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AIRPORT PRIVATIZATION

Issues Related to the Sale or Lease of U.S. Commercial Airports

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss airport privatization. This issue has generated significant interest in the Congress and the aviation community in recent years. Altering the current ownership and operation of commercial airports could have a considerable impact on the nation's aviation system. Airports are major employers in many communities and directly affect millions of airline passengers every day.

Our testimony today is based on ongoing work requested by your Subcommittee and will cover three topics: (1) the current extent of private sector participation at commercial airports in the United States and foreign countries; (2) the incentives and impediments to more extensive forms of privatization, such as selling an airport outright; and (3) the implications arising from more extensive privatization for major stakeholders, such as passengers, airlines, and government. I would like to summarize our findings:

- First, commercial airports in the United States are almost without exception owned and operated by municipalities or states. Nevertheless, the private sector plays a significant role in operating and financing U.S. commercial airports, forming a close association with the airports' local municipal owners. Private companies—airlines, concessionaires, and contractors—deliver most airport services. Like a private entity, a substantial portion of airport development is financed through long-term debt raised in the capital markets. And such debt is subject to the scrutiny of credit-rating agencies and investors. The private sector's participation encourages airports to be efficient and commercially oriented in their operating and investment decisions. Outside of the United States, a majority of airports around the world are owned and operated by their national governments. However, in recent years, a growing number of countries have sought to sell or lease their airports to the private sector and discontinue government subsidies.
- Second, legal and economic constraints currently inhibit more extensive privatization of U.S. airports. While the Federal Aviation Administration (FAA) has permitted and even encouraged some privatization, such as contracting for airport management or allowing private companies to develop and lease terminals, it has expressed concern about selling or leasing an entire airport to the private sector. The FAA's concern is that the sale or lease of an airport would violate the obligations undertaken by the municipal owner as a condition of its federal grants. Most notable is the obligation not to divert an airport's revenues. In broad terms, federal law

requires that a public airport's revenues be used for capital and operating costs. FAA generally considers sale or lease proceeds to be airport revenue that cannot be transferred to other municipal uses. Therefore, a public airport's financial incentives to privatize are reduced. Other constraints could impede a privatized airport from being profitable by raising its cost of capital and ability to generate more revenues.

- Third, predicting how various stakeholders might be affected by more extensive airport privatization is difficult because outcomes largely depend on how privatization might be implemented. If sale or lease proceeds are not bound by federal restrictions on revenue diversions, then states and municipalities that own the airports could receive millions of dollars in proceeds. Privatization's effect on airlines' and passengers' costs depends on whether airports' charges to airlines would continue to be regulated and whether privatized airports would have access to federal grants and tax-exempt debt. Privatization's effect on the federal budget is contingent on whether private airports would have access to tax-exempt borrowing and whether privatization would lead to an overall reduction in the funding level for federal airport grants.

Background on U.S. Airport Privatization

Privatization, broadly speaking, refers to reducing government's involvement in providing services. To what extent government control is relinquished to the private sector depends on the means employed, ranging from contracting for services to selling government assets or operations.

Enabling more extensive privatization at any of the nation's 567 public commercial airports¹ would depend on local, state, and federal support. Unlike the air traffic control system, whose assets are owned entirely by the federal government, commercial airports are owned by local municipalities and, in limited circumstances, states. However, because commercial airports also receive federal airport development grants, have access to federal tax-exempt financing, and are subject to federal regulatory control, federal laws can substantially influence whether a public airport owner would choose to sell or lease its airport. Federal airport development grants are funded through passenger and other taxes that are deposited in the Airport and Airway Trust Fund.²

¹49 U.S.C. 47102 defines commercial service airports as publicly owned airports that receive scheduled passenger service and enplane 2,500 or more passengers per year. In addition, eight other airports have a sufficient number of enplanements but do not meet other criteria to be designated as commercial service airports.

²For more information on airport development grants, see Airport Improvement Program: Update of Allocation of Funds and Passenger Facility Charges, 1992-94 (GAO/RCED-95-225FS, July 17, 1995).

Interest in airport privatization has heightened in recent years. In 1989, Albany County, New York, sought to sell or lease its airport to a consortium of airport developers and operators as a way to eliminate the operating subsidies that the airport regularly drew from the county. While FAA objected to the county's proposal, which Albany County eventually dropped, debate over privatization's viability and legality continued. An executive order issued in 1992 encouraged federal agencies to assist state and local governments' efforts to privatize infrastructure assets, including airports.³ An executive order issued in 1994 affirmed the 1992 order and directed federal agencies to seek greater private sector participation in infrastructure investment and management.⁴ Bills have been introduced in the House and Senate to waive the requirements to repay federal grants in order to encourage infrastructure privatization.⁵ Both the House and Senate bills were referred to subcommittees and have not yet been voted on.

Private Sector Participation at Airports in the United States and Other Countries

Commercial airports around the world are attempting to reduce their reliance on government support and make their operations more businesslike. In the United States, while almost all commercial airports are publicly owned, airport services and financing are linked extensively to the private sector. In other countries, commercial airports are typically owned and financed directly by central governments. In recent years, however, a number of countries have sold or leased their airports to the private sector and discontinued government subsidies.

Public-Private Partnerships Are the Norm at U.S. Commercial Airports

U.S. commercial airports have long sought to control their costs and improve services by collaborating with the private sector. While local municipalities and, in a few instances, states own almost all of the nation's commercial airports, we found that the bulk of services, such as baggage handling, cleaning, retail concessions, and ground transportation, are provided by private contractors or tenants, according to officials at the airports we visited. For example, only 1,600 (less than 3 percent) of the 62,000 people who work at the three airports—Kennedy, LaGuardia, and Newark—operated by the Port Authority of New York and New Jersey are public employees. This ratio of public to private employees is typical of

³Executive Order No. 12803, "Infrastructure Privatization," dated April 30, 1992.

⁴Executive Order No. 12893, "Principles for Federal Infrastructure Investments," dated January 27, 1994.

⁵These are H.R. 1907 and S. 1063, "Federal-Aid Facility Privatization Act of 1995."

the airports we visited. According to the airport executives we spoke with, reliance on the private sector is crucial to reducing costs and improving services. Some municipalities have gone so far as to contract out the management of their entire airport to the private sector. While airport management contracts have tended to be with smaller airports, in September 1995, the Indianapolis Airport Authority signed a 10-year contract with a private firm to manage its system of airports. According to Indianapolis officials, the private firm has guaranteed at least \$32 million, and expects \$140 million, in cost savings and increased revenues over the life of the contract. Seventy percent of any savings will go to the airport authority, which intends to use it to cut charges to airlines, and the rest will go to the private contractor.

Similarly, many airports have sought to operate in a more businesslike manner by expanding and diversifying their sources of revenue. Industry analysts have noted a trend toward shorter and more flexible operating agreements between airports and airlines, which allow the airports to retain more revenue and more easily renegotiate terms. Airports have also sought to expand and diversify their revenues, especially from retail concessions. Our analysis of 82 commercial airports shows that only 20 percent of these airports' total revenues are derived from landing fees charged to airlines, while over 40 percent of total revenues are derived from concessions and parking, 20 percent from terminal leases, and 20 percent from other sources.⁶ The Airmall⁷ terminal at Pittsburgh International Airport is a good illustration of this trend toward exploiting an airport's retail potential. In Pittsburgh, a private operator manages the retail facility, which includes over 100 retail outlets, for Allegheny County. Since the mall opened in 1992, per passenger retail spending has increased by 250 percent.

Like private sector projects, airport development is financed to a great extent through funds raised in capital markets and privately. However, unlike most private sector projects, public airports have access to federal airport development grants, passenger facility charges (PFCs), and tax-exempt debt. Commercial airports have long relied on tax-exempt municipal debt to finance their development. And airports' debt levels have grown substantially in recent years, especially among larger airports. According to the financial statements of 22 of the nation's largest airports,

⁶Based on an analysis of airport financial statements for the most recent reporting period as provided by Van Kampen American Capital Management's Merritt System Airport Database. Generally, these airports are among the largest in the United States.

⁷Airmall is a registered trademark by BAA USA, Inc.

average debt levels nearly doubled from \$445 million in 1988 to over \$880 million in 1994. And like private companies, airports' financial performance and investment plans are scrutinized by credit-rating agencies and municipal debt insurers before capital can be raised. Also, numerous airport facilities, including terminals at Kennedy, O'Hare, and Cincinnati, were privately paid for and developed. For large projects, private developers have used their own capital and special facility bonds.⁸

Airport Privatization Is Gaining Popularity in Other Countries

In recent years, many countries have adopted extensive privatization programs within their economies. These countries have privatized many parts of their infrastructure, including airports, trucking, telecommunications, railroads, and shipping.⁹ Generally, these countries' privatization policies have been driven by a desire to reduce the size of the public sector and to improve economic efficiency.

We identified airport privatization efforts in 47 countries. These efforts vary from selling minority shares in individual airports or inviting private developers to construct runways or terminals to leasing or selling the country's major airports. For example, in December 1995, the Mexican government approved legislation that would allow private operation of its 58 airports. Key features of the legislation include 50-year renewable leases between the government and a private operator and limits on participation by foreign companies and airlines.

The United Kingdom, which privatized its commercial airports in 1987, is one of the few cases where airport privatization is far enough along to provide measurable results. To privatize, the United Kingdom sold the government corporation—British Airports Authority (BAA)—which operates seven major airports, including London's Heathrow and Gatwick airports, in a \$2.5 billion public share offering. Even after privatization, the airports remain subject to government regulation of airlines' access, airports' charges to airlines, safety, security, and environmental protection. The government also maintains a "golden share" that allows it to veto new airport investment or divestiture. BAA has generated profits every year since 1987 and is now valued at \$4.5 billion. Owing to steadily increasing passenger traffic and growth in retail revenues, BAA generated \$455 million in profits for its shareholders in 1995, despite

⁸Generally, special facility bonds are tax-exempt debt issued by the airport and backed by the lease revenues from private tenants, typically airlines.

⁹For additional information on other countries' privatization efforts, see *Budget Issues: Privatization/Divestiture Practices in Other Nations* (GAO/AIMD-96-23, Dec. 15, 1995).

government-imposed caps on charges to airlines and \$782 million in infrastructure improvements, including a rail link to central London from Heathrow International Airport.

The privatization of BAA has not been without its critics, however. Some private economists have noted that by selling BAA's seven airports together, instead of separately, the United Kingdom's government did not maximize its sale price or instill greater competition. Rather, these critics charge that the government converted a public asset into a regulated private monopoly.

Despite Incentives, Significant Impediments Currently Block More Extensive Privatization in the United States

In recent years, the idea of turning commercial airports over to the private sector has generated considerable interest. Despite this interest, more extensive privatization remains largely untested because of legal barriers, economic constraints, and opposition from airlines and the FAA.

Incentives to Privatize

Several factors are motivating the current interest in more-extensive privatization of commercial airports in the United States. First, commercial airports generate significant revenues, in some cases exceeding \$100 million annually. Second, well-capitalized firms with experience in airport management and development have emerged in response to the demand created by privatizations worldwide. These firms believe that many U.S. airports possess considerable untapped profit potential and have aggressively sought greater opportunities in the United States. Third, funding levels for federal airport grants have dropped from \$1.9 billion in fiscal year 1992 to \$1.45 billion in fiscal year 1996. Accordingly, some airports are eager to tap alternative sources of revenue, according to airline industry representatives. Fourth, municipalities facing budget problems view their airports as a potential source of fiscal relief.

Federal Grant Requirements Pose Legal Impediments to Privatization

Thus far, all but one attempt to sell or lease a commercial airport in this country has been abandoned after encountering various legal obstacles. Privatization proponents and legal experts believe that a lease arrangement, whereby the public authority retains ownership and some

control, faces fewer hurdles than an outright sale. Nevertheless, FAA has opposed lease-based privatization proposals for some commercial airports, citing statutory problems and concerns about privatization's effect on the national aviation system. For example, in 1995, Orange County, California, sought to sell John Wayne Airport as a way to obtain revenue for its general fund after the county filed for bankruptcy in December 1994. The county abandoned its privatization effort after concluding that any sale or lease proceeds could not be retained for its general fund.

Under grant agreements, FAA must approve the transfer of any commercial airport, whether the transfer is to a public or private entity.¹⁰ In opposing proposals for selling or leasing airports to private companies, FAA has cited a concern that a private owner or lessee would not be able to satisfy the legal obligations that the airport made as a condition of obtaining a federal grant.¹¹ According to FAA, these legal obligations cannot be extinguished by repaying grants to the federal government.

A grant assurance that is frequently cited as an obstacle to privatization concerns the use of airports' revenues. Current law requires that public airports' revenues be used exclusively to pay for the airports' capital and operating costs and cannot be diverted for nonairport purposes.¹² Although FAA currently considers airports' revenues to include lease or sale proceeds subject to this law, states and local governments would be entitled to recover any unreimbursed capital or operating costs that they have incurred. It is uncertain which costs would be reimbursed—for example, if a rate of return is allowed. Reimbursement would likely be an issue for discussion between FAA and the airport in any privatization proceedings. Therefore, the financial benefits that might accrue to municipalities from privatizing airports are uncertain.

FAA has not universally applied its broad interpretation of what constitutes revenue, however. In 1986, Atlantic City, New Jersey, leased its terminal at Atlantic City International and its general aviation airport to a private management firm. The lease required minimum payments of \$400,000

¹⁰FAA's grant program handbook (Order 5100.38A) states that, for publicly controlled airports, grant obligations shall remain in effect for the useful life, up to 20 years, of any facilities developed or equipment acquired with grants and shall remain in effect indefinitely for any real property acquired with grants.

¹¹See 49 U.S.C. sections 47101 through 47131.

¹²49 U.S.C. section 47107 (b) allows public airports with preestablished revenue-sharing legislation or debt covenants to legally take some revenue from the airport. We found only a few airports that qualify for this provision. Private airports are not similarly bound by revenue diversion restrictions.

annually to the city.¹³ FAA officials cannot fully explain why Atlantic City was allowed to divert revenue in 1986, when the agency opposed similar lease proposals by Albany County in 1989, Los Angeles in 1992, and Orange County in 1995.

Another legal issue concerns whether federal grants and donations of surplus federal property would have to be repaid from sale or lease proceeds. Since 1946, the federal government has awarded over \$23.5 billion in airport grants and donated an unknown value of surplus federal property to assist in the development of airports. Under current law, when an airport's asset is sold and no longer used for its originally intended purpose, the federal government can seek reimbursement for its share in assets acquired through grants, while surplus federal property would automatically revert to the federal government. If assets are transferred from a public to a private owner but continue to serve their originally intended purpose, it is less likely that the federal government would claim any reimbursement, according to FAA officials. FAA has not sought any reimbursement when airport ownership has been transferred between public entities, in part because the airport was still used for its originally intended purpose. However, when a privatized airport no longer uses an asset for its original purpose, then the federal government could make a claim for reimbursement against the private owner. Bills introduced in the last Congress (H.R. 1907 and S. 1063) would allow the Secretary of Transportation to waive state and local governments' obligations to repay federal grant moneys when there was a legal agreement or regulation requiring that the privatized asset continued to serve its originally intended purpose.

Federal Financing and Airlines Pose Economic Impediments to Privatization

A privatized airport's ability to operate profitably under current rules and conditions is unknown. The loss of federal airport apportionment grants, PFCs, and tax-exempt financing would raise airports' financing costs significantly.¹⁴ Together, these sources of finance generally constitute the majority of an airport's capital base. In fiscal year 1995, commercial

¹³In 1992, Atlantic City sold the main airport terminal to a new public transportation authority for \$11.3 million and annual payments of \$500,000. Under P.L. 102-143, the Congress specifically exempted this transaction from revenue diversion restrictions. A private firm continues to operate the airport under a lease.

¹⁴FAA provides airport development grants under two broad categories—either apportionment or discretionary. Apportionment, or "formula," grants are available to all public airports on the basis of the number of passengers enplaned and other factors. Privately owned airports may not receive apportionment grants. Both publicly and privately owned airports are eligible for discretionary grants, which go to projects that address goals established by the Congress. The Congress, in 1990, authorized publicly owned commercial service airports to charge each passenger a \$1, \$2, or \$3 PFC per trip.

airports' apportionment funding accounted for about one-third of the total \$1.45 billion federal grant program's funding level.¹⁵ Additionally, between 1992 and January 1996, 244 airports have been approved to collect more than \$12.5 billion in PFCs. However, a privately owned airport could legally collect other types of passenger usage fees to replace lost PFC revenues. Finally, according to public-finance professionals, the loss of tax-exempt status for airport debt would add at least 2 percentage points to an airport's cost of debt capital. For example, a \$100 million debt issue would cost an airport at least \$2 million more in additional interest costs each year.

In addition to more expensive capital, a private airport owner or lessee could encounter constraints on its revenues, making it more difficult to recover its investment costs, for two reasons. First, FAA's current policy on rates and charges prohibits airports from increasing their charges to airlines to reflect the costs of appreciated or revalued assets or to earn a return on investment.¹⁶ Therefore, a private owner or lessee would have to recover its investment from an airport's nonaeronautical operations—for example, from retail concessions. Second, a private buyer or lessee may need to renegotiate the airport's agreements with its tenant airlines. Often these agreements, which are generally long-term and govern how the airport is operated and methods for charging aeronautical and nonaeronautical fees, restrict how much and in which ways an airport can make a profit. Some of these agreements, known as residual agreements, require the airport to return any profits to the airlines in the form of lower fees. According to officials from the airlines that we spoke with, they almost universally oppose the sale or lease of airports, in part because they fear that their airport-related costs would increase. Therefore, airlines would likely be hesitant to renegotiate their airport agreements with a new private owner if they believed it would increase their costs.

FAA's Unclear Interpretation of Privatization Policy Is an Impediment

FAA has not clarified its interpretation of various legal, congressional, and presidential directives. Instead, according to FAA officials, they consider each privatization proposal separately. The lack of guidance is an impediment in itself, according to privatization proponents, in that any attempt to sell or lease an airport is likely to encounter a long and costly

¹⁵In fiscal year 1995, the Congress provided commercial airports with \$729 million in apportionment grants before the imposition of statutorily required cuts. After cuts were imposed to meet other statutory requirements, commercial airports' actual apportionment funding was just over \$450 million.

¹⁶On September 8, 1995 (60 Fed Reg 47017), FAA proposed a change to its rates and charges policy which would allow private airport owners to charge their tenant airlines rates that would provide a reasonable return on investment. FAA has not made this policy change final.

legal contest. The lack of any succinct privatization policy can be tied, in part, to differing policy direction from the Congress and an executive order. Executive Order 12803 encouraged federal agencies to approve state and local governments' requests to sell or lease infrastructure as long as it continued to be used for its intended purpose. Meanwhile, in August 1994, the Congress directed FAA to issue policies and procedures related to revenue diversion because of concerns about possible abuses by some airports.¹⁷ On February 26, 1996, FAA issued its proposed policy on airport revenue diversion for public comment. FAA's proposed policy still considers sale or lease proceeds to be revenue subject to diversion restrictions. The proposed policy also states that FAA would consider privatization proposals on a case-by-case basis. However, encouraging more extensive privatization while meeting revenue diversion requirements is difficult as long as FAA considers sale or lease proceeds to constitute airport revenue that is subject to diversion restrictions.

Municipalities Would Likely Benefit, While Privatization's Other Effects Are Harder to Predict

It is difficult to predict how more extensive privatization would affect state and local governments, airlines, passengers, and the federal government because so many assumptions have to be made about how privatization might be implemented. However, some general observations can be made on the basis of the current situation and likely scenarios:

- The effect of more extensive privatization on local governments depends on whether restrictions on revenue diversion are changed and municipalities could retain all privatization proceeds. If municipalities are able to privatize their airports and retain all privatization proceeds, then they could expect to reap a financial windfall. In addition, municipalities would benefit from adding airports to their local tax bases. It is difficult to estimate how much a municipality could expect to gain by selling or leasing its airport. Although airports have billions of dollars in reported assets, such assets are not an accurate measure of market value, which may be substantially more or less. An airport's market value principally depends on the present value of its future earnings, which in turn depends on the manner in which it is privatized and the constraints imposed and subsidies granted by various levels of government.
- The effect of more extensive privatization on airlines largely depends on how the rates charged to airlines by airports are regulated and if privatized airports remain ineligible to receive apportionment grants and tax subsidies. First, FAA's policy on rates and charges prohibits airports from

¹⁷Section 112 of the Federal Aviation Administration Authorization Act of 1994, P.L. 103-305 (enacted Aug. 23, 1994), required the Secretary of Transportation to establish revenue diversion policies not later than 90 days after enactment.

charging airlines market-based rates. If this policy is changed, airports could generally raise their fees because they face only limited competition. Other countries that have privatized airports generally impose some form of price regulation on airports' charges to airlines. For example, in the United Kingdom, airline charges are capped at historical rates plus an inflation factor. Second, under current law, a private commercial airport would no longer receive federal apportionment grants or tax-exempt financing, which could increase an airport's costs and, correspondingly, the fees it might charge airlines. According to the airlines we spoke to and other cost studies, airport costs average about 5 percent of airlines' total costs. However, the airline industry is also highly competitive and historically has a profit margin one-half that of the average U.S. company in other industries. Therefore, a small cost increase could have a pronounced effect on profitability.

- The effect of more extensive privatization on passengers depends on the extent to which airlines' costs increase and the degree to which airlines adjust their ticket prices in response to rate changes. According to economic studies,¹⁸ passenger traffic is very sensitive to changes in ticket prices. These studies show that a 1-percent increase in ticket prices may lead to more than a 1-percent decline in passengers. Therefore, airlines are cautious in passing on cost increases to passengers.
- The effect of more extensive privatization on the federal budget depends on whether privatized airports are denied tax-exempt status and federal apportionment grants. Privatization proponents complain that providing these benefits to public airports but not private ones creates an unlevel playing field. Access to tax-exempt debt represents significant cost savings for public airports. According to public-finance professionals we spoke to, the interest rate on taxable bonds is generally 2 to 2.5 percentage points higher than tax-exempt debt with equivalent credit risk. According to one rating agency, an estimated \$25 billion in tax-exempt airport debt is currently outstanding. In aggregate, using a 2-percentage-point differential, this translates into \$500 million in potentially taxable revenue forgone each year. Therefore, removing tax-exempt status for commercial airports that privatize could result in more federal revenues. More extensive privatization could also affect the funding level for airport grants. In fiscal year 1995, the federal apportionment grant funding level for commercial airports was about \$450 million. The effect on apportionment grants would depend on whether grants that previously went to a public airport would be redirected to other airports or if the overall funding level for the grants program would be cut.

¹⁸Report to Congress: Child Restraint Systems, U.S. Department of Transportation, Federal Aviation Administration (May 1995), summarizes 25 economic studies on the relation of ticket prices to the demand for air travel.

Mr. Chairman, this concludes our prepared statement. We would be happy to respond to any questions you or the Members of the Subcommittee may have.

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