate much more nonairline revenue through parking, rental cars, ground transportation, or terminal concession revenues. This can potentially be achieved by adding product offerings, adopting different pricing strategies, and improving concession facilities.
4. Optimize capital expenditure. A private operator is subject to fewer regulations than a public operator with respect to construction activities such as the review and approval process, the procurement method, prevailing wages, and completion incentives. Therefore, a private operator may deliver a needed capital project faster and at a lower cost. In addition, a private operator may invest in preventive care, which leads to long-term savings.

Evaluating the Business Case

Many actions a private operator may take to improve an airport's financial situation could theoretically be taken by a public operator, undermining the argument that airport privatization is necessary. For example, a public operator theoretically could hire a consultant to conduct market research or develop air service, conduct a zero-based budget to reduce operating expenses, add parking products or concession offerings, and optimize the capital investment. Capital project delivery is probably the only exception in terms of what a private operator can provide much more efficiently.

However, a public operator does not have the incentive – or intentionally decides not to pursue those actions – to generate a higher profit:

1. Due to the revenue use policy, a public operator cannot move money outside an airport system, and therefore may not have an incentive to maximize operating profits. For example, many airports have a residual methodology for airline rates and charges, in which all nonairline revenues are used to reduce airline payments. Although the airport could increase parking rates to generate much more revenue, this additional revenue would only serve to reduce the airline payment. Therefore, the airport may hesitate to offend local residents simply to reduce airline burdens.
2. In addition, the primary role of an airport is to serve as the economic engine for the local community. The indirect economic impact of an airport far exceeds its direct impact. Therefore, an airport may intentionally accept some business deals that may not generate the highest possible amount of revenues. For example, an airport may provide utilities and road/airfield access to a parcel of land for a future industry park even though the market value of the potential ground rent is inadequate to cover the amortization of the related investment.

When viewed through the lens of profitability, airport privatization may trigger concerns from the local community. Although a portion of the revenue enhancement would come in the form of lower operating or lower capital costs from the efficient delivery of capital projects, inevitably some rates of using the airport would increase, and a portion would be transferred to airport users. It is also implicit that the interest of the local community would be subordinate to the profit maximization of the private operator. It may be unrealistic to expect that the private operator would continue sacrificing its interest for the good of the local community, such as by undertaking an unprofitable economic development project.

Application Process and Structure

The FAA site provides an application procedure dated September 1997, which is illustrated in ACRP report 66, Figure 6.1, on page 49. Two primary documents in the final application are the lease agreement and the airport use agreement.

The lease agreement between the public operator and the private operator spells out the contractual agreement to lease the airport. The lease agreement for Luis Munoz Marin International Airport (SJU) includes, among other contents:

1. Transaction details, the annual payment, the transition date, and other payments. The Puerto Rico Port Authority would receive an annual payment of $15.4 million or a total of $615 million over 40 years (4.2 million enplaned passengers in calendar year 2012, or 4.3 million in 2016), plus 5% to 10% of the gross airport revenues starting from the 6th year, among other revenues.
2. Lease term: 40 years for SJU
3. Capital projects: committed in the airport use agreement
4. Operating standards
5. Reporting, indemnification, insurance, and other clauses

The SJU airport use agreement between the private operator and the airlines is for a term of 15 years, and includes the following key sections.

New Airline Agreement and Extension

The SJU airport use agreement includes, in Section 2.5, a potentially problematic clause that future private operators may want to avoid. It mentions that the existing agreement would continue unless a new agreement is approved by the private operator or a majority-in-interest of the air carriers. Although the section appears harmless on the first read, it eliminates any possibility that the private operator could negotiate for a better business deal than the current agreement. In that case, the airlines would simply reject the new lease, allowing the existing agreement to continue beyond the 15th year. At other airports, an operator may opt to terminate the lease and set the rate unilaterally. This option is not available at SJU.

The 15-year lease term does not appear to be a major concern. The exemption from the revenue use policy seems to be valid for the entire term of airport privatization, and is not contingent upon continuing airline support and approval.

Limitation on Airline Payments

Airport privatization is unlikely to be the direct driver for an increase in airfare because airline payments under airport privatization would be lower than they otherwise would be. As discussed previously, at least 65% of the air carriers accounting for at least 65% of the landed weight must approve airport privatization. This gives the air carriers the ultimate bargaining chip, allowing them to demand a lower level of airline payment. In the final airport use agreement for SJU, the airline payment is capped at $62 million, escalating with the inflation rate and subject to certain adjustments, for the term of 15 years. Additional airline payments may be provided if the airlines approve additional capital projects not initially committed to by the private operator. Nevertheless, a large portion of the operating risk is transferred to the private operator.

Allocation of Airline Payments

The total annual contribution is allocated 42% to the airfield and 58% to the terminal. The airfield portion is recovered via landed weight, and the terminal portion is recovered first through the exclusive use rent, with the rest allocated on a per-passenger basis. Domestic terminal payment accounts for 63% of the terminal payments; international terminal payment accounts for 36% of the terminal payment; local terminal payment accounts for the remaining 1%.

Capital Projects

The private operator commits to a list of initial capital projects, which was no less than $34 million for SJU. The private operator commits that it would not recover the related investment from the airline rate base. If additional capital projects are required, the private operator must submit the project to the air carriers for review and approval, except for exempted projects that are mostly safety or security related.

As mentioned in multiple other articles, a capital project is the primary cause of disagreements between airports and airlines. In many situations, the airport recognizes the need to proceed with a major capital project, such as a new terminal or runway, while the airlines are satisfied with the status quo. In the SJU airport use agreement, if the airlines do not support an additional project, the private operator cannot add the related costs to the airline rate base.

Space Assignment and Facility Control

The SJU airport use agreement includes a schedule F, which spells out the details of terminal facility utilization. The ticket counter, airline office, club, and operation space are on an exclusive-use basis, with the rest on a common-use basis. The agreement also includes reassignment of exclusive-use space, and reassignment and recapture of common-use space.

Additional Thoughts

Airport privatization is relatively inactive in the United States, with only SJU and Stewart International Airport (SWF) approved under the Pilot Program (SWF reverted to public operator afterwards), but is gaining momentum in 2017. Multiple issues must be addressed and managed, which could enhance the possibility and outcome of airport privatization.

Public operators

If there is a long-term goal to privatize an airport, the public operator should consider evaluating its rates-and-charges methodology and adopting a commercial compensatory approach. The public operator would be able to generate a higher level of airline payments and increase the opportunity cost of the airlines when the airlines review a proposed airport privatization transaction. Similarly, a public operator should evaluate options to reduce operating costs and increase nonairline revenues, all of which would contribute to negotiations for a higher level of airline revenues under airport privatization, and eventually a higher bid amount from potential bidders.

Potential Bidders

Potential bidders must be familiar with airline rates and charges regulations, as described in other articles on this site. Among other issues, the private operator has the opportunity to convert to a commercial compensatory airline rates-and-charges methodology after the termination of the initial agreement, and therefore realizes a higher level of airline payments. This requires that the private operator carefully evaluate the contract terms, such as removing the MII approval for a future agreement or preserving the right to amortize additional capital projects under a future agreement.

Regulatory

Federal regulation remains a major uncertainty in airport privatization, including the potential privatization of the air traffic control system, the funding of the Airport Improvement Program, the Transportation Security Administration fee and recovery, additional security screening requirements, an increase in the Passenger Facility Charge level, or the elimination of tax-exempt status for airport revenue bonds. Those issues become relevant when the proposed term of airport privatization could be 40 to 99 years. At the same time, opportunities exist that could stimulate further development of airport privatization, including the granting of tax-exempt status to private operators when issuing bonds, and the relaxing of the limitation on using proceeds for non-airport purposes. The August 2017 report from Congressional Research Services provides further details.