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Number 141  
July 1992

## EXPANDING AIRPORT CAPACITY: GETTING PRIVATIZATION OFF THE GROUND

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### Executive Summary

The national air transportation system faces a tremendous challenge in the coming years. Airport congestion is already a serious problem, with delays at the most congested airports "rippling" through the air transportation system. Expected growth in the demand for air transportation will add to delays and reduce the overall reliability of air transportation. Unfortunately, developing new airports and airport facilities is a time-consuming, costly process, and there is minimal new development underway to meet the growing demand. Worse still, the current system suffers from an apparent shortage of capital to meet the airport system's future financing needs.

Increased private involvement in infrastructure development has proven to be an effective remedy for similar problems in other modes of transportation, and the growing support at all levels of government is a reflection of this success. Unfortunately, federal airport policy has exhibited a clear bias against increasing private-sector involvement. This bias in federal airport policy is inconsistent with the April 30, 1992 Executive Order on privatization, overall federal transportation policy, and with Secretary Andrew Card's stated support for airport privatization. Furthermore, by limiting local airport authorities' ability to increase private involvement, the bias ultimately contributes to more-congested, less-efficient airports.

If it is to meet the coming challenges of congestion, long development times, and an apparent shortage of capital, the national air transportation system *must* be able to efficiently access the capabilities of both the public and private sectors. This will not happen unless federal airport policy is altered to remove the bias against private sector operation and ownership of airports. Federal policy needs to recognize that the private sector can safely and efficiently develop and operate airports, and allow local governments and authorities to make use of the private sector's capabilities.

The ultimate need, however, is for the federal government to defer decisions on private involvement to state and local government. The decision on the appropriate level of private involvement should be made on a case-by-case basis depending on each airport's unique circumstances, a decision which local governments and authorities are uniquely qualified to make. Federal policy should recognize this and allow local authorities to determine the appropriate level of private involvement (within broad guidelines). Implementation of the

recent Executive Order could lead to improvements in federal airport policy, but until the current bias against private involvement is corrected, private involvement in airports will remain in a holding pattern, along with irate passengers.

## **I. INTRODUCTION: THE NEED FOR INCREASED PRIVATE INVOLVEMENT**

Between 1980 and 1988, annual domestic passenger enplanements increased from 191.1 million to 444.7 million, and the Federal Aviation Administration (FAA) forecasts an increase to 761.4 million enplanements by 2000. Aircraft operations have increased from 14.7 million in 1980 to 21 million in 1988, and are forecasted to reach 29.7 million by 2000. Despite this boom in air travel, there has been minimal new airport construction. The last major airport, Dallas-Fort Worth, was opened in 1974, and the only major passenger airport under construction will replace Denver Stapleton.

The mismatch between demand and capacity is causing growing delays in aircraft operations and passenger movement. In 1988, 21 major airports were listed by the FAA as "seriously congested" (over 20,000 annual air-carrier flight delay hours), and the FAA forecasts that 41 airports will be seriously congested by 1998, with the most-congested airports exceeding 100,000 hours of air carrier delays. In addition to increasing delays, several studies have shown that inadequate airport facilities also hinder airline competition by limiting both the number of landing slots and the available terminal space (primarily aircraft gates). This can restrict the entrance of new carriers in certain markets, or force entrants to pay substantial premiums to gain access to new markets.

Unfortunately, developing additional facilities is a time-consuming process. Under the current pattern of development, a major new airport can take more than 20 years from the start of planning until the start of operations. Even if a massive public works program were begun today, most of the benefits would not be felt until well into the 21st century, by which time passenger demand will have doubled. Given the current level of congestion and projected growth in demand, there is a pressing need to accelerate the airport-development process.

Adding to the problem, in light of the current fiscal constraints on government spending, a massive public-works program to increase air-system capacity appears infeasible due to an apparent lack of funds. Because some airport projects can be largely self-financing, some new development will be feasible under the current system, but higher-risk projects such as major expansions and wayports will probably continue to be marginally feasible at best without increased private involvement. If these projects (and the consequent potential reduction in congestion) are to be developed, a new source of equity will be needed. Increased private involvement can play a major role in meeting the challenges currently facing the national air transportation system, and has the potential to increase investment in the airport system, accelerate facility development, and increase the efficiency of airport infrastructure.

## **II. DEFINITION OF ENHANCED PRIVATE INVOLVEMENT**

Much of the prior debate on increasing private involvement in airports has suffered from a lack of clear, common definitions. For clarity, this paper will define the level of private involvement as having two major characteristics: the scope of private involvement (*i.e.*, how many areas of airport operations is the private sector active in) and the degree of private involvement (*i.e.*, how significant is the private sector's role in a given area). Most U.S. airports already have a high scope of private involvement. Airport terminals are generally financed with bonds backed by lease revenue from airlines; maintenance and fueling facilities are often privately built and operated; rental car facilities and other concessions are usually operated by private companies on leased airport property.

The degree of private-sector involvement at U.S. airports, however, tends to be more limited. Private companies are rarely given a direct ownership interest or financial interest in airport operations. Without such an interest, the incentives for improved performance are reduced. In general, the debate on private involvement tends to focus on the degree of private involvement (and not the scope). To clarify this focus on increasing the degree of private involvement (as opposed to increasing the scope of private involvement), this paper will use the term *enhanced private involvement* to refer to cases where the private sector takes a lead role in planning, financing, ownership, and operation (generally under public-sector regulation and review). While this definition excludes many forms of contracting, it includes a wide range of approaches, each with its own strengths and weaknesses. An overview of current examples of enhanced private involvement in airports is provided in Figure 1. Among the general approaches to enhanced private involvement are:

- × Perpetual Franchise;
- × Mixed-Ownership Franchise;
- × Build-Transfer-Operate;
- × Lease-Develop-Operate (Of an Existing Airport).

#### *A. Perpetual Franchise*

Under a perpetual franchise, a private operator/developer holds title to the facility in perpetuity, although the government may revoke the franchise if the terms of the franchise agreement are violated. The private operator may also be subject to regulatory constraints on operations and, in some cases, pricing. The long-term right to operate the facility, along with the ability to earn a reasonable return on investment, provides the developer with significant financial incentives for capital investment in the facility. Under a perpetual franchise, the developer is responsible for all business decisions, including capital investment, operating procedures, and whole or majority control of pricing policy. The public sponsor of the airport, however, can use the franchise agreement to exercise control over access, airport noise, and other public concerns. An example of a perpetual franchise is BAA, plc. (the privatized company which was previously the British Airport Authority). BAA is closely regulated on aeronautical charges, but has considerable flexibility to develop alternative revenue sources. Since privatization, BAA has significantly increased investment in facility improvements and new facilities.

#### *B. Mixed-Ownership Franchise*

A new airport could be divided into distinct airside and landside facilities; the areas which traditionally receive high levels of Airport Improvement Program (AIP) grants (*i.e.*, the airside facilities) would be placed under a public authority's ownership and control, while the landside facilities would be privately constructed, owned, and operated. Policy for the airport as a whole would be handled by a mixed public-private board whose voting powers were distributed according to the degree of financial investment in the airport. All policy making, including rates and charges, planning and construction, and the distribution of net revenues, would take place within the limits and terms of the franchise agreement between the private entity and the public authority/AIP grantee.

Within the landside facilities, the terminal space and gates could be leased from the developer to the airlines and concessionaires. To maintain an element of public control and minimize capital costs, all airport land would be owned by the public authority, with the private sector receiving a long-term lease on its portion of the land. A further source of revenues for the

airport could come from the private airport developer's sale of airport-related real-estate development rights. This approach would offer many of the potential benefits of a private airport, while retaining public input into decision making and airport operation (through the franchise agreement, airport board, and control over the airside), and possibly maintaining AIP entitlement grant eligibility for the publicly owned airside.

### *C. Build-Transfer-Operate*

Under the Build-Transfer-Operate (BTO) model of development a private developer constructs the facility and, upon completion, transfers title to the sponsoring public entity. The public entity then leases the facility back to the developer under a long-term lease, during which the developer operates the facility and has the opportunity to recover its investment and a reasonable profit through user fees and commercial enterprises. BTO has a somewhat lower degree of private involvement than the mixed-ownership model.

Under BTO, the public sector would hold title to the entire airport, although most of the planning, development, and construction would be done by a private firm. Financing would come from public and private sources, with the public sector being reimbursed for all publicly financed sections of the airport, while the private developer would receive temporary operating and revenue collection rights to the terminal, in exchange for providing terminal financing. The primary advantage of Build-Transfer-Operate is that the terminal facilities would continue to be government-owned, thus helping ensure access to tax-exempt financing and AIP grants, while retaining the potential advantages of private construction, development, and operation.

### *D. Lease-Develop-Operate*

A partnership based on a public-sector need for new capital, such as the large-scale improvement of an underdeveloped airport, could be implemented through a Lease-Develop-Operate arrangement similar to the arrangements used at Atlantic City International, Bader Field, and Morristown. Lease-Develop-Operate has a positive track record at these facilities, with the private developers making considerable investments in upgrading the facilities.

Under the Lease-Develop-Operate model, a private developer is given a long-term lease to operate and expand an existing facility. The developer then invests in facility improvements and recovers the cost of investment over the life of the lease. Depending on the terms of the lease, the airport might retain eligibility for AIP entitlement grants.

## **III. THE POTENTIAL OF ENHANCED PRIVATE INVOLVEMENT**

Enhanced private involvement can help address several pressing problems facing the American airport system. Among the potential benefits are:

- × Catalyzed new airport development;
- × Accelerated development;
- × Increased revenue for federal, state, and local governments;
- × Improved operational efficiency;
- × Increased economic activity.

### *A. Catalyzed New Airport Development*

By providing incentives to the private sector, enhanced private involvement can serve as a catalyst for new airport development. The extraordinary expansion of the British airport system following the public sale of the British Airport Authority is one often-cited example of the catalytic effect that private involvement can have on investment in infrastructure. A private airport firm would have a clear financial interest in helping a new project or expansion go forward, and also would have a direct incentive to search for new, potentially profitable projects.

As an example of the ability of enhanced private involvement to catalyze development, many of the recent self-financing transportation projects proposed by private firms (e.g., in Virginia and California), had not been previously identified by state transportation officials. If there had not been an incentive for private-sector activity, these projects would not have been identified and developed, and a genuine need would have been unmet. Similarly, the current lack of active private-sector involvement in airport project identification, and the lack of financial incentives for the private sector, suggests that there may be similar unidentified opportunities in airport development that could improve system capacity and reduce congestion.

### *B. Accelerated Development*

Private developers have the potential to develop projects in less time than government agencies. Private developers do not have to comply with many of the government procurement requirements that stretch out planning and construction schedules, including detailed contracting procedures, extensive paperwork, and interoffice/interagency coordination. The private sector is a leader in the use of innovative construction techniques and processes, such as the use of the design-build approach (starting construction immediately after initial design approvals), which can substantially reduce time and cost.

An example of the potential of the private sector to accelerate development is Terminal 3 at Toronto's Lester B. Pearson Airport, which was developed by a private consortium in roughly half the time the government estimated would be required to complete the project. Similarly, the Toll Road Corporation of Virginia expedited environmental permitting by agreeing to replace wetlands destroyed by the project at a two-to-one ratio (compared to the one-for-one replacement required by law), thus reducing environmental objections to the project, and accelerating project development.

### *C. Increased Revenue for Federal, State, and Local Governments*

Enhanced private involvement has the potential to provide a substantial boost to public revenues. Depending on the source and institutional arrangements, these revenues may be either discretionary revenues or obligated revenues. In reviewing enhanced private involvement, the potential for increased public revenues should be considered, with the level of existing payments such as payments in lieu of taxes (PILOTs) factored into the analysis. Three major sources of potential revenue increases are:

Tax Revenues - Privately developed transportation projects can pay over \$2.00 in direct tax revenue over their tax life for every \$1.00 of project cost. Placing an existing airport into the federal, state, and local tax base would have roughly the same effect. Although taxes are a cost from the airport operator's perspective, tax payments are a direct benefit to the affected governments and should be recognized as such. The potential for increased tax revenues from private projects is a clear additional argument for limited government financial input to privately developed projects that cannot support themselves through user fees alone.

Profit-Sharing - Airports developed without AIP grants, or which have paid back their AIP

grants, or which are exempted from AIP restrictions on the use of revenues, would be ideal for profit-sharing arrangements with local governments. This sharing can go beyond taxes. The airport, even though privately developed, could provide public revenue through taxes and profit-sharing. This could help bring more of the airport revenues "downtown" to the community. This profit-sharing would arise from the public-private franchise agreement, and not from the government holding any stock in a private firm, which is constitutionally prohibited in many states. Profit-sharing mechanisms are included in the plans for the California and Virginia private toll road projects. The use of a profit-sharing mechanism, however, would be restricted or prohibited if the facility received AIP grants, and is subject to the AIP revenue use clauses. Even in these cases, however, it might be possible to use a profit-sharing mechanism for ancillary facilities.

Proceeds from Sale - In addition to property taxes and revenue sharing, the local government can also receive revenue from the sale of the airport. Although there are still some restrictions on the revenue from transferring of assets, the Executive Order (Number 12803) issued April 30, 1992 on privatization eliminated many federal barriers to local governments seeking to privatize infrastructure assets which had received federal grants. The executive order states that local governments may recover not only discretionary revenue equal to the community's investment in the airport with interest, but also any remaining balance after repaying the depreciated amount of federal grants. This remaining balance and *only this remaining balance* is subject to the restriction that it be used only for infrastructure investment or tax/debt reduction. For public airports which are exempt from the restriction on the use of revenues, it is probable that there would be no restriction on the use of any of the sale proceeds. If the transfer of assets includes non-airport property, revenues from the non-airport property would be excluded from this restriction.

#### *D. Improved Operational Efficiency*

A large body of evidence suggests that motivated private management can significantly lower airport operating costs through the use of more flexible personnel practices and job categories, streamlined operating procedures, and simplified procurement. Numerous studies of contract-operated municipal services have demonstrated the potential for efficiency gains and cost savings from privatizing services. Other research comparing government-owned and privately owned electric utilities suggested that private ownership was somewhat more efficient (in terms of gross cost and labor hours per unit of output) in monopoly operation than government-owned facilities. Moreover, electric utilities have a homogeneous product and defined production technologies, and thus have few of the opportunities for creating new economic value that airports have. This suggests that private airport operators would have even greater opportunities to increase revenue.

The U.S. experience with private airport operation has been relatively successful so far. Although private involvement has been limited primarily to reliever and general aviation airports, private involvement has usually led to higher productivity and cost savings. For example, before private involvement, the public authority at Teterboro Airport was losing approximately \$300,000 to \$400,000 per year. Since it was leased to a private operator, however, airport revenues have increased substantially, even after deducting the private management fee. Similarly, Morristown Airport was losing money and in need of improvements prior to its lease to a private operator in 1982. The airport has since been extensively refurbished, and is now operating at a surplus under private management.

While this evidence is not conclusive, in light of the potential benefit to the U.S. airport system, the FAA should research and analyze the relative performance of public and private airports in the United States and abroad. One of the more valuable research approaches would be a review and analysis of performance ratios at existing public airports and the development

of a reliable methodology for comparing them to privately managed airports.

### *E. Increased Economic Activity*

A major objective of local governments is to increase economic activity. Private ownership and operation may contribute to maximizing the value of airport resources, such as developable land, on-site retail opportunities, and multimodal cargo and passenger facilities. For example, private lease-holders at the Morristown, Teterboro, and Atlantic City International airports, and at Rickenbacker Field have made extensive investments in airport facilities, which contribute to increased local economic activity. These investments would not have been possible without private involvement due to the financial constraints on the public sector. Similarly, since BAA was privatized, its investment levels have climbed dramatically; in the first three years following privatization, BAA's capital investment rate roughly doubled, ultimately creating additional jobs in the local economy.

## **IV. BARRIERS TO ENHANCED PRIVATE INVOLVEMENT**

Although enhanced private involvement offers considerable potential benefits at federal, state, and local levels, there are a number of issues and potential barriers to consider before enhancing private involvement. The costs, delays, and uncertainty created by these issues and barriers will reduce the potential benefits of enhanced private involvement, and may block or delay implementation. This is particularly unfortunate as many of the barriers to enhanced private involvement are unwarranted and inconsistent with overall government policy. If enhanced private involvement in airports is to be a success, governments at all levels will need to review their policies to determine if they create unnecessary barriers to privatization. Among the major issues and concerns in increasing private involvement are:

- × Public participation;
- × Airport safety;
- × Airport noise;
- × AIP grant eligibility;
- × AIP grant assurances;
- × Preventing monopoly pricing;
- × Taking profits off the airport;
- × Antitrust considerations;
- × Sovereign immunity;
- × Access to tax-exempt financing;
- × Potential administrative delays and misunderstandings.

### *A. Public Participation*

One common argument against enhanced private involvement is that public control will be diminished by private ownership. Public participation, however, can be built into the transfer

process, and institutionalized in the franchise agreement to ensure ongoing public input. Ways to provide for citizen participation include the formation of a citizen advisory board, naming activist citizens or elected officials to the board of directors, and holding regular meetings with local civic or government organizations and committees. Ultimately, good airport-community relations are in the interests of both parties, as the airport is a major employer with a significant impact on the community, while the community, in turn, can have considerable influence over the airport through zoning, noise control, and through the franchise-agreement provisions.

Because each community is different, the form of citizen participation should be a reflection of each community. The key in every instance is formal access and genuine attention to the issues raised by the public. A deliberate effort should be made to provide for citizen participation both in the decision to enhance private involvement and in future decisions affecting the community. A reasonable amount of time invested on this issue in the beginning can help both the private airport operator and the local community avoid conflict.

### *B. Airport Safety*

Some opponents of enhanced private involvement in airports charge that private operators would focus solely on profits, to the detriment of airport safety. Several factors suggest that this concern is unsupported: (1) any airport operator, whether public or private, must comply with the full array of federal laws and regulations on safety, or face possible action by the FAA; (2) private airport operators could have reduced protection from legal liability (compared to a public authority) and, if so, would face a greater liability from any negligence, which would provide strong incentives for private operators to pay close attention to safety; (3) the appearance of an unsafe airport would reduce the demand for airport services; and (4) the franchise agreement can be written to include provisions requiring the private operator to pay proper attention to safety, and specifying penalties (and possible public take-over) in the event of default.

### *C. Airport Noise*

Airport noise creates one of the greatest barriers to airport development, public or private. There is reason to believe that a public-private airport could handle noise mitigation as effectively as a public airport. A private firm would have incentives to reduce exposure to noise-related litigation, and might be able to charge noise-related landing fees to encourage the use of quieter aircraft. This could also provide revenues for noise-mitigation efforts.

As an example of a private operator's ability to handle noise mitigation, BAA has implemented a system of noise-related surcharges and rebates. Despite sizeable increases in traffic, the size of the area which is adversely impacted by noise has substantially decreased. At Burbank Airport, operated under contract by Lockheed Air Terminal, noise mitigation programs have also been successful. Future public-private airports would be eligible for AIP noise-mitigation grants. In addition, if other options are insufficient to obtain public support, there appears to be nothing to prevent a private airport developer from directly compensating existing residents for noise impacts.

### *D. AIP Grant Eligibility*

Under the FAA's Airport Improvement Program (AIP), airports can be eligible for federal grants-in-aid for facility development and noise mitigation. Most small- and medium-sized airports rely heavily upon these grants (although larger airports generally receive only a small portion of their capital from the AIP program). AIP grants can increase project feasibility and reduce the need for user fees. Public airports, which are defined by the Airport and Airway



Improvement Act of 1982 as airports used for public purposes under the control of a public agency with publicly owned landing areas, are eligible for both entitlement AIP grants (the largest class of grants) and for discretionary AIP grants. Private airports are not eligible for entitlement grants, but can receive discretionary grants.

A major objective for local communities in enhancing private involvement should be to maximize AIP grant eligibility (although the importance will vary depending on the significance of AIP grants to the airport). Under the definitions in the Airport and Airway Improvement Act, public control over the airport and ownership of the landing area should qualify the airport as a "public airport." It is unclear, however, what level of private involvement the FAA would be willing to accept and still classify the airport as a "public airport." Ideally, eligibility for AIP entitlement grants can be maintained while providing considerable flexibility for the private developer/operator. A statement by the FAA, defining allowable levels of private involvement, by area, on a public airport would assist airports in planning for enhanced private involvement.

#### *E. AIP Grant Assurances*

The Airport and Airways Improvement Act of 1982 imposes a number of conditions on recipients of AIP funds. Project sponsors must ensure compliance with these grant assurances, and it is probable that compliance requirements would apply to a private operator. As a result, the FAA's, DOT's, OMB's, and even the DOJ's AIP grant-related provisions and rulings will affect the future of enhanced private involvement at airports which have received AIP funds. Unfavorable interpretation of the Act's grant-related provisions could limit enhanced private involvement to airports which have not received AIP grants, or which are willing to repay all AIP grants to dismiss the accompanying restrictions.

For example, an unfavorable interpretation by the FAA of the revenue use clause (Section 511 a(12) of The Act) effectively blocked Lockheed Air Terminal's proposal to acquire Albany Airport, even though the FAA's interpretation was eventually found invalid by the Department of Justice's Office of Legal Council. Barring a severely unfavorable interpretation of the AIP grant assurances, however, the AIP grant assurances should not be a problem as private airports which have received AIP grants are already required to comply with the grant assurances, and have managed to do so successfully.

#### *F. Taking Profits Off-Airport*

There is one grant assurance, however, which poses a particular barrier to enhanced private involvement. Section 511 a(12) of the Act applies only to public airports, and requires that:

All revenues generated by the airport, if it is a public airport, and any local taxes on aviation fuel... will be expended for the capital and operating costs of the airport, the local airport system, or other local facilities which are owned or operated by the owner or operator of the airport and directly and substantially related to the actual air transportation of passengers or property...

The current FAA interpretation of Section 511 a(12) limits the ability of airport operators and developers to benefit from their ownership interest. Although the FAA allows private-contract operators to earn a reasonable profit under long-term lease-management contracts at a number of publicly owned airports, the FAA does not appear to view return on investment as a legitimate cost of business. This severely restricts private operators' ability to earn a reasonable profit. The FAA in the past has viewed proceeds from the sale of an airport as airport revenues and required that they also be spent on airport development.

Both of these interpretations are unwarranted and inconsistent with the April 30, 1992 Executive Order on privatization, and with the findings of a Department of Justice Office of Legal Counsel memorandum on the Albany Airport privatization proposal. The Office of Legal Counsel concluded that the only restriction on a private operator's ability to recoup its acquisition costs is that user charges comply with the grant assurances in the Airport and Airways Improvement Act of 1982, which requires that the airport be made available for public use on "fair and reasonable" terms. The FAA's decision not to allow a reasonable profit on investment is also inconsistent with Section 511 (a)12 itself, which allows revenues to be spent on the *capital* costs of the airport. Because profit is a return on capital investment, a reasonable profit is an integral part of the capital costs of an airport.

Regardless of the final outcome on this, there are two important exceptions to Section 511 (a)12. Private "public-use" airports are eligible for discretionary AIP grants, but are exempted from Section 511 (a)12. In addition, a number of public commercial airports are also exempted from Section 511 (a)12. These airports include several of the largest U.S. airports, including Logan, LaGuardia, and Kennedy. Public airports exempted from Section 511 (a)12 could have an increased ability to enhance private involvement and bring airport revenues downtown.

### *G. Preventing Monopoly Pricing*

One of the largest concerns in airport privatization is that private operators will use monopoly pricing to abuse the public interest. While airports have many of the characteristics of a natural monopoly, the principles for regulating private monopolies are well established, and the necessary provisions can be incorporated into the franchise agreement. The April 30, 1992 Executive Order requires that users be protected from excessive or unreasonable increases in user charges, either through a market mechanism, legally enforceable agreement, or regulatory mechanism.

In some cases, there may be adequate market competition so that regulation or legal agreements will not be necessary to limit user charges. If regulation is necessary, airports can be economically regulated in either of two basic ways: through limitations on rates and charges, or through limitations on profits (either on returns to equity, or on returns to total capital). Limiting rates is intended to protect users from discriminatory or monopolistic price-gouging, while limiting profits is often seen as the *quid pro quo* for governmental protection of an enterprise's monopoly status. Both types of regulation, however, are closely related, since limiting rates and charges places some kind of upper bound on profits, while limiting profits or returns to capital places a relatively firm upper limit on rates.

Both rate-of-return regulation and rates and charges regulation have advantages and disadvantages. Limiting rates and charges encourages aggressive cost controls and marketing, but also means that the airport developer has little recourse if demand falls. Moreover, rates must be adjusted as costs and market conditions change. The required rate hearings are costly and often adversarial. Limiting profits, on the other hand, gives an airport developer the freedom to set rates and adjust service levels to provide the best protection for lenders and equity investors. The developer has far less incentive, however, to reduce costs and attract business once the facility has reached the profitability limit. Moreover, it can be difficult to find an appropriate limit on profits. Overall, however, rate-of-return regulation is a well-established practice for utilities, with a large body of case law and standard regulatory practices, and should not place an undue burden on private ownership.

In newly emerging transportation projects, such as the private toll roads in California, continuous Public Utility Commission (PUC) oversight is being replaced by a long-term franchise agreement, which is a legally binding agreement between the private operator and the

sponsoring government. Because the franchise agreement contains all of the financial and economic contract provisions under which the franchise will operate, there is little or no need for regular revisiting of rates or profits. In the four California AB 680 private toll road projects, the agreement includes a limit on returns to total employed capital (equity and debt), plus efficiency incentives, but no limit on toll rates. With the economic regulation running on autopilot, the agreement can be managed on the public side by a state agency without the involvement of a PUC.

The use of a franchise agreement can help to create a stable policy environment for the private sector, which reduces policy risk and increases feasibility while protecting the public interest. Because of the PUCs' unfamiliarity with the business and policy risks of transportation infrastructure, private transportation developers fear that while the PUCs will not and cannot limit private-sector losses during years of poor returns, the PUCs will be quick to limit private-sector profits in good years. As a result, the franchise agreement or "autopilot" method may be the most appropriate regulatory mechanism, since it recognizes the large up-front risk taken by a developer by allowing (but not guaranteeing) reasonably high returns on investment in later years. Alternatively, a PUC could be required by law to abide by the provisions of an initial franchise agreement and to protect the integrity of that agreement against actions by other state and local government agencies.

#### *H. Antitrust Considerations*

Private operators, unlike public authorities, are subject to antitrust restraints. Therefore, business practices included in public airport agreements, such as majority-in-interest agreement clauses and landing-slot practices, might be subject to antitrust action if used by a private operator, especially if the operator or investor was an airline. This is a bias against private involvement, and could restrict a private operator's flexibility, thus decreasing the feasibility of enhancing private involvement. Overall, however, antitrust provisions would provide an additional protection to user groups and the travelling public, which is not applicable to the current public airport system.

#### *I. Sovereign Immunity*

In many jurisdictions the airport is considered to be a governmental unit and is not liable for actions deemed to be governmental functions. This is called "sovereign immunity" and results in reduced tort liability exposure for the airport. A possible consequence of enhanced private involvement, however, could be the loss of sovereign immunity protection where it now exists. It is possible, however, that with legislative action or a carefully arranged public-private partnership, the airport may be able to maintain at least a portion of the sovereign-immunity shield.

#### *J. Access to Tax-Exempt Financing*

One of the more significant economic barriers to private ownership is the different federal and state tax treatment of public and private debt. Unlike private projects, which are usually financed by a combination of corporate debt and private equity, publicly financed projects are usually financed with tax-exempt municipal debt. Because of its tax-exempt status, a public airport financed with airport revenue bonds can have interest rates up to two or three percentage points less than the total financing costs (debt and equity) of an identical privately owned facility; effectively, government-owned airports enjoy a roughly 30-percent federal subsidy on their cost of capital compared to the taxable, corporate finance alternative, although the ability of a private firm to depreciate and to deduct airport losses against other taxable corporate income could cut this gap roughly in half. Private equity is taxed at an even higher rate due to double taxation: first, the corporation pays taxes on its net income; then the

stockholder pays taxes on dividends or capital gain. By contrast, a deeply subordinated lien on a public facility (which might be roughly comparable to equity in terms of the risk its holders bear) is not taxed, except for state taxes paid by out-of-state bond buyers.

Although a private firm might have limited access to tax-exempt debt, it is probable that a significant portion of the facility would have to be financed with taxable debt.

Given higher financing costs, a private developer/operator would have to be more efficient in construction and operation than a public sponsor to offset the effective subsidy offered by the federal government to other levels of government. Although sophisticated tax depreciation and limited partnership structures can help to reduce the disparity in financing costs, this is not always possible.

As noted earlier in this report, there is evidence that private development of infrastructure can be accomplished faster and for less money than for a comparable public facility. The capital cost bias obscures the cost-saving potential of private development and means that America may be paying more than necessary for its infrastructure. Reducing the federal tax barriers to the private development of airport infrastructure should be given a high priority by the U.S. Congress.

#### *K. Potential Administrative Delays and Misunderstandings*

A final concern which has been raised by several prospective private developers and operators is the potential for administrative delays and misunderstandings. Some members of the federal, state, and local community are either opposed to private development or do not understand the requirements of successful public-private partnership. As a result, on several occasions, innovative public-private airport partnerships have been blocked or delayed by unwarranted interpretations of aviation laws and regulations, or by a lack of familiarity with the issues at hand. If the FAA intends to facilitate enhanced private involvement in airports, it should consider developing a clear policy statement promoting private involvement and outlining guidelines for future public-private partnerships. Moreover, it may also wish to consider establishing an office to advise and assist regional offices in how to advance public-private airport partnerships.

### **V. THE POTENTIAL FOR PRIVATE INNOVATION**

Although there have been a number of interesting proposals, innovative projects, such as wayports, cargo/industrial airports, and airbase conversions, have made only limited progress. These projects tend to have higher risk than traditional airport projects, which can make conventional financing difficult. Private equity, however, could facilitate financing by providing additional protection to debt investors and by demonstrating that the project is likely to be well utilized.

Without private equity at risk, there is the potential that "regional boosterism" would motivate development (as opposed to a genuine need for airport services). This could lead to low utilization and eventual default. Innovative projects could also require considerable real-estate development expertise and the aggressive marketing of airport services, which are areas of private sector strength. As a result, a significant private role could stimulate development of:

- × Wayports;
- × Cargo/Industrial Airports;
- × Military Airbase Conversions.

### *A. Wayports*

Wayports are airports used primarily for the transfer of passengers and cargo on connecting flights. Some likely uses of wayports include:

- × Domestic passenger transfer hub;
- × International long-haul transfers;
- × Transfer for mail, cargo, and package services;
- × Access for local passengers;
- × Use as centralized maintenance base.

Wayports have the potential to relieve congestion at urban airports currently handling these tasks. Unlike origin-and-destination (O&D) airports, which are dependent on local passengers, a wayport can be located in a rural setting, enjoying the advantages of low-cost land, lower labor costs, fewer neighbors (and thus fewer noise problems), and reduced air-traffic congestion. These advantages of wayports have been recognized in recent reports for the Transportation Research Board and the Federal Aviation Administration.

In certain cases a wayport located near a major metropolitan area served by a congested hub airport might be far more cost-effective than expanding the existing airport. The environmental impact report on the proposed expansion of the Dallas/Ft. Worth airport noted the possibility of such a wayport, which could bleed off much of the growth in transfer traffic. Similar possibilities exist for the congested Atlanta and St. Louis airports.

Entrepreneurs have begun serious efforts to develop wayports. One of the furthest-advanced projects is the proposed Aeroplex in Florida. Developer Robin Rockwell has obtained an option on a 35-square-mile parcel (currently a ranch) in the northwest corner of Martin County, north of West Palm Beach. He envisions development of a superhub airport, meeting the future growth needs of southeast Florida for both passenger and cargo traffic.

Another project which meets some definitions of a wayport is the planned Northwest Arkansas Regional Airport. An airport authority has conducted feasibility studies and picked a rural site for the proposed \$250 million airport in Benton County. Four major airlines in mid-1991 indicated interest in serving the airport if it is built. Cargo would be a major factor, and among the project's supporters are Wal-Mart, Tyson Foods, and J.B. Hunt trucking company, all of which have major facilities in the area.

### *B. Cargo/Industrial Airports*

Cargo and industrial airports offer the potential to serve industry's multimodal transportation needs and could be established with minimal public involvement, since cargo shipments entail fewer issues of broad public safety than passenger transportation. It is conceivable that a single large developer/user/operator could be responsible for the entire facility, charging other users market rates for use. Like wayports, cargo/industrial airports would serve to relieve congested urban airports.

The prototype cargo/industrial airport is Alliance Airport in Fort Worth, Texas, which opened for business in December 1989. Developed as a public/private partnership by the Perot Group, the 4,200-acre project consists of a city-owned airfield (on land donated by the

company) adjacent to a privately developed airport-industrial park. The airport complex is managed by Pinnacle Air Services, a division of the Perot Group. Its anchor tenant is a major American Airlines maintenance facility.

Several other cargo/industrial airports are in various stages of development. In Colorado, a private firm—CenterPort International—is developing the Front Range Industrial Airport in Adams County, near the site of the new Denver International. In North Carolina, Gov. James Martin has promoted a proposed Global Air Cargo Industrial Complex, which was recently sited at an existing under-utilized airport. A third project is under way in Kentucky: the Central Midwest International Airport, being developed by Central City Economic Development Corporation in a rural location.

### *C. Military Base Conversion*

The declining need for domestic defense bases opens up another potential for airport capacity expansion. Converting idle military air bases—many of which are located near large cities—to passenger facilities would obviate the vexing difficulties associated with airport siting, since these existing bases already have clear flight paths, sufficient land/runway space, and noise buffer zones. All that military bases lack is the capital and initiative to transform them into passenger facilities to serve as wayports or, for those bases located near large cities, as reliever airports.

Austin, Texas, for example, has decided to redevelop Bergstrom Air Force Base as its new airport, rather than proceeding with earlier plans for a greenfield site. And the city of Adelanto, California has proposed the privatized development of a major airport at what is now George Air Force Base; it would be called the High Desert International Airport.

## **VI. WORKING WITHIN THE CURRENT SYSTEM**

As discussed, there are significant barriers to enhancing private involvement within the current system. With the right approach, however, these barriers can be overcome, and significant benefits from enhancing privatization can be obtained. This section will discuss specific measures designed to address policy obstacles and protect the public interest, and provide a general outline of the approach for implementation.

### *A. Approach to Federal Policy Obstacles*

Current federal policy has been one of the major existing barriers to enhanced private involvement (although this may change). The proper organizational framework, however, can help to avoid many of the potential problems. Before beginning development of a specific implementation plan, a detailed legal review of federal policy will be necessary. Major objectives in organizing the public-private partnership include:

- × Retaining tax-exempt status for as large a portion of the facility as possible;
- × Providing the maximum discretionary revenues for the local government;
- × Providing the private sector with the maximum incentive for efficient and timely development and operation of the facility;
- × Ensuring travelers are provided ready, cost-effective access to air transportation;

- × Ensuring an adequate level of public oversight to meet federal requirements and ensure that public concerns are met.

Unfortunately, because current FAA policy has a bias against enhanced private involvement, any U.S. airport authority which desires to use enhanced private involvement faces a possible risk of administrative delays and punitive actions to block or delay the proposed enhanced private involvement. While this may be a genuine risk, it appears possible to work within the current federal guidelines to enhance private involvement and achieve most of the objectives outlined above if the potential policy barriers are identified in advance, and an appropriate response prepared. In light of the potential problems, it is important that this process be an integral component of the feasibility and implementation processes.

### *B. Protecting the Public Interest*

A public-private partnership is a cooperative venture between the government and the private sector, and should not be confused with transferring an existing operation to full private control. Even in partnerships in which the private partner manages day-to-day operations, the public partner can retain a considerable degree of control over policy and strategic decisions and have input on operations.

The primary instruments for public control are the franchise agreement and continuing regulatory oversight by a public airport board. The franchise agreement is the legal contract which authorizes the private sector to operate the facility and specifies ownership rights and responsibilities. The franchise agreement also defines how and to what extent the private developer/operator will be regulated. A clearly defined franchise agreement helps reduce uncertainty, limits the risk of constant intervention, and increases project feasibility.

Therefore, a successful public-private airport development process requires a clear division of control and responsibility. Areas of critical concern to the government should be spelled out clearly in the franchise agreement. In other areas, the private sector should be given control. In addition to the franchise agreement, the government can use negotiations over zoning approvals, state grants, and infrastructure improvements to obtain additional influence on the private developer.

### *C. Feasibility Assessment*

Prior to initiation of the implementation process, an initial feasibility assessment should be made of the costs and benefits of enhancing private involvement. Among the issues this assessment should address are:

- × Required airport capital expenditures;
- × Potential for improved operational performance, based on analysis and comparison of airport operating ratios;
- × Potential to take airport revenue "off-airport";
- × Approximate market valuation of airport;
- × Possible transitional process;
- × Possible impact of transfer on airport users, local community, airport employees, government revenues and expenditures;

× Other issues (need for local input, noise considerations).

Because it is impossible to determine the precise costs and benefits of privatization without going through the implementation process, the initial feasibility study should focus on whether there is sufficient chance of an overall benefit from enhanced private involvement to justify further implementation. If the initial steps in the implementation process indicate enhanced private involvement will clearly carry a net cost, then the process can be stopped at that point.

The feasibility assessment should also determine the major issues and barriers in enhancing private involvement. For example, if an airport has poor employee/enplaned passenger ratios (after adjusting for other factors such as the range of services provided by the airport), enhanced private involvement might lead to higher efficiency and reduced staffing levels. This would lower airport costs, but would also potentially threaten current airport employees' jobs. To limit possible adverse impacts on airport employees and reduce a possible source of resistance, it might be necessary to provide a measure of job security for current employees. If so, this should be planned for in the implementation process. Once the major issues are outlined, an implementation plan can be developed to maximize benefits and reduce costs.

#### *D. Implementation*

The move from the planning to the implementation phase of a public-private partnership brings on a more complicated set of problems, as the cooperation among government agencies cannot be guaranteed. A good implementation plan, however, can help overcome the resistance of non-contract parties. An airport partnership arrangement will follow a development process similar to other types of public-private partnerships. The steps in this process are briefly reviewed below:

- 1.If necessary, the state legislature passes legislation authorizing the use of public-private partnerships on existing facilities, or the private development of new facilities. In any case, the local government passes a similar initiative to support the process.
- 2.A government agency or prospective private developer identifies an unmet need. Private firms submit initial qualifications and proposals to the agency, demonstrating their financial capabilities and record of performance.
- 3.The sponsoring government agency is identified, and a partnership mechanism is created to oversee the negotiation of the partnership and its implementation. The sponsoring government agency is identified.
- 4.Broad specifications for a future facility or the expansion of an existing facility are agreed upon by the public and private partners, acting through the partnership mechanism.
- 5.Initial engineering and financial feasibility are demonstrated by the private developer; environmental review is conducted by the private developer or by the sponsoring government agency.
- 6.The public and private parties negotiate the terms of an initial agreement which specifies the responsibilities of each party and the timetable for action.
- 7.The detailed proposals are accepted or modified by the sponsoring public agency in the public-private negotiations and are incorporated into a final agreement. Mechanisms for design standards, price/return regulation, insurance



and tort liability, and dispute resolution are also incorporated.

8.The developer (with or without the assistance of the public sponsor) obtains start-up financing and begins the permitting and detailed design phase of the project.

9.Construction and/or takeover financing is arranged, construction completed, and the facility is opened under private ownership.

10.The facility operates under the standards detailed in the final agreement. Fees are paid and, if so agreed, profits are shared or limited according to the agreement.

11.Modifications to the existing facility or to service levels are made periodically and prior approval is granted by the sponsoring or governing public body. The agreement may be periodically reopened to account for changes in circumstances.

## **VII. CONCLUSION: IMPROVING THE SYSTEM—ISTEA OF THE AIRWAYS?**

The Federal Aviation Administration has created several artificial barriers to privatization that are not supported by reasonable interpretations of the law. For example, the FAA has continually expressed concern that private ownership, and specifically the earning of profits by the private airport owner, would amount to taking revenue "off airport" in violation of the Airport and Airways Improvement Act of 1982, and that allowing airports to earn a profit would lead to the decapitalization of American airports.

In making that argument, however, the FAA has drawn an unjustifiable distinction between payments to one type of capital (debt), and payments to another type of capital (equity). This distinction can be found nowhere in aviation law. Moreover, the FAA has clearly permitted payments on invested capital through its allowance of interest payments on debt. In fact, many forms of debt look and act very much like equity, with deep subordination to more senior lien holders and interest payments that vary with the profitability of a project.

This treatment of private equity is particularly inappropriate because profit is not an "extra" cost of doing business; it is a payment to capital just as interest is a payment to debt capital. Profits are higher or lower (or nonexistent) depending upon the managerial success of the owners who have invested that capital. Further, without a provision for a return on capital, investors have no incentive to invest. Given the level of financing the national air transportation system will require for expansion, the FAA's policy against returns on capital is inappropriate.

As for the FAA's fears that private developers will earn unreasonable profits, virtually all infrastructure privatization projects developed around the world are economically regulated either by limiting rates and charges, or by the allowable rate of return to investors. This regulation is intended to recognize the level of risk taken by providers of equity capital and to reward them (if they are successful) with an acceptable, but not excessive return. Similar requirements that limit private airport developers to "reasonable" returns could be readily incorporated into airport partnerships if necessary.

The current FAA restriction on airport profits, and other obstacles to privatization created by the FAA, stand in sharp contrast to the April 30, 1992 Executive Order on Privatization, and to the National Transportation Policy's avowed support of greater private investment, ownership, and operation of the nation's transportation infrastructure. They also stand in contrast to initiatives taken by other Department of Transportation agencies, including the

former Urban Mass Transportation Administration and the Federal Highway Administration (FHWA).

In 1991, FHWA drafted a new highway bill which included several provisions to encourage private development and ownership of toll roads and bridges. These and other privatization provisions were adopted by Congress in the Intermodal Surface Transportation Efficiency Act (ISTEA) of 1991. Among the most important provisions were provisions that allowed federal-aid funds to the states to be used for up to 50 percent of the cost of a private toll road and up to 80 percent of the cost of a private toll bridge. This money can be given to the private developer as either a grant or subordinated loan. The private firm must have an agreement with the government agency that receives the grant, and the private firm's profits will be limited to a reasonable return on investment.

The ISTEA of 1991 is a precedent worth following in aviation policy, especially since AIP grants can already be made to privately owned airports in a manner similar to that embodied in ISTEA. Listed below are five steps the FAA could take to align itself with both the administration's policy and a more supportable interpretation of aviation law:

- × First, the FAA could issue a policy statement consistent with the recent Executive Order and with the National Transportation Policy's support for private investment in infrastructure. Explicit federal support is important to local decision makers and would improve airports' ability to attract private capital.
- × Second, the FAA could establish clear principles for valuation, management, repayment of prior federal investment in local airports, and for valuing local governments' investments in their airports and permitting them to recover that investment. Though the situation has been greatly ameliorated by the recent Executive Order, some uncertainty remains over what is required and the terms of repayment, which makes it difficult for a private investor or local government to make an informed decision on privatization.
- × Third, the FAA could recognize in its discretionary grant policy the net federal revenue benefit of private ownership of airports (with taxable corporate debt and equity financing) compared to public-ownership and tax-exempt debt financing. Because of these revenue consequences, the federal government has a compelling financial interest in privatization.
- × Fourth, the FAA could draft legislation similar to ISTEA to encourage private involvement in airports by reducing legal discrimination against private involvement, such as by permitting private airports to receive entitlement grants if the private sponsor agrees to certain conditions (such as being limited to a reasonable rate of return on investment).
- × Finally, the FAA could, as has the FHWA with the ISTEA, defer to the state or local level the full decision-making authority to enter into privatization and public-private partnership agreements, leaving the FAA with the discretion to decide *whether* federal-aid guidelines are being met by the government sponsor of the airport, but not *how* they are met.

These five steps are neither radical nor unprecedented. If implemented they would simply align FAA policy with the recent Executive Order and the National Transportation Policy. Implementation would not require congressional action. Implementation is feasible, and would significantly advance private involvement in airports. In addition to the steps the FAA could take to facilitate enhanced private involvement, the U.S. Congress could also facilitate enhanced private involvement by drafting and passing airport legislation similar to the 1991 ISTEA. If the national air transportation system is to benefit from the full capabilities of the private sector, it will require government action to enhance private involvement at the federal, state, and local levels.

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