Policy Study No. 194
August 1995

HOW TO PRIVATIZE ORANGE COUNTY'S AIRPORTS

by
Robert W. Poole, Jr.

EXECUTIVE SUMMARY

The sale of assets, including John Wayne Airport, has been discussed as part of the solution to Orange County's fiscal woes. But the County faces a dilemma with regard to the potential sale of John Wayne, for two reasons. First is the potential of serious competition from a future airport at El Toro, which might drain business prematurely from John Wayne, threatening its financial viability. Second is the likelihood of litigation by the airlines, who contend that a municipality may not legally make use of the proceeds from the sale of an existing federally aided airport.

This study identifies several different types of airport privatization (contract management, lease, and sale) and outlines the legal status of each, with respect to federal grants and constraints. The nexus of federal control is the grant agreement between an airport receiving federal grants and the grant-making agency, the Federal Aviation Administration. In the absence of such an agreement, there is no restriction on the use of airport revenues or privatization proceeds. Moreover, a privately owned airport is eligible to receive the principal type of federal grant used in airport development (discretionary grants). Airports privatized via lease and contract management are eligible for all types of federal grants.

The solution to Orange County's apparent dilemma is therefore to use two different types of privatization, in a coordinated fashion. The County should seek a single firm that will enter into two separate agreements: 1) a long-term contract to manage John Wayne Airport; and 2) a purchase or lease agreement under which the firm will develop a commercial airport at El Toro. Development of the latter will be closely coordinated with future activities at the former, to ensure the continued financial viability of John Wayne Airport through the years needed to retire its outstanding bonds.

This approach will permit Orange County to receive sales proceeds or lease payments from the private developer of the El Toro airport. It will also permit such an airport to be financed and developed, independent of the County's impaired fiscal condition in the wake of its bankruptcy. It avoids all gray areas in federal aviation law, thereby minimizing the risk of litigation. Ideally, it should also win the support of the airlines, as offering a lower-risk way of bringing about the timely development of the El Toro airport.

I. BACKGROUND: ORANGE COUNTY'S APPARENT DILEMMA

Orange County's bankruptcy has made the concept of asset sales particularly attractive. A previous Reason Foundation report identified some $1.0-1.5 billion in County-owned assets and another $2.5 billion in assets owned by water and sanitation districts.[1] Selling assets would generate up-front cash, as well as putting the assets onto the property tax rolls, thereby expanding the County's tax base.

A number of public officials have identified John Wayne Airport as a potentially attractive asset for these purposes. With its busy flight activity and modern terminal, it appears to be a profitable business enterprise that would attract potential buyers, such as those firms active in airport ownership and operation in this country and overseas.

Closer examination, however, reveals several factors that limit the attractiveness of John Wayne to a potential buyer:

- A legally binding Settlement Agreement limits the annual passenger volume to significantly less than the airport's unconstrained demand.
- The airport's single, relatively short runway further limits its growth potential.
- It is surrounded by built-up, high-value land, which both limits its possible physical expansion and guarantees continued political opposition to growth in its flight operations.
- The airport's concessions areas are relatively well-developed; there is only limited potential for expanding them.
- The airport appears to be run reasonably efficiently.

Taken together, these factors would limit the potential for a private operator to significantly increase revenues or decrease operating costs. In addition, John Wayne Airport has a relatively high debt level, and its bond covenants call for the redemption of this outstanding debt in the event of an ownership change.

Another major problem is the potential adverse impact of John Wayne Airport on the future development of a new commercial airport at the El Toro air base. Any private firm buying John Wayne would face huge and unquantifiable uncertainty over the extent to which this competing airport would siphon off business as it developed. Such revenue losses might make it difficult or impossible to meet John Wayne Airport's debt-service needs. Hence, raising the capital to acquire it would be difficult or impossible as long as this large risk factor remained unaddressed.

It was for these reasons that the previous Reason Foundation report recommended the privatization of the two airports—John Wayne and El Toro—as a package, to a single acquiring entity. As noted in that study,

> *The two-airport* ***system*** *would be highly attractive to private airport firms, with extensive runway capacity already in place [in both locations], the ability to develop terminal facilities in a cost-effective phased-in manner, and extensive real-estate development potential. Under unified ownership, we could expect the orderly development of El Toro into a world-class airport offering transcontinental and trans-Pacific service, with John Wayne's role gradually shifting to short-haul, commuter, and general-aviation flights.*

---

[1] Robert W. Poole, Jr., "Rescuing Orange County," Policy Study No. 186, Los Angeles: Reason Foundation, February 1995.

But even though the logic of this scenario appears compelling, there are significant legal uncertainties. When the Board of Supervisors considered issuing a Request for Qualifications for John Wayne Airport in April, the airlines (via their trade organization, the Air Transport Association), threatened to sue. The legal basis for their promised suit would be the claim that federal law prohibits the use of "airport revenue" (arguably, including sale proceeds) for nonairport purposes. If this interpretation were sustained in court, the County would be unable to make use of the proceeds of a sale for general purposes, thereby defeating its main purpose in privatizing the airport.

Even if contrary legal interpretations (discussed below) turned out to be correct, it might take years of litigation to establish that point, thereby preventing any financial benefits to the County (and incurring significant legal expenses) for a number of years. Thus, by the time of the June election on Measure R, many officials (including the Airport Revenue/Sale Task Force[2]) had concluded that airport privatization could not contribute to solving the County's fiscal problems.

This report sets out to challenge that conclusion.

II. DIFFERENT FORMS OF AIRPORT PRIVATIZATION

To understand how privatization can best be applied to the Orange County airport situation, the first requirement is to understand the various modes of privatization that apply to airports.

A. Existing Airports

There are three principal modes of privatization that can be applied to an already-operating airport such as John Wayne. In order of increasing reliance on the private sector, they are: a) contract management; b) long-term lease; and c) sale.

1. Contract Management

Many types of municipal facilities are being operated by private contractors via management contracts. Convention centers, data-processing centers, golf courses, jails, sports arenas, and wastewater plants are among the facilities now routinely contracted out by city, county, and sometimes state governments. Governments use the competitive process to stimulate greater efficiency in the operation of these facilities, since a firm must rethink the way it does business in order to be competitive in winning an operating contract.

Typically, in a facility management contract, the operating budget is proposed by the contractor and approved by the government; funds needed for budgeted items are appropriated by the government and passed through to the contractor. Fees and charges are paid by users to the government agency, not to the contractor. The contractor receives a management fee from the government agency, which may be based in part on the contractor's performance. The facility's employees and managers work for the contractor, not the government.

A number of U.S. airports are operated by contractors. Table 1 lists the five air-carrier airports under contract management as of mid-1995. Also listed are a number of general-aviation airports managed by contractors, including the five general-aviation airports in Los Angeles County.

2. Long-Term Lease

A long-term lease is quite different from a management contract. Generally, a lease is used in preference to a contract where significant airport development is anticipated. The aim is to shift a significant portion of

[2] "John Wayne Airport Revenue/Sale Task Force," Santa Ana: County of Orange, June 1995.

the risks (and rewards) of development away from the taxpayers and to the private-sector lessee. The term of the lease is often related to the length of time needed by the private operator to recover its investment in new facilities. A lease arrangement transfers the principal responsibility for airport operations and development to the private lessee. Hence, unlike the management contract case, in a lease situation airport users pay fees and charges directly to the lessee, and the lessee must cover its operating and capital costs out of those revenues (and hope to have enough money left over to show a profit).

Table 1: U.S. Airports Managed by Private Contractors	
Airport	Contractor
Air-Carrier Airports	
· Albany, NY	· Airport Group International
· Burbank, CA	· Airport Group International
· Indianapolis, IN	· BAA, USA
· Stewart, NY	· Airport Group International
· White Plains/Westchester Co., NY	· Johnson Controls World Series
General Aviation (GA) Airports	
· Alliance Airport, Fort Worth, TX	· Pinnacle Air Services
· Brackett Field, LaVerne, CA	· COMARCO, Inc.
· Capital City Airport, Fairview, PA	· Johnson Controls World Services
· Compton Airport, Compton, CA	· COMARCO, Inc.
· Danielson Airport, Killingly, CT	· Executive Air Service
· El Monte Airport, El Monte, CA	· COMARCO, Inc.
· Peru Municipal Airport, Peru, IN	· Miami County Air Services
· Fox Airfield, Lancaster, CA	· COMARCO, Inc.
· Republic Airport, E. Farmingdale, NY	· Johnson Controls World Services
· Whiteman Airport, Pacoima, CA	· COMARCO, Inc.

The typical lease agreement provides for a lease payment to the government based, in part, on a percentage of the airport's gross revenue. This gives the government an incentive to work cooperatively with the lessee, since the government will share in the proceeds. But this arrangement also gives the lessee an incentive to minimize costs, so that it can maximize the difference between gross revenue and costs. And since the lessee is responsible for capital investment in the airport, it will have strong incentives to add only that amount of runway or terminal capacity that will produce an acceptable return on its investment.

Several small air-carrier and large general-aviation airports in the United States are currently leased to private firms, as noted in Table 2. A number of other airports have been leased by municipal governments to independent public authorities; a principal example is the lease by the cities of New York and Newark of Kennedy, LaGuardia, and Newark airports to the Port Authority of New York and New Jersey.

Table 2: U.S. Airports Leased to Private Sector			
	Airport	Lessee	Operator
86	Atlantic City, NJ	Johnson Controls World Services	Johnson Controls World Services
86	Bader Field, NJ	Johnson Controls World Services	Johnson Controls World Services
82	Morristown, NJ	D.M. Airport Developers	D.M. Airport Developers
84	Rickenbacker, OH	Turner Construction	Lockheed Air Terminal
70	Teterboro, NJ	Johnson Controls World Services	Johnson Controls World Services

3. Sale

Worldwide, the most common mode of airport privatization is the sale of either a part-interest or the entire airport. Governments generally sell airports as part of an overall program of divesting themselves of noncore businesses, using the proceeds either to reduce outstanding debt or for investment in other needed infrastructure. This was the motivation for the British government's 1987 sale of the British Airports Authority and the planned sale of the airports belonging to Australia's Federal Airports Corporation.

In some cases, governments sell only a majority interest, retaining some fraction of ownership and therefore a direct voice in airport management. Liverpool, England sold a 76-percent interest in its airport to a single strategic investor, British Aerospace. Several other British cities are planning similar sales of majority interests.

Some other countries are thus far selling only minority interests. Austria has sold 47 percent of Vienna International; the proceeds are being used for airport expansion. Denmark sold 25 percent of the Copenhagen Airport in 1994, and airport authorities in several other European countries are considering similar sales of minority stakes. Table 3 summarizes the status of airport sales worldwide as of end-1994.

Table 3: Airport Sales Worldwide

Country	Airport/City	Type	Status
Current Airport Sales Activity			
Argentina	Buenos Aires	Sale or lease	Planned
Austria	Vienna Vienna	Minority (47%)	Occurred
Australia	Federal Airports Corp.-23 airports	Divestiture	Planned
Czech Republic	Pardubice	Divestiture	Occurred
Denmark	Copenhagen	Minority (25%)	Occurred
Italy	Rome Milan	Divestiture Divestiture	Planned Planned
Malaysia	Airports Corp.	Divestiture	Planned
New Zealand	Auckland	Divestiture	Planned
Panama	Commercial airports	Sale or Lease	Planned
Peru	Lima	Divestiture	Planned
United Kingdom	BAA (7 airports) Liverpool East Midlands Prestwick Belfast Coventry Birmingham 24 local airports	Divestiture Majority Divestiture Re-sold Divestiture Divestiture Majority Majority	Occurred Occurred Occurred Occurred Occurred Occurred Planned Planned
Airport Sale Proposals Under Study			
Belgium	Brussels Airport Terminal Corp.	Divestiture	Under Study
France	Aeroports de Paris	Minority	Under Study
Germany	Berlin Brandenberg Airport Hold. Dusseldorf airport Cologne/Bonn airport	Divestiture Divestiture Divestiture	Under Study Under Study Under Study

Table 3: Airport Sales Worldwide			
Country	Airport/City	Type	Status
Current Airport Sales Activity			
Ireland	Aer Rianta (3 airports)	Divestiture	Under Study
New Zealand	Christchurch airport	Divestiture	Under Study
	Wellington airport	Divestiture	Under Study
Philippines	Manila Int'l Airport Authority	Divestiture	Under Study
Russia	70 Aeroflot airports	Minority	Under Study
Spain	Aeropuertos (5 airports)	Partial	Under Study

Thus far, although a number of U.S. cities have considered the idea of selling their airport, none has actually done so.

B. New Airport Capacity

New airport capacity may be developed privately in two ways. The more conventional is via the government granting of a long-term franchise (called a "concession" in most other countries), at the end of which the airport (or terminal) reverts to government ownership. This type of transaction (which sometimes involves some financial participation by the government) is a kind of public-private partnership. The other approach is for the private sector to develop an airport entirely on its own, subject only to the planning permissions required (airspace approval by the national aviation authority, local land-use regulations, etc.). In effect, the airport company has what amounts to a perpetual franchise, though there may not be an actual agreement to that effect (any more than there is for an investor-owned steel mill).

1. Long-Term Franchise (BOT or LDO)

Around the world, long-term franchises for infrastructure facilities are usually referred to as BOT projects, because under this type of contractual agreement the private sector builds, operates, and eventually transfers to government the facility in question. When a lease of the underlying land is involved, this type of arrangement is sometimes called Lease-Develop-Operate (LDO); in this case the "transfer" back to government is implicit, since the lease has a fixed number of years.

The BOT approach is widely used for several reasons. First, it taps into a different pool of capital than is normally available for public infrastructure projects, thereby expanding the range of potential funding sources. Second, private consortia are often able to design and build large facilities in significantly less time than is possible via traditional government procurement methods. Third, both the up-front cost and the operating costs may be lower in a facility that is designed, built, and operated by a single team interested in long-term profitability. Fourth, BOT is a way of shifting many of the risks of project development from the public sector to the private sector.

For these reasons, airport BOT projects have proliferated in recent years. As of 1994, there were 16 airport BOT terminal or runway projects under way worldwide, and another five projects to develop entirely new airports. In addition, another 13 such projects were under study.[3]

No airport BOT project has yet occurred in the United States, but Transport Canada used this process to develop the successful international terminal (Terminal 3) at Toronto. Many U.S. airports have used something resembling an LDO process to develop new terminals sponsored by either one or a group of airlines, which gain exclusive control of the gates in that terminal. But this type of project raises important competition and access issues that do not arise when the developer/operator is an independent third party which relates to all airlines equally as users (as is the case with BOT terminal projects worldwide).

[3] John O'Leary (ed), *Privatization 1994*, Los Angeles: Reason Foundation, April 1994.

2. *Perpetual Franchise*

The number of fully private air-carrier airports (as opposed to small general-aviation fields) is quite small. Among those currently in operation are the London City Airport (a short/medium-haul airport in the Docklands area near the financial district), the Freeport airport on Grand Bahama island in the Caribbean, and the Punta Cana airport serving a resort area in the Dominican Republic. Hawaiian Airlines built and operated a small commercial airport in West Maui, Hawaii in the 1980s, but turned it over to the state as unprofitable several years later.

Several entrepreneurial private airport proposals have been made in the United States, several of them as potential “wayports”—freestanding hub airports aimed primarily at transferring passengers from one flight to another (and therefore not linked to a city's origin/destination market). One of the best-known is the proposed Aeroplex, planned to occupy 22,500 acres in northwest Martin County, on the east coast of Florida. Its developer received airspace clearance from the Federal Aviation Administration in 1991, but as of early 1995 development had not begun.

C. Military Base Conversions

Over 100 major military bases are expected to be closed during the 1990s, including the El Toro base. Many of these are airfields, and quite a few are in or near urban areas.

The general procedure for federal disposal of surplus bases is that if no other federal agency needs the property, the local government has first claim on it; under certain conditions, the municipality may be able to obtain it at no charge. In the case of air fields, if the Federal Aviation Administration recommends the site for airport use, the property may be given to the local government for that purpose. Without such a recommendation, the municipality may buy the base or arrange for a private firm to purchase it.

A number of military bases have been or are being converted to civilian airport use. Orlando International Airport is the former Strategic Air Command McCoy Air Force Base, converted in 1974. In New Hampshire, the former Pease AFB became a civilian airport, Pease International Tradeport, in 1991. Scott AFB, 15 miles east of St. Louis, is becoming Mid-America Airport. And in Austin, Texas, officials abandoned a greenfield site for the city's new airport when Bergstrom AFB became available; the base is now being redeveloped as the replacement for Austin's outmoded air-carrier airport.

Either an outright sale or a long-term lease or franchise would be suitable for converting a military airfield to a civilian airport. Instead of attempting the complex task of developing, financing, and managing the airport project itself, the base-redevelopment authority can seek competitive proposals from private-sector consortia. In this way, not only can the professional expertise of world-class firms be brought to bear, but much of the risk involved in new-airport development can be shifted from taxpayers to investors.

III. LEGAL ISSUES IN AIRPORT PRIVATIZATION

A. Federal Grant Eligibility

Under the Airport & Airway Improvement Act of 1982 and subsequent amendments, the Federal Aviation Administration (FAA) makes grants to air-carrier and general-aviation airports. Air-carrier airports receive *entitlement* grants based on a formula related to annual enplanements. They and other airports may also apply for *discretionary* grants for specific projects, in competition with other airports.

Airports accepting federal airport grants (generally known as AIP grants, meaning Airport Improvement Program grants) must sign contractual grant agreements with the FAA. Under the terms of those agreements, the recipient (the airport “sponsor”) must provide assurances that the airport be open to all users on a non-discriminatory basis, that airport charges be fair and reasonable, and that “all revenues

generated by the airport" must be used only for airport (or airport-system) purposes. It is well-established in federal law that the FAA's control over such economic issues as airport access and charges stems from the grant agreements. If an airport did not make use of federal grants, the FAA's jurisdiction would be limited to safety and air traffic control issues only.

How does privatization affect grant eligibility? Under contract management, the government which owns the airport remains the sponsor, and the airport remains eligible for the same types of grants for which it was eligible when managed directly by the municipality. Likewise, under most forms of long-term leases and BOT arrangements, the government which remains the airport owner would remain the airport sponsor, so grant eligibility would be unchanged.[4]

With respect to an airport sale, in which the airport becomes privately owned, post-1982 federal law permits discretionary and noise-related grants to be made to privately owned airports, but entitlement grants are not permitted. Thus, an airport can be owned by the private sector and operated by it for profit and still receive federal grants for capital projects (though it must compete for such grants against other airports).

To sum up, air-carrier airports can receive discretionary and noise related grants under any form of privatization, but if privately owned, cannot receive entitlement grants. Entitlement grants are a relatively small component of the revenue of large and medium airports, but can be significant for smaller air-carrier airports.

B. Lease or Sale Proceeds

The 1982 Act which provides for airport grants contains the above-noted clause about the nondiversion of "revenues generated by the airport." The legal question is whether payments made to a government for the purchase or lease of an airport constitute airport revenues in the sense meant by these words in the statute.

This question has been examined by several legal experts who have concluded that such payments are not airport revenues and hence are not prohibited by the Act. These include former U.S. Transportation Secretary Jim Burnley[5] and former FAA Chief Counsel E. Tazewell Ellett.[6] One of the most detailed assessments was carried out by the law firm of Skadden, Arps, Slate, Meagher & Flom for the City of Los Angeles in 1992.[7] The Skadden Arps assessment concluded that current federal law permits the sale or lease of a municipal airport to a private firm, and that a privatized airport would be eligible to receive federal grants, as outlined in the previous subsection.

What about the proceeds from such a transaction? With respect to a sale, Skadden Arps concluded that a municipality would be able to use sale proceeds for general purposes because the term "airport revenues" as used in the Act refers to *operating* revenues, not the one-time proceeds from an asset transaction. This would be consistent with: 1) the legislative history of the 1982 Act; 2) accounting definitions; and 3) the

---

[4] Although the FAA raised questions about the 1990 proposal by Albany County, New York for a long-term lease of its airport to a private consortium, it did not maintain that such a lease was per se in violation of the grant agreements. Indeed, grants continue to flow to airports leased to the private sector, such as Atlantic City and Morristown.

[5] Jim Burnley, Jim Pitts, and Karen Grubber, "Legal Analysis and Policy Review Pertaining to Public/Private Partnership for Commercial Airports," Washington, D.C.: Winston & Strawn, March 24, 1993.

[6] E. Tazewell Ellett, "FAA's Airport Privatization Policy: Past, Present, and Future," *Public Works Financing*, October 1992.

[7] Karen J. Hedlund and John P. Giraudo, "A Legal Memorandum to John F. Brown Company, Inc. Regarding Federal Restrictions on Transfer of Airport Revenues and Sale or Lease of Airport Property," Los Angeles: Skadden, Arps, Slate, Meagher & Flom, June 12, 1992.

FAA's own AIP handbook, which states that “Airport revenue does not include proceeds from the sale of real property owned by the sponsor.”[8]

With respect to lease payments, Skadden Arps notes that the FAA Compliance Manual already provides for the lease of entire airports. Not noted by Skadden Arps is the fact that lease payments being made by private lessees in the case of airports such as Atlantic City and Morristown are going “off the airport” today, to the general funds of the underlying government owners.

Former DOT Secretary Jim Burnley and his colleagues also conclude from the legislative history of the Act that the term “airport revenues” refers to operating revenues of the airport itself, not to other flows of money such as revenues received by airlines and concession operators or lease or sale payments made to the municipality. They also conclude that in the event of the sale or lease of an airport, there is no requirement in law that previous federal grants must be repaid. Indeed, they point out that it would be inconsistent with the continued federal oversight via an ongoing grant agreement to require that grants be repaid (if there is no grant money at stake, then there is no basis for a grant agreement).

President Bush's Executive Order No. 12803 (April 1992) was intended to remove federal barriers to the lease or sale of federally aided infrastructure facilities, including airports, by state and local governments. It directs the federal agencies which have made such grants (e.g., the FAA) to approve such requests. The only conditions attached to such transactions are that: 1) the proceeds from the sale or lease be used in accordance with the provisions spelled out in the Order (and with pre-existing federal law); and 2) that some sort of mechanism (either market, contract, or regulatory) be in place to ensure that the facility continues to be used for its original purpose and that user charges will be structured so as to protect users from abuse.

In 1994, President Clinton issued Executive Order 12893 on Principles for Federal Infrastructure Investment. It specifically directs each agency with responsibility for transportation, water, energy, and environmental facilities to “seek private-sector participation in infrastructure investment and management” and seek to work with state and local governments to “minimize legal and regulatory barriers to private-sector participation.” It also endorses market pricing for infrastructure and sound cost-benefit analysis. E.O. 12893 supplements and reinforces E.O. 12803; it does not supercede it.

C. Existing Bonds/Tax-Exemption

A change in the ownership (sale) or de-facto ownership (long-term lease) may affect the status of existing bonds used to construct a portion of the airport. In most cases, these bonds will have been issued by the municipality on a tax-exempt basis. Most airport bonds are revenue bonds (secured solely by airport revenues), though some may be general-obligation bonds (secured by the general taxing powers of the issuing government).

If privatization via sale or lease is contemplated, the bonds themselves must be reviewed to determine if there are any provisions that restrict the use of revenues or require the bonds to be defeased or redeemed in the event of a sale or lease. (Such provisions do exist in John Wayne Airport's bonds.) Even in the absence of such provisions, the bond language may require that the bonds satisfy IRS requirements as to tax-exemption. Having to defease or redeem the bonds may not prevent a sale or lease from taking place, but may affect its cost and therefore its financial feasibility.

Another factor to consider is the IRS itself. Thanks to a recent change in its procedures, the IRS is now able to consider requests to retain the tax-exempt status of bonds when the facility which they have financed is sold or leased (assuming bond covenants permit). In 1993, the agency issued Revenue Procedure 93-17, which allows interest on outstanding bonds to continue to be tax-exempt when the facility is sold or leased, if certain other conditions are met. The most important of these is that the

[8] “FAA Airport Improvement Program Handbook,” Order 5100.38A, Washington, D.C.: Federal Aviation Administration, 1989, p. 73.

disposition proceeds (i.e., the lease or sale payments) must be used in an alternative manner that would have qualified for tax-exempt status. Devoting the proceeds to other public-works investment, for example, would be one such purpose. In addition, the facility must continue to be used for its original purpose for at least five years, and the new owner or lessee must transact business with the original government owner on an arms-length basis and for fair-market value.[9]

Hence, provided that neither state law nor the bond covenants prevent it, existing tax-exempt airport bonds may remain in existence (and tax-exempt) following the sale or long-term lease of an airport.

D. Access to Future Tax-Exempt Bonds

The difference in interest rates between taxable and tax-exempt bonds is in the vicinity of 200 basis points (e.g. two percentage points).[10] In financing airport expansions, that difference in interest costs can lead to major differences in debt-service expenses. Thus, airport users would benefit from the availability of less-expensive debt, other things being equal.

Under contract management, capital expansions are the responsibility of the government owner of the airport, which can make use of tax-exempt bonds. Under long-term lease arrangements, it is generally possible for the government owner to issue tax-exempt revenue bonds on behalf of the private lessee or franchise-holder, with project revenues earmarked for debt service. (This is simply a variant on the common method of financing airline maintenance facilities and terminal buildings, in which the municipality or airport authority issues revenue bonds on behalf of the airline(s) committing to use the facility for a long-term period.)

Under current federal and state tax law, it appears difficult or impossible for tax-exempt bonds to be issued for an airport which is owned and operated by the private sector. As a matter of public policy, this lack of a “level playing field” between public and private ownership is likely to skew the choice between public and private ownership, though it might not prevent full private ownership in certain cases of high profit potential.

E. Surplus Property Disposition

The disposition of surplus government property for use as public airports is governed by subchapter II of 49 USC 471, which provides for the transfer of surplus properties to state or local governments at no cost, so long as those properties are used for airports serving the public. The FAA has adopted regulations that impose language similar to that contained in grant agreements, requiring that all “airport revenues” from such airports be used only for airport purposes. Opponents of airport privatization argue that this language would prohibit a government such as Orange County from selling or leasing a property such as El Toro to an airport firm and using the proceeds for general governmental purposes.

The Secretary of Transportation has discretion under 49 USC 47153 to release the state or local government from any of the conditions spelled out in the statute, if such a waiver is considered by the Secretary to be “necessary to protect or advance the civil aviation interests of the United States.” Thus, if the Secretary concludes that privatization of former military bases to create new airport capacity is in the public interest, he has the legal discretionary authority to approve such privatizations.

F. Anti-Head Tax Act

---

9 Karen Hedlund, “New IRS `Change-in-Use' Rule Protects Bonds Issued to Finance Privatized Governmental Assets,” Los Angeles: Skadden, Arps, Slate, Meagher & Flom, March 29, 1993.

10 The discriminatory effects of federal tax law on privatization of infrastructure, and potential reforms to create a more-level playing field, are discussed in Robert W. Poole, Jr., “Revitalizing State and Local Infrastructure: Empowering Cities and States to Tap Private Capital and Rebuild America,” Policy Study No. 190, Los Angeles: Reason Foundation, May 1995.

One other relevant federal law is the Anti-Head Tax Act (49 USC Sec. 40116). This act makes it illegal for a public agency to charge a tax or fee on a per-person basis in air transportation. It was modified in 1990 to permit the affected airports to levy a passenger facility charge (PFC) of up to $3 per person, subject to approval by the FAA of both the amount and duration of the charge and the uses to which the proceeds are put. Since the FAA may withdraw its approval of an airport's PFC at any time, airports have been unable to issue bonds backed by a PFC-based revenue stream.

For purposes of this discussion, the most important point to note is that privately owned airports are exempt from the Anti-Head Tax Act. Thus, were El Toro to be sold to a private airport developer, that firm would have access to a bondable source of revenue unavailable to government-owned airports.

IV. STRUCTURING AIRPORT PRIVATIZATION IN ORANGE COUNTY

The legal analysis in Section III pointed out that privately owned airports can receive two of the three types of federal airport grants, and that airports either leased to or managed by private firms (but still owned by a government entity) can receive all three types of federal airport grants. It also noted that existing tax-exempt bonds can remain in existence with their tax exemption intact in the event of a change of ownership, unless bond covenants prevent this (as they do in the case of John Wayne), and that privately managed or leased (but not owned) airports can access the tax-exempt bond market to finance new facilities. These points are not in dispute.

Section III also showed that there is sound legal opinion that an airport leased or sold to the private sector need not repay previous federal grants, and that the proceeds from such transactions are not “airport revenue” within the meaning of federal airport-grants law—and hence may be used for general governmental purposes by the government which sells or leases the airport. These points, however, are disputed by the airlines and would almost certainly be litigated were Orange County to seek to sell or lease John Wayne Airport.

How, then, could Orange County structure airport privatization to avoid costly litigation and still achieve its goals of: 1) ensuring the future development of needed airport capacity; and 2) receiving cash from its airports to assist with its fiscal crisis?

The solution is to structure a pair of privatization transactions, each of which avoids legally disputable territory. John Wayne Airport would be privatized via a long-term management contract. El Toro would be sold or leased. *And, to ensure coordinated development and operation of the two-airport system, the same firm would be selected for both transactions.*

In other words, Orange County would issue an RFP requesting qualified parties to submit a pair of proposals, one for the John Wayne management contract and the other for the purchase or long-term lease of El Toro. The winning bidder would be the firm that offered the best overall proposal for coordinated airport development and operation, with a reasonable return to County coffers.

This approach avoids all the legal gray areas. There is no legal uncertainty about contracting out the management of John Wayne Airport; this is no different from what is now being done at Burbank (and more recently at Indianapolis). The only new ground being broken would be the length of the contract, which would be sufficiently long to permit the retirement of John Wayne bonds (hence, in the vicinity of 20 years). The longest-duration U.S. airport management contract to date is the 10-year contract currently being negotiated for Indianapolis. No “airport revenues” would be transferred to Orange County government from John Wayne. And all existing grant agreements could remain in force.

El Toro is not currently a commercial airport. Hence, it has no grant agreements in force. Therefore, all the issues raised by the airlines in connection with the sale or lease of an existing airport have no legal force in connection with the sale or lease of El Toro by Orange County to a firm which agrees to develop a commercial airport on this site. In other words, once Orange County possesses clear title to the El Toro

site, it is free to sell or lease this property for airport purposes and keep the proceeds, so long as either Congress or the U.S. DOT grants a waiver under the Surplus Property Act of 1944.

If the acquiring firm buys the property, under a long-term or perpetual franchise agreement with the County, then the firm would become the “airport sponsor” within the meaning of the 1982 Act, as amended. As such, it would be eligible to apply for discretionary grants from the Airport Improvement Program to assist in developing the needed facilities at El Toro, on the same basis as a government-owned airport. It would also be able to levy passenger facility fees (PFCs) as an additional, bondable source of revenue. But under current law, the firm would not be able to receive annual FAA entitlement grants (which are available only to government-owned airports).

If the County prefers a long-term lease of El Toro, the County itself would become the “airport sponsor,” thereby preserving eligibility for entitlement as well as discretionary grants. This approach would also permit the use of tax-exempt bonds, which could be issued by the County on behalf of the lessee for development of airport facilities. Under this approach, any PFCs would be subject to the usual FAA conditions that apply to publicly owned airports.

The trade-off between sale and long-term lease involves a number of factors. A sale would produce significantly more up-front proceeds for the County, but could lead to higher costs for airport users, since the acquiring company would most likely finance a significant portion of the purchase price. In addition, the inability of a privately owned airport to receive entitlement grants and to use tax-exempt bonds would also raise its costs, other things being equal. On the other hand, a firm that owned the airport outright might have stronger incentives for cost-effectiveness that could produce some offsetting efficiencies. And it would be able to issue bonds against its PFC revenues, which a government-owned airport cannot do.

The critical first step toward implementing this approach is for Orange County to obtain clear title to El Toro in the near future. The most feasible way to do this is probably via legislation, such as that introduced by Rep. Ed Royce. That legislation could include an explicit provision exempting this transaction (or all such transactions) from the provision of the Surplus Property Act that would prevent sale or lease proceeds from being used for general governmental purposes.

The question of whether El Toro should become a commercial airport still needs a final decision within Orange County. The Southern California Association of Governments found that El Toro has the greatest potential of all current Southern California military bases for meeting future air passenger demand.[11] An advisory referendum in November 1994 produced a majority vote in favor of locating a commercial airport at El Toro. At present, the County is selecting a consultant to carry out an environmental impact study of such an airport. Assuming the conclusion of that study is that an airport is an acceptable use, the County could then proceed with the privatization approach outlined here.

V. BENEFITS OF PRIVATIZATION APPROACH

A. Enhanced Ability to Finance New Airport

In the wake of Orange County's bankruptcy, the County's ability to obtain financing will be impaired for many years. The development of major new infrastructure, such as a several-billion-dollar airport at El Toro, could prove particularly daunting. Such projects are inherently risky (see next subsection), even when carried out by a municipality with an excellent credit rating.

By delegating El Toro development to a separate, commercial entity, the County will insulate this development from its own difficult financial situation over the next decade. The greater degree of

[11] *Southern California Military Air Base Study*, Los Angeles: Southern California Association of Governments, August 1994.

insulation would be provided by the private-ownership option, in which the airport purchaser develops the airport with equity and (taxable) debt instruments. But a long-term lease, in which the County formally issued the (tax-exempt) revenue bonds but the entire development was controlled by the private-sector airport firm and the bonds secured solely by airport revenues would also provide a significant degree of insulation.

B. Reduced Development Risk

A principal reason why the World Bank is now urging privatization of major infrastructure (including airports) in developing countries is to minimize the risk of unwise investment, leading to “white elephant” projects which cost several times what they can generate in revenues. In this country, airlines have grown weary of being faced with grandiose plans for architectural monuments (often referred to as Taj Mahals) posing as new airport terminals. Recent cases in point include the (now-cancelled) JFK 2000 project to build a new central terminal at New York's Kennedy airport, the large new terminal at Washington National airport, and the very costly new Denver International airport.

How and why does privatization make a difference in new-project development? Privatization of airport capital project development (whether by sale, long-term lease, or BOT) shifts many of the risks from the taxpayers to private investors. This, in turn, forces a high degree of “due diligence” in reviewing the design and cost of the project, and especially an insistence on “investment-grade” traffic and revenue forecasts. Privatization helps to ensure that project decisions are made on rational economic and financial grounds, not on political grounds.

The arrangement proposed in this paper, in which development of an El Toro airport is phased in, coordinated with a gradual, orderly transition of various types of airline activity from John Wayne to El Toro over a 10-20-year period, would lower the risk both to existing bondholders of John Wayne and to the developer of the El Toro airport.

C. More User-Friendly Airports

A privatized airport firm will typically adopt an expansive retail approach involving a much broader array of goods and services aimed not only at passengers but also at airport and airline employees and airport neighbors. New business opportunities also include providing business services, conference facilities, hotel accommodations (both short-term and longer-term), as well as developing more high-value airport real estate uses.

It is sometimes noted that there is nothing in the preceding list that is uniquely known to the private sector, which is correct. However, most of these activities require specialized knowledge and an entrepreneurial corporate culture which historically has not been present in the public sector. There is a higher risk of failure in seeking to convert civil servants into entrepeneurs than in hiring genuine entrepreneurs to do these things. In addition, the competitive process may well generate innovative new ideas for cutting costs or increasing revenues, ideas which would not otherwise have been brought to bear.

The most dramatic difference which privatization can bring about is a new approach to airport retail activities. Air travelers who have used London's Heathrow or Gatwick airports (privatized via sale in 1987), the new international Terminal 3 at Toronto (developed via BOT/LDO and opened in 1991), or the new Pittsburgh terminal (whose concessions are managed privately by BAA under a 15-year lease) will have experienced airport retail that differs dramatically from other U.S. airports in three respects: 1) the amount of retail space is several times as much as in other terminals of comparable size; 2) the retailers include numerous national and international brand-name outlets; 3) the quality and diversity of goods and services are considerably greater than one traditionally finds at airports; and 4) the prices charged are not high “airport prices” but are the same as one would find in the local shopping mall.

The new privatized retail approach produces a situation in which all parties are better off. Air travelers like the lower prices and greater variety of goods and services, as proven by per-passenger sales two to three

times higher than in traditional terminals. The airport operator is happy because the higher sales volume produces higher net revenues. And the airlines are happy because concession revenues cover a higher fraction of total airport costs.

D. A Better Deal for the Airlines?

U.S. airlines are generally considered to be opposed to airport privatization. Indeed, airlines were the principal opponents of the proposed sale of Albany Airport in 1989 and have spoken out against proposed privatizations of Baltimore-Washington International, Los Angeles International, and John Wayne Airport.

But there are signs that airline opposition may be waning. In the Albany case, the final version of the long-term lease proposal succeeded in winning the airlines' endorsement (even though it ended up not going through, for other reasons). The parties in question had worked out lease terms which adequately protected the airlines' exposure to future charges, while providing for development of a badly needed new airport terminal.[12]

More recently, airlines have been outspoken in opposing grandiose expansion plans at municipal airports such as the $3.2-billion JFK 2000 project and the new terminal at Washington National. Airlines have also been quite concerned over the new Denver International's cost overruns and delayed opening. The private sector cannot afford to build “Taj Mahal” terminals or to add runways before they are truly justified in terms of return on investment. Thus, airlines would be better protected from a costly, premature airport development at El Toro if the private sector were in charge of that development.

In the spring of 1995, the airlines were pleasantly surprised at the large cost savings proposed by the two finalists for the 10-year management contract of the Indianapolis airport. This landmark contract appears to be further softening knee-jerk airline opposition to airport privatization. It is also interesting to note that at least one airline's parent company, AMR (parent of American), is attempting to enter the airport privatization business itself.

The proposal outlined here avoids the type of privatization which has been the subject of the airlines' principal concern: the sale of an existing airport with the transfer of the sales proceeds to the local government's general fund. It proposes only techniques which airlines have accepted in other contexts: long-term management contracts (as in Indianapolis) and privately developed and managed new-airport capacity (as in Toronto). It may be possible to win the support of airlines for this approach, especially considering that Orange County's financial difficulties might make it more difficult for the County itself to develop an El Toro airport in the near future.

E. Fair Deal for Airport Neighbors

There is considerable opposition in south Orange County to a commercial airport being developed at El Toro, especially in those communities which are adjacent to the properties. Although military aircraft have been operating at the El Toro Marine Corps Air Station for many years, and although the noise “footprint” from a commercial airport will be far smaller than that of the Marine base (due to the stringent “Stage 3” noise requirements with which all jet airliners must comply by 1999), for those living within that footprint (primarily in Lake Forest), the number of daily aircraft operations and the hours of daily noise exposure could well be greater than those of the Marine base.

The private sector has been flexible and innovative in coming up with ways to compensate those who must live nearby “locally undesirable land uses—LULUs.” One approach, used especially in the siting of new waste-disposal facilities, is the host-community benefit fee. The developer/operator generally negotiates either a one-time or an ongoing payment to one or more local government agencies,

[12] Kevin Roach, “US Air Backs BA/Lockheed Plan, *Daily Gazette* [Schenectady], Feb. 20, 1991; Brian Nearing, “American Airlines Endorses Airport Suitor,” *Daily Gazette*, April 20, 1991.

sometimes earmarked for highly desired community improvements.[13] If an El Toro airport is developed via a long-term lease, a portion of the lease payments could be earmarked for community improvements in Lake Forest (and perhaps other neighboring communities).

Another approach has been suggested by investment banker Charles Millard in a recent op-ed article.[14] He proposed that the property be sold to the airport development company, which would raise a portion of the purchase price via a public stock offering. Shares could be offered on preferential terms to residents of neighboring communities, and perhaps on slightly less preferential terms to other Orange County residents. (There are direct precedents for this in Britain's privatization of its electric, gas, and water utilities.) In this way, airport neighbors would become part-owners of the El Toro Airport, benefiting directly from its economic success (via both dividend payments and increases in the value of their stock).

Techniques of this sort would provide tangible economic benefits specifically targeted to those who would suffer the most direct adverse impacts from the development of this new airport. It should be noted, as well, that a lease or sale transaction creates new ways to compensate airport opponents. This provides an additional argument to the FAA, DOT, and the airlines as to why privatization can increase the likelihood of this needed airport actually coming into existence in a timely manner.

VI. IMPLEMENTATION

There are a number of steps Orange County should take in order to bring about the privatization approach outlined here, assuming a positive decision on the local land-use question now being addressed in the environmental impact study.

A. Obtain Title to El Toro

The entire scenario depends on Orange County quickly obtaining legal title to the El Toro site from the federal government, so that it can set in motion the subsequent steps. Accomplishing this may require extensive activity by the County's congressional delegation, as well as obtaining support from the White House and the Secretary of Transportation. The White House National Economic Council seeks to encourage private investment in the nation's infrastructure, as called for in President Clinton's Executive Order 12893. They are well aware of the Orange County airport situation and the potential use of privatization for an El Toro airport project. County officials should press their case for this scenario in these quarters.

B. Request for Strategies and Qualifications

In order to ascertain the private-sector's degree of interest, the County should publish and publicize a request for private firms to submit expressions of interest in the scenario outlined here, for private management of John Wayne linked with development of the El Toro airport. Interested parties could be asked to comment upon sale vs. lease of the El Toro site, their intentions regarding federal grants and bond financing, etc. This process can obtain expert opinions from airport professionals at very little cost to the County. In 1994, Indianapolis received eight responses to such a request, from domestic as well as overseas firms. The Dupage, Illinois airport authority received 11 responses to its request for privatization ideas for its general-aviation airport. The firms should also be asked to submit their airport-management and development qualifications, in some detail, as part of their submissions.

C. Consultant Assistance

---

[13] Rodney Fort and Lynn Scarlett, “Too Little, Too Late? Host-Community Benefits and Siting Solid Waste Facilities,” Policy Study No. 157, Los Angeles: Reason Foundation, May 1993.

[14] Charles Millard, “A Conversion Plan for El Toro that Might Fly,” *The Register*, June 22, 1995.

The County's next step should be to retain a consultant knowledgeable about both airports and privatization to review the airport financial and operational data and assist with designing the competitive process and the required documents. The consultant can assist in assessing the responses to the RFS/RFQ. Legal advice may also be advisable at this step.

D. Request for Proposals

The next step is to issue a formal request for proposals to those firms which constitute the "short list," by virtue of having survived the RFS/RFQ process. The County would be well-advised to hold a bidders' conference for these firms prior to finalizing the RFP, at which it presents an early draft of the document and seeks feedback and suggestions from them. This kind of interaction can lead to a more realistic RFP, which will lead to more responsive proposals and should make the subsequent negotiations with the winning firm go more smoothly.

Given that airport privatization is at an early stage in the United States (there is still no clear-cut policy guidance on the subject from the FAA or its parent, the U.S. Department of Transportation), an important element in the RFP should be for the bidder to document its plan for obtaining DOT approval of the transaction. This will involve demonstrating to the various stakeholders, especially the airlines serving Orange County, that the privatization will not harm their interests.

E. Proposal Evaluation

Because of the size and complexity of the proposed privatization, bidders should be given from three to four months to prepare and submit their proposals. Rigorous evaluation should then be carried out by senior officials, with assistance from the consultant. Here again, it is important that the evaluation process be as objective and "transparent" as possible, with detailed evaluation criteria having been spelled out in advance in the RFP. In addition, the scoring of proposals against these criteria should be documented and be made public following the completion of the process. The objective is to guard against subjective or biased decisions, as well as to minimize the likelihood of legal challenges by losing bidders.

F. Negotiation

The final step will be the negotiation of two legal agreements between the County and the winning bidder. One of these will be a management contract for John Wayne Airport, and the other will be either a lease/BOT agreement or a bill of sale (and possibly a perpetual franchise). Consultant and (especially) legal advice will be essential at this step. Once the agreements have been negotiated, any needed stakeholder agreements will also have to be obtained (e.g., airline lessees or signatories, U.S. DOT).

VII. CONCLUSION

Orange County can use airport privatization to assist in recovery from its bankruptcy, without violating federal airport-grants law, without the need for difficult-to-obtain changes in that law, and without the likelihood of costly, time-wasting litigation. The key is to use two different modes of privatization—contract management for the existing airport and sale or lease for developing the new airport—but to require both to be done by the same firm, to ensure coordinated development. This approach offers airport users the many benefits of private-sector incentives and expertise while minimizing the risks involved in developing the new airport.

ABOUT THE AUTHOR

Robert Poole holds two engineering degrees from MIT and has previous experience in the aerospace industry. As president of the Reason Foundation since 1978, he has written and consulted on transportation issues in the United States and overseas.