Appendix H
Detailed Airport Case Studies

H.1 Case Study Selections

Case studies can be a useful means of illustrating first-hand experiences and lessons learned from those experiences. The purpose of this task is to document case studies to illustrate lessons learned for a range of airport sizes, privatization strategies, and forms of governance for both successful and unsuccessful efforts. For each case study, the research team documented (1) the initial goals and objectives of the airport sponsor for undertaking the privatization initiative, (2) a summary of the process employed, (4) a summary of the business terms of the initiative, (4) documentation of the experience to date, and (5) lessons learned. Literature reviews, transaction document reviews, and interviews were used to gather information for the case studies.

Each case study considers the objectives, timeline, competitive bidding process, stakeholder interests, business terms, and the consequences (including development and operational experiences) and then presents lessons learned.

It should be noted that, where the responses of individual interview participants are referred to in this report, these represent the interviewee's own views and perceptions. However such responses have only been included to where they appear to represent opinions held more widely, or have been directly substantiated by other means

On the basis of recommendations and justifications put forth by the research team, the ACRP Panel decided to ask the team to conduct case studies of the domestic and international airports as noted below.

H.1.1 Domestic Airports

Airport System Management Contract:

1. ***Indianapolis Airport Authority*** – airport system comprising a medium-hub airport and 5 general aviation airports, which entered into an airport system management contract that reverted back to public operation.

Developer Financing and Operation:

2. ***John F. Kennedy International Airport, Terminal 4 (JFK-IAT)*** – large-hub airport, private development, financing, and operation of a major international unit terminal.
3. ***Boston Logan International Airport Terminal A*** – large-hub, terminal development, where private developer financing was initially considered, then airline special facility financing was undertaken, which was followed by the airline's bankruptcy resulting in a workout of the transaction documents.

Airport Privatization Pilot Program (APPP) applicants:

4. ***Stewart International Airport*** – non-hub airport and only airport approved under the APPP, which reverted back to public operation.

5. ***Chicago Midway International Airport*** – large-hub airport that occupies the only large-hub slot under the APPP, which was put on hold after the financial crisis in the fall of 2008.

The case studies for Stewart International Airport and Midway Airport provide interesting contrasts and helpful background for any airport considering privatization under the APPP.

Full Privatization Outside the APPP:

6. ***Morristown Municipal Airport*** – general aviation airport with long-standing, long-term airport-wide management and development agreement.

H.1.1 International Airports

7. ***Sydney Airport or Kingsford Smith Airport*** -- trade sale under 99-year lease, which includes light-handed regulatory regime with relationship between privatization, regulation, and service quality (June 2002).
8. ***London Gatwick Airport International Airport*** -- secondary sale to pre-empt the expected actions of the UK Competition Commission, which was the largest airport transaction since the credit crunch and "Great Recession" and offers the opportunity to consider interesting issues such as competition concerns, economic regulation, pricing of risk, and financing considerations (December 2009).

The panel made the decision for the case studies on the basis of working papers submitted by the research team on the merits of the various candidates for airport case studies and the diversity to cover the full spectrum of privatization strategies and airport sizes.

H.2 Indianapolis Airport Authority

H.2.1 Background

Indianapolis International Airport (IND) is a medium-hub airport located 7 miles west of downtown Indianapolis. IND is operated by the Indianapolis Airport Authority, a municipal corporation formed in 1962 and governed by an 8-member Board (with 5 members appointed by the mayor of Indianapolis) that also operates a downtown heliport and 4 reliever airports (Eagle Creek Airpark, Hendricks County Airport/Gordon Graham Field, Metropolitan Airport, and Mt. Comfort Airport), collectively, the airport system.

In November 2010, 9 passenger airlines and their regional affiliates provided scheduled service from IND to 34 airports in the U.S., Canada, and Mexico. Delta Air Lines and its regional affiliates have the largest share (approximately 26%) of scheduled departing seats at IND, followed by Southwest Airlines with an 18% share and US Airways with a 13% share.[1] No other airline (including regional affiliates, if any) account for more than 10% of seats. IND is also the second-largest hub for FedEx Express, with approximately 650 flights per month supported by a 2-million-square-foot facility on 280 acres on airport.[2] Also on airport is the Indianapolis Maintenance Center, one of the largest maintenance, repair, and overhaul facilities in the world, built in 1994 for United Airlines but turned back to the Authority in 2004 as a result of United's Chapter 11 bankruptcy.

In 1994, the Board created a Managed Competition Committee to oversee a competitive bidding process for the rights to operate, maintain, and manage the airport system. Although the Board considered an outright sale or lease of the Authority's airports, it decided against doing so because of the difficulty in getting regulatory approval.

The Authority staff participated in the competitive-bidding process against four private-sector firms, but lost the competition to BAA Indianapolis LLC, a subsidiary of BAA USA, itself a subsidiary of BAA International (collectively "BAA"). At the time of executing the management contract with the Authority in October 1995, BAA operated 6 airports in the United Kingdom, including London's Heathrow and Gatwick airports, and maintained a contract with Allegheny County to manage the terminal concession program at Pittsburgh International Airport. The contract was anticipated to generate cost savings and nonairline revenue increases totaling $100 million over its 10-year term through 2005. Under the terms of the management contract, BAA was to be compensated on the basis of savings in airline payments per enplaned passenger versus a baseline cost defined in the contract.

In 2003, the management contract was extended through December 31, 2007. However, in June 2007, the Authority and BAA negotiated an early termination of the management contract and the following month the Authority again assumed full responsibility for the operation and management of airport system. Much of the management and staff of BAA remained at the Authority in the same or similar positions following the transition to back Authority management.

[1] Based on schedules published by Official Airline Guides for 2010.
[2] *FedEx in Indianapolis,* FedEx Corporation, *http://news.van.fedex.com/node/743,* retrieved November 10, 2010.

H.2.2 Objectives

With the election of Stephen Goldsmith as mayor in 1991, the city ideologically pursued many privatization initiatives. The initiatives were undertaken as the city faced pension funding deficits, unfunded infrastructure needs, and increased competition from suburban municipalities for jobs. The city adopted a "managed competition" approach whereby private-sector companies competed to operate "policy-implementing" functions, with the city retaining control over "policy-making" decisions. Existing municipal departments were invited to participate in the competitive-bidding process. Between 1992 and 1997, the city outsourced more than 70 city services to managed competition with an estimated total savings of $230 million being achieved. Non-public safety headcount fell by more than 40 percent over this period, with taxes decreasing slightly.[3]

After a high profile privatization of the city's wastewater treatment operations in 1993 that resulted in operating expense savings and improved customer service, Mayor Goldsmith (who appointed 5 of the 9 Authority board members) identified the Authority as a potential managed competition opportunity. Increasing airline costs, lackluster nonairline revenue performance, and upcoming capital requirements were cited as a rationale for evaluating privatization, with airline costs being the overriding driver. Airline rates and charges at IND were calculated using an airport-system residual methodology, whereby airlines paid for the net costs of operating the airport system after a credit of all nonairline revenues. Therefore, all other things unchanged, any reductions in operating expenses and capital charges or increases in nonairline revenues would accrue to the airlines.

With the requisite infrastructure in place, the Authority hoped that private-sector management expertise would help the airport reduce airline costs, therefore attracting additional passenger and cargo airline service, and become a premier intermodal distribution hub. As stated by Stephen Goldsmith in 1999[4]:

"The resulting lower airline fees should have a ripple effect that benefits the airline industry, the city, and the consumer. Taxpayers will benefit from lower airport costs because Indianapolis' low fees and professional approach will be a magnet for increased economic activity. New maintenance facilities, air-cargo traffic, and airline routes are all rational expectations. Local customers will certainly notice an increase in service . . . Airport passengers may even notice a decrease in airfare as the number of airline routes increases."

In summary, the overarching objective for pursuing the airport privatization initiative was to attract new airline service and encourage economic development by reducing airline costs through increased nonairline revenues and reduced operating expenses. Other objectives were to improve customer service and quality and improve the diversity and expertise of airport staff. These objectives reflected an ideological belief that a private sector operator with airport expertise could achieve these goals inherently better than a public sector operator.

[3] Hai-Chao Chang et al., *Managed Competition in Indianapolis: The Case of Indianapolis Fleet Services,* Columbia University, 2005.
[4] Stephen Goldsmith, *The Twenty-First Century City: Resurrecting Urban America,* Rowman & Littlefield, 1999.

H.2.3 Timeline

A timeline for the Authority-BAA management contract and related material events is as follows:

Table H.1. Indianapolis Airport Authority-BAA Management Contract Timeline

January 1992	Stephen Goldsmith sworn in as mayor of Indianapolis
October 1992	Midfield Terminal opens at Pittsburgh International Airport; BAA USA introduces “Air Mall” terminal concession concept with name-brand stores and “street pricing”
Late 1993	City of Indianapolis enters into contract with private consortium to operate two wastewater treatment plants
Summer 1994	Indianapolis Airport Authority forms Managed Competition Committee
September 1994	Authority issues request for proposals to operate, maintain, and manage the airport system
March 1995	BAA selected as winning bidder
March–September 1995	Negotiation of management contract takes place between Authority and BAA
October 1, 1995	10-year management contract becomes effective; BAA assumes operational responsibility for airport system
January 1998	BAA enters into 10-year agreement with Susquehanna Area Regional Airport Authority (SARAA) to manage Harrisburg International and Capital City airports
July 2001	Susquehanna Area Regional Airport Authority terminates BAA management contract citing the authority’s concerns about declines in passenger traffic and BAA’s administration of the airport system
January 2003	IND management contract extended 5 years through December 31, 2007
June 14, 2007	BAA and Authority agree on terms to terminate the management contract
July17, 2007	Management contract terminates; all personnel and operations transferred back to Authority responsibility
November 11, 2008	Col. Harvey Weir-Cook Midfield Terminal opens at Indianapolis International Airport

H.2.4 Competitive Bidding Process

After evaluating options through the Managed Competition Committee, the Board issued a request for proposals (RFP) in September 1994. Respondents were asked to detail their plans to achieve four goals[5]:

- Provide better service at the same or reduced cost
- Attract economic development at Indianapolis International Airport
- Improve the airport’s long-term competitive position
- Increase the expertise and diversity of Airport staff

The bidders were asked to provide the following:

[5] Id.

- Management and operations plan
- Development and investment strategy plan
- Business plan
- Transition plan

Five bidders responded:

- BAA
- Authority staff
- Johnson Controls World Services
- Lockheed Air Terminal
- Tishman

All private-sector bidders had experience operating airports or airport terminals. The bidders identified revenue enhancement opportunities with improved concessions, new parking products, and enhanced commercial development. Cost saving opportunities identified by the respondents principally involved outsourcing operations such as janitorial and shuttle buses with third parties.

The proposal submitted by the Authority staff identified many of the potential improvements identified by the private-sector proponents, including street pricing and many of the other nonairline revenue enhancement and operating expense reductions proposed by other bidders. In advance of its bid for the budget year 1995, the Authority implemented operating expense reductions of $1.7 million (approximately 5%). As a municipal department, however, the Authority was not legally permitted to propose in a joint venture with a private company, make contractual guarantees for improved performance, or commit any of its own capital toward capital improvements.

In March 1995, BAA was selected as the preferred bidder on the basis of its experience in managing its airport system in the UK, serving more than 80 million passengers in total. (The other private-sector bidders had experience managing either only terminals or non hub airports.) BAA's success in managing the concession program at Pittsburgh's new Midfield Terminal was also cited as a factor affecting the decision and its international air service development experience. While BAA proposed to receive a management fee consisting of both fixed and variable portions, during negotiations it agreed to the fee being entirely variable and dependent upon contractual goals being met.

H.2.5 Stakeholder Interests

Authority Board. As noted earlier, the Board's main interest was to increase economic development by stimulating new airline service. The Board felt that it could achieve this goal through reduced airline costs, and that this goal could be best achieved through a managed competition process in which private sector companies would guarantee increases in nonairline revenues and decreases in operating expenses. The privatization effort was, in large part, a continuation of similar privatization efforts by the city of Indianapolis.

BAA. BAA was created in 1987, as part of the British privatization efforts of the Thatcher administration and was less than a decade old at the time of the issuance of the Indianapolis RFP. BAA anticipated similar privatization efforts around the world and was motivated to expand its reach. Having recently implemented a successful concessions program at Pittsburgh International

Airport, BAA believed the U.S. would be a logical market for future privatization.[6] The Indianapolis opportunity was attractive as it entailed the management of all airport operations, including operations at the Authority's reliever airports. BAA believed that experience gained at Indianapolis would position it well for similar opportunities in the future. BAA also viewed the contract as an opportunity to sell other services, such as planning and construction management, an important consideration since a new midfield terminal was contemplated during the term of the management contract.

Airlines. Airline interests included reduced rates and charges, maintaining capital project approval ("majority-in-interest") rights, and ensuring that any monies generated on airport remained in the airport system and were not diverted to other purposes. While the airlines were opposed in principle to paying management fees for a private operator, they were the beneficiary of efficiencies achieved at the airport as a result of the "residual" methodology employed for the calculation of airline rates and charges. Notwithstanding this benefit, the airlines regularly questioned the value BAA contributed in relation to its annual fee.

Labor. As noted earlier, Authority staff ("Team IND") submitted a proposal to manage and operate the airport system and were keen to continue to run the entity. Team IND felt that they had earned the credibility and confidence of the airlines, which was a critical concern, as demonstrated by letters of support from the airlines in its proposal. In addition, Team IND felt that it had already demonstrated innovative management practices. Team IND also committed to outsourcing janitorial services and general aviation airport operations as well as managed competition of all parking facilities, ground transportation facilities, and shuttle bus operations, but to require the private subcontractors to hire all existing Authority employees in those positions under terms and conditions similar to those in place at that time. A lower wage scale would have been permitted for new hires, but Team IND wanted to protect existing employees.

As noted later, the management contract required BAA to use its best efforts to employ all Authority staff and offer each employee an initial compensation and benefits package similar to what the employee was receiving as an Authority employee. Substantially all Authority staff became employees of BAA.

H.2.6 Business Terms

After being selected as the winning bidder in March 1995, BAA and the Authority negotiated the terms of the management contract, which took effect on October 1, 1995. The agreement gave BAA the exclusive right to operate, maintain, and manage the airport system for 10 years. The agreement contained an option to extend the term in the seventh year of the agreement for a term mutually acceptable to the Authority and BAA. While the agreement focused on operations at the airport, BAA was also charged with the operation of the reliever airports.

Scope of Services. The scope of services was organized into three components, with functions as follows:

[6] BAA USA was also retained as the master developer and manager of the retail, food, and beverage operations for Boston Logan International Airport (Terminals B and E) in July 2000, the new concourse at Baltimore/Washington International Thurgood Marshall Airport in March 2004, and Cleveland Hopkins International Airport in February 2008. In addition, BAA was retained to manage Harrisburg International and Capital City airports on behalf of the Susquehanna Area Regional Airport Authority in January 1998.

1. Terminal services
   - Terminal maintenance and janitorial
   - Terminal operation
   - Terminal concessions
   - Parking and rental car
   - Terminal advertising
   - Grounds maintenance
   - Terminal security
   - Planning and engineering for terminal
   - Terminal land development

2. Airfield support services
   - Airfield maintenance and snow removal
   - Ramp operations
   - Airfield signage and navigation
   - Fire and rescue
   - Reliever and general aviation airports and heliport
   - Non-terminal buildings maintenance
   - Fixed-based operator and general aviation facilities maintenance
   - Vehicle maintenance
   - Intermodal and cargo support
   - Planning and engineering for airfield
   - De-icing
   - Airside land development
   - Airside security
   - Fuel farms and fill stands

3. Administrative support services
   - Finance and accounting
   - Grant management
   - Management information systems
   - Public relations, including noise abatement programs
   - Human resources management
   - Purchasing and contracts management
   - Administration of bond issuance and PFC collection and accounting
   - Land acquisition and relocation implementation
   - Legal
   - Air service marketing, including freight

BAA was charged with administering and enforcing all agreements maintained by the Authority, subject to the policy decisions of the Board. The planning function as identified in the scope of services was limited to the scope of strategic planning historically performed by the Authority and excluded those services that were typically bid out to third-parties (e.g., master planning). BAA was allowed to bid competitively to provide such expanded planning services, but with no preference over other bidders. Any revenues to be received by BAA for providing such services were to be

retained in full by BAA and were not to be considered under the terms of the management contract. BAA was responsible for managing the implementation of capital improvements, subject to approval by the Board and any other responsible parties (e.g., the FAA) in compliance with all governmental regulations.

The Authority retained under its control the following functions:

- Airline use agreement compliance
- Compliance with the authority's obligations under the law and under federal grant agreements
- Air service development policy
- Debt issuance policy
- Rates and charges policy
- Long-range planning
- Land acquisition and development policy and planning
- Airport industrial and economic development policy
- Environmental policy
- Capital expenditure policy and implementation of capital improvements

Oversight. Under the terms of the agreement, BAA was required to appoint an airport director to serve as its liaison with the Board. The agreement allowed the Authority to appoint one or more persons to assist the Board with contract compliance issues. The airport director was not accountable to any such Authority personnel, but was encouraged to cooperate fully with any requests.

Compensation. As noted earlier, the Authority's main objective in contracting with BAA was to reduce airline payments per enplaned passenger as an inducement for the airlines to provide more air service and thus stimulate economic development. Under the agreement, any expenses incurred by BAA on behalf of the operation and maintenance of the airport (under the terms of its agreement), net of nonairline revenues, were to be recovered from the airlines, consistent with the approach before BAA assumed operational responsibility.

During negotiation of the management contract, BAA and the Authority agreed to share in the reduction in airline payments per enplaned passenger versus a "baseline" projected assuming no efficiencies were gained. The savings were calculated annually as the difference between the baseline and actual airline payments per enplaned passenger number, times the number of enplaned passengers for that year. The agreement provided for BAA to receive 32.5% of the savings as a management fee, subject to a $4 million annual cap, escalated for inflation. The Authority's share of the savings (67.5%) would accrue to the airlines in the form of reduced rates and charges. (In essence, the airlines were to receive $0.675 of every $1.00 of savings produced by BAA.)

A hypothetical illustration of the calculation is provided in the Table H.2.

Table H.2. Illustrative Calculation of the BAA Management Fee per the Management Contract

Baseline airline payments per enplaned passenger	[A]	$5.00
Airline payments per enplaned passenger before management fee	[B]	$4.50
Difference	[C=A-B]	$0.50
Enplaned passengers (in 000s)	[D]	4,000
Savings (in 000s)	[E=C*D]	$2,000
BAA share (management fee, in 000s)	[F=0.325*E]	$650
Authority share (to airlines in the form of reduced rates and charges, in 000s)	[0.675*E]	$1,350
Airline payments per enplaned passenger after management fee	[B+(F/D)]	$4.66

The baseline was subject to adjustment to neutralize the effect of the following:

- Implementation of capital projects and increases in debt service
- All parking revenues and incremental expenses associated with new parking products
- Difference between actual inflation and inflation assumed in the baseline projections
- 60% of voluntary severance costs
- Additional operating expenses incurred as a result of accounting changes or legal mandates
- Bad debts
- Costs that were the responsibility of the Authority under the agreement, including contract compliance
- Other items subject to annual negotiation

If enplaned passenger levels varied by more than 10% (up or down) in any given year versus the baseline projection, the parties were required to negotiate in good faith an appropriate adjustment to the projection. Subject to these provisions, BAA committed to guaranteed minimum reductions in airline payments per enplaned passenger against the baseline for the 13-year period of the agreement (10-year term plus 3-year option period). The guaranteed minimum reduction per passenger (in 1994 dollars) was $0.27 in the first year of the agreement, $0.57 in the second year, and $0.456 in the remaining years. The management fee was to be paid monthly on the basis of actual performance versus budget, with a reconciliation following the annual audit.

In addition to the management fee, BAA was eligible for a 5% "quality bonus" for meeting certain quality improvement goals, with goals set annually as part of the budget process. BAA was also eligible for an incentive fee at the Board's discretion for developing new parking products.

During 2002 (and into early 2003), the Authority and BAA negotiated an amendment to the management contract, which was contemplated in the seventh year of the contract. Both parties had an incentive at the time to negotiate the extension. The Authority was motivated to change the compensation structure, as the annual processes required to calculate the fee became increasingly difficult to administer. Although BAA had two other U.S. contracts at the time (Pittsburgh and Boston Terminals B and E), these contracts were limited to managing only concession programs. BAA still viewed its contract with the Authority as important experience in anticipation of similar

opportunities arising in the future especially after having its management contract for the Harrisburg airport system terminated in mid 2001. BAA also saw the extension as an opportunity to market planning and development services related to the Midfield Terminal redevelopment, which was at the time expected to be completed by 2007.

The amended agreement changed the compensation methodology by providing for a fixed and a variable component. The fixed fee was set at $555,000 per year in 2003 dollars and was intended to compensate BAA for its expertise in airport management. The variable fee (the "performance fee") was capped at $1,295,000 per year in 2003 dollars and was intended to allow for BAA to be compensated on the basis of performance achieved towards different goals as opposed to a single goal (i.e., reduction in airline payments per enplaned passenger). The goal areas and their shares of the maximum performance fee were set as follows:

- Financial results (20%)
- Safety and security (20%)
- Customer relations (20%)
- Operation and maintenance (25%)
- Capital program management (15%)

Specific targets were set each year as part of the budget process. BAA was evaluated annually against progress towards these targets, receiving 70% of the maximum fee for each segment for minimal performance towards meeting target, 85% for meeting target, and 100% for outstanding performance towards meeting target. BAA also guaranteed minimum performance and was obligated to pay to the Authority up to $400,000 per year if it received less than 50% of the maximum performance fee. Under the revised agreement, BAA's minimum annual compensation was $150,000 (the $550,000 fixed fee less the maximum $400,000 penalty).

BAA management fees paid during the term of the management contract are provided in the later section "Consequences."

Personnel. The management contract required BAA to use its best efforts to employ all Authority staff. BAA was required to offer each employee an initial compensation and benefits package similar to what the employee was receiving as an Authority employee. BAA was also required to offer health insurance coverage under its own group plan. Concurrent with the effective date of the management contract, the Authority terminated its defined benefit pension plan, with employees eligible to rollover accumulated balances into a defined contribution plan offered by BAA. Severance costs related to any voluntary attrition of employees were shared by BAA (40%) and the Authority (60%, subject to a cumulative cap of $480,000). The agreement also required BAA to institute an employee training and development plan intended to improve staff's airport management expertise.

Other Provisions. The agreement required BAA to implement the customer survey program included in its proposal. BAA was also required to implement the "street pricing" program pioneered at Pittsburgh International Airport to ensure that the price of goods and services offered at airport concessionaires were on average the same as those in non-airport retail outlets in the Indianapolis area.

BAA was not released from the requirements of Authority procurement ordinances. All operating contracts entered into by BAA with a value of more than $50,000 were subject to written approval

by the Board. BAA covenanted to make its best efforts to meet Authority disadvantaged business enterprise (DBE) goals.

H.2.7 Consequences

Although the Authority initially viewed the managed competition concept as a way to change the way business was conducted over the long term at the airport, the Authority reassumed control of the airport system following the early termination of the agreement in June 2007. In the end, not all of the expectations were met. The Authority acknowledged that BAA was successful in gaining certain efficiencies and conceded that BAA was able to do so more quickly than the Authority may have been able to do so otherwise. There is also general agreement that BAA's operation was beneficial for staff as a whole, as employees gained broader airport management expertise and the opportunity to interact with colleagues in the United Kingdom. This interaction was valuable, as it brought to staff the private sector airport management perspective.

BAA assumed operational control in the year that reflected budget cuts implemented by the Authority in advance of the competitive bidding process. Under the terms of the management contract, in which the baseline was projected from the year before the reductions, BAA received the benefit of most of these operating expense cuts. As rental car and terminal concession agreements expired, BAA negotiated more favorable financial terms. BAA fully implemented the successful Pittsburgh "AirMall" concept with street pricing at the airport, which it later introduced at the airports serving Baltimore, Boston, and Cleveland. Although various attempts were made to increase parking revenues with the introduction of new products such as valet parking, most of these initiatives were not deemed to be particularly effective. While BAA did pursue outsourcing of services such as janitorial, in general, the savings were not significantly greater than the contracts the Authority already had in place. Air service marketing efforts were expanded, but without achieving the desired effect of new international service.

From the first year of the contract, it became apparent that the compensation methodology prescribed by the agreement would be difficult to administer. Since under the residual airline ratemaking structure, the airlines ultimately paid BAA's management fee, they lobbied the Authority to ensure that BAA did not receive the benefits of "windfall improvements" not subject to its control. To protect its financial interests, BAA spent much time and effort in documenting and estimating the effects of its efforts. The financial effect of many of BAA's initiatives such as implementing a new customer complaint program for parking operations, employee training programs, and new schedules and other changes to shuttle bus operations were impossible to measure meaningfully. Internal documents prepared by BAA in support of its proposed compensation calculation illustrate the structural problems with the compensation calculation that were experienced throughout the term of the contract:[7]

"Not all of [the initiatives being implemented by BAA may be directly financially appraised, but all will contribute to the enhancement of customer service and safety and therefore indirectly enhance revenue streams and facilitate cost savings."

The structure of the compensation calculation dis-incentivized BAA from implementing any customer service initiative that resulted in increased operating expenses, even though improved

[7] *Compensation Calculation, 1 October 1995 to 31 December 1996,* BAA Indianapolis LLC, August 1996.

customer service was cited as a goal during the competitive bidding process and was supported by the spirit of the management contract. While the parties attempted in good faith to use a more technical approach to identify appropriate baseline adjustments in the initial years of the contract, the annual compensation calculation eventually became more of a negotiation. The negotiation became more contentious as the baseline projected in 1994 became increasingly meaningless as a result of changes in the airline industry, the economy, and new security requirements as a result of September 11.

The Authority began planning efforts for the Midfield Terminal redevelopment during the term of the management contract. BAA viewed the redevelopment as an opportunity to market new services such as planning and construction development to the Authority. Such services would have been considerably more profitable to BAA than the management contract and were part of BAA's rationale in pursuing the contract in the first place. However, BAA did not realize any opportunities as the Authority engaged other outside parties. In 2000, the Authority engaged its own Executive Director, to manage its Capital Improvement Program, which included the $1 billion new Midfield Terminal. Over time, as the calculation of the management fee became increasingly contentious, and BAA's views on the Midfield Terminal project diverged from the Board's view, the Executive Director assumed an increasing role as the Board's liaison with BAA's airport director. This experience accounts, in part, for the change in compensation structure negotiated by the Board for the extension term.

As discussed previously, the overarching objective of the management contract was to attract increased airline service and economic development. The Board felt that it could achieve such goals by reducing airline costs and outsourcing airport management to a private-sector operator with airport expertise. With these goals in mind, the Board negotiated what it believed to be a performance-based compensation structure. While the experience of the Authority and BAA demonstrates the inherent difficulty in measuring the success of a private sector operator versus a public sector operator, trends in the following metrics can be used in part to analyze success versus goals stated by the Authority during the competitive bidding process:

- Enplaned passengers
- Airline payments per enplaned passenger
- BAA management fee

Enplaned passengers. As shown in Table H.18, between 1995 and 2007, enplaned passengers (in millions) at IND increased an average of 1.8% per year, which was lower than the average for the nation as a whole (2.6%). The lower rate for IND can be explained, however, in large part, as a result of changes in airline service. ATA Airlines, based at IND, liquidated and suspended its scheduled low-fare operations in 2006. Northwest Airlines built up service from IND to major business markets beginning in 2004, but discontinued a portion of the service following its merger with Delta Air Lines in 2008. Both events were outside of the control of BAA and the Authority. Regardless of these events, the trend does not suggest that BAA had success in air service development efforts. In particular, BAA was unsuccessful at attracting international air service, which was a stated goal of the Authority, other than seasonal charter service.

Table H.3. Enplaned Passengers, Indianapolis (IND) and United States

Year	IND *(a)*	Percent annual change	U.S. *(b)*	Percent annual change
1995	3.4	n.a.	572.0	n.a.
1996	3.5	5.4%	604.8	5.7%
1997	3.6	1.4%	624.6	3.3%
1998	3.7	1.8%	640.2	2.5%
1999	3.7	2.1%	666.9	4.2%
2000	3.9	4.0%	694.9	4.2%
2001	3.6	-6.6%	646.1	-7.0%
2002	3.4	-4.7%	633.4	-2.0%
2003	3.7	6.6%	666.5	5.2%
2004	4.0	9.4%	721.7	8.3%
2005	4.3	5.9%	751.7	4.2%
2006	4.0	-5.0%	753.9	0.3%
2007	4.1	2.4%	778.5	3.3%
Average annual increase				
1995 - 2007		1.8%		2.6%
(a) Indianapolis Airport Authority records.				
(b) U.S. Department of Transportation T100 database.				

Airline payments per enplaned passenger. Table H.4 shows airline payments per enplaned passenger (in nominal and constant 1995 dollars). As shown in the table, airline payments per enplaned passenger in constant 1995 dollars exceeded the 1995 amount only twice in the 13 years in which BAA operated the airport system (2002 and 2003). The lowest numbers were achieved in the first 2 full years of operation (1996 and 1997), suggesting that BAA was able to supplement prior operating expense reductions by Authority staff with increased nonairline revenues. Airline payments per passenger peaked in 2003 and 2004 following the September 11 as a result of additional operating expenses related to increased security measures. The relative stability in airline payments over the period is attributable in part to minimal capital expenditure requirements as the existing terminal was to be replaced with the Midfield Terminal that opened in late 2008. While the data indicate general stability in airline payments during the term of the BAA management contract, it is difficult to compare with payments that would have been under continued Authority operation. As stated in the prior section "Competitive Bidding Process," many of the improvements identified by the private sector bidders were proposed by the Authority staff.

Table H.4. Airline Payments per Enplaned Passenger, IND and United States (in millions)

	Airline payments per enplaned passenger (nominal dollars) *(a)*	Airline payments per enplaned passenger (1995 dollars) *(b)*
1995	$5.58	$5.58
1996	3.87	3.75
1997	3.84	3.65
1998	3.78	3.54
1999	5.02	4.57
2000	5.06	4.47
2001	6.18	5.33
2002	6.13	5.20
2003	7.15	5.93
2004	7.09	5.71
2005	6.44	5.00
2006	6.87	5.19
2007	7.38	5.41

(a) *Comprehensive Annual Financial Reports*, Indianapolis Airport Authority.

(b) Adjusted to 1995 dollars using the U.S. Department of Labor Consumer Price Index for All Urban Consumers.

BAA management fee. Table H.5 shows the annual management fee paid to BAA. As shown in the table, payments increased every year between 1996 and 2000. As operating expenses increased and passenger numbers decreased following September 11, the management fee was reduced. The provisions of the extended agreement capped the amount that BAA was eligible to receive to a maximum of $1,850,000 ($555,000 fixed component and $1,295,000 variable component) in 2003 dollars. The maximum amount under the extension term was much reduced from the maximum under the original agreement ($4 million) and less than the amount earned by BAA in each year between 1998 and 2001, suggesting that the Authority valued BAA's services less than it had in the past.

Table H5. **BAA Management Fee (in thousands)**

Year	Management Fee
Original Term	
1996	$1,003
1997	1,490
1998	2,265
1999	2,314
2000	2,417
2001	2,195
2002	1,003
Extension Term	
2003	1,459
2004	1,480
2005	1,780
2006	1,792
2007	1,976

Sources:
1996-1997: *Official Statement, Indianapolis Airport Authority, Refunding Revenue Bonds, Series 1998A*, May 21, 2008.
1998-2007: *Comprehensive Annual Financial Reports,* Indianapolis Airport Authority.

While the data presented in Tables H.3, H.4, and H.5 do not provide empirical evidence that BAA was able to achieve financial improvements that could not have been achieved under continued Authority operation, BAA cited the following, among others, as being indicative of its success:

- Implemented new food/beverage program throughout IND, introducing brand-name outlets with guaranteed street prices
- Completed a terminal refurbishment program with new lighting and carpeting, fresh paint, and new signage.
- Opened the airport's first fueling station and convenience center, which improved customer service at the airport's facilities.

In the first year after the Authority resumed operation (2008), the Authority reported that administration costs decreased $1.1 million, or 8.7% from the prior year, which was primarily attributable to the termination of the management contract.

H.2.8 Lessons Learned

Lessons by the stakeholders in this airport system management contract included the following:

- Government departments competing in managed competition efforts can be disadvantaged, as regulations generally prevent them from partnering with private firms or guaranteeing performance. Evaluation criteria may need to be assessed with this potential conflict in mind.

- Whatever metrics are used to gauge performance should be transparent and easily measurable. Improvements made by BAA as measured by airline payments per enplaned passenger were difficult to track as they required the estimation of a hypothetical baseline comparison (including numerous categories of operating expenses and nonairline revenues, which can be extremely variable from year to year). Over the long-term agreement, especially after the operational changes necessitated by increased security measures following the September 11, 2001 terrorist attacks, it became increasingly difficult to estimate meaningfully what the baseline would have been. In this respect, the annual management fee became an annual negotiation between the Authority and BAA and was frequently contentious.

- Tracking contract compliance became a substantial undertaking for the Board, which eventually hired professionals with airport and public management expertise to oversee the contract. Much time was spent defining a peer set of airports to use for benchmarking BAA's performance, with inconclusive results.

- Once initial efficiencies had been gained by BAA, it became difficult to make ongoing improvements with effects similar in magnitude. For this reason, a strategy may be to contract with a private-sector firm on a short-term basis to gain the majority of potential efficiencies before transferring the operational responsibilities back to the public sector. The Authority-BAA contract worked in this regard to the extent that staff gained broader, international airport management expertise during the term of the contract.

- From BAA's perspective, once initial efficiencies were attained, it became increasingly difficult to attain further improvements and realize the full value of the management fee. Moreover, the relatively small maximum annual compensation amount (initially $4 million, reduced later to $1.85 million), while appropriate for a firm that may have viewed the opportunity as a "loss leader" necessary to achieve more lucrative contracts in the future, may not have been enough of an incentive to attain more difficult-to-achieve improvements.[8]

- When many goals are trying to be achieved through privatization, the compensation needs to be tied to each goal. The initial compensation structure for BAA was tied to improvement in one variable—airline payments per enplaned passenger—and not separately to the individual goals the Authority was trying to achieve (e.g., improved customer service and

[8] As a point of reference, the management fee for airport management services for Albany International Airport was fixed at $407,286 in 2010, an airport that accommodated 1.3 million enplaned passengers in 2009, compared with IND's 3.7 million enplaned passengers.

new air service). The amended agreement changed the compensation structure so that BAA was compensated for its progress against separate goals, but the new structure may also have been difficult to truly measure efficiencies for the purpose of justifying compensation.

- To achieve the full benefits of privatization, it may be more effective to contract with multiple firms specializing in each area in which improvement was targeted. While BAA had successful U.S. experience with concession programs, other firms may have had more expertise in areas such as parking or building maintenance. While the management contract allowed BAA to contract with other firms, BAA often was incentivized to maintain as much control as possible.

- With few exceptions, there were no 'magic solutions' that could not have been attained under continued public management. When acquiring services on behalf of the Authority, BAA was not released from Authority procurement regulations, which is often a large motivation in privatization efforts. However, BAA's procurement of goods with their own operating funds was not considered 'public' dollars in the same way as the Authority's funds. Moreover, BAA employed substantially the same staff as the Authority did before. In the end, BAA's approach to improve performance involved typical airport management best practices to increase nonairline revenues with more advantageous contract terms, increase parking revenues without sacrificing market share, increase commercial development, and outsource non-core services. Notwithstanding these industry-accepted approaches, having a private operator involved may have streamlined and improved certain processes, especially with regard to renegotiating concession, rental car, and other nonairline contracts.

H.2.9 References

Agreement for the Operations and Maintenance of the Indianapolis International Facilities, Indianapolis Airport Authority, 1995.

Amended Agreement for the Operations and Maintenance of the Indianapolis International Facilities, Indianapolis Airport Authority, 2003. (Extension Agreement)

Amended Agreement for the Operations and Maintenance of the Indianapolis International Facilities, Indianapolis Airport Authority, 2007. (Termination Agreement)

Compensation Calculation, 1 October 1995 to 31 December 1996, BAA Indianapolis LLC, August 1996.

Comprehensive Annual Financial Reports, Indianapolis Airport Authority, fiscal years 1998-2007.

FedEx in Indianapolis, FedEx Corporation, *http://news.van.fedex.com/node/743,* retrieved November 10, 2010.

Stephen Goldsmith, *The Twenty-First Century City: Resurrecting Urban America,* Rowman & Littlefield, 1999.

Hai-Chao Chang et al., *Managed Competition in Indianapolis: The Case of Indianapolis Fleet Services,* Columbia University, 2005.

Russell Hotten, *BAA Spread Wings in Indianapolis, The Independent,* September 13, 1995.

Indianapolis International Airport to Get New Management, Inside Indiana Business, May 4, 2007.

Official Statement, Indianapolis Airport Authority, Refunding Revenue Bonds, Series 1998A, May 21, 2008.

Official Statement, Indianapolis Airport Authority, Airport Revenue *Bonds, Series 2010A,*, January 15, 2010.

Presentation of Proposal Summaries to the Indianapolis Airport Authority Board of Directors, Infrastructure Management Group, 1995.

Michael Wells, former Board President, Indianapolis Airport Authority, phone interview, October 26, 2010.

H.3 John F. Kennedy International Airport Terminal 4 (JFKIAT)

H.3.1 Background

JFK International Air Terminal LLC ("JFKIAT") was formed in 1997 in partnership with the Port Authority of New York and New Jersey to build, operate, develop, and manage the $1.4 billion Terminal 4 at John F. Kennedy International Airport ("JFK"). Terminal 4 replaced the original International Arrivals Building ("IAB"), which had been built, operated, expanded, and renovated by the Port Authority since 1957. Since the central terminal complex was developed in the late 1950s and early 1960s, the IAB has been the only terminal at JFK not exclusively leased, developed, and operated by airlines. For this reason, the terminal has traditionally housed the operations of numerous foreign-flag airlines, typically operating with low frequencies. (In November 2010, 38 airlines provided service at Terminal 4.)

Recognizing that the IAB no longer functioned efficiently due to insufficient capacity and outdated building systems, the Port Authority initiated in 1993 planning and design studies for redevelopment of the IAB. Realizing that the project would require significant capital investment and program management and oversight, the Port Authority decided in 1995 to involve the private sector in the design, construction, and operation of the new facility on the site of the existing IAB.

JFKIAT was selected by the Port Authority following a competitive bidding process. JFKIAT was a joint venture of LCOR JFK Airport, LLC, Schiphol USA Inc., and Lehman JFK LLC. JFKIAT assumed responsibility for the operation of the IAB and development of the new state-of-the-art international terminal building in May 1997 shortly after the financial closing of the special facility bonds issued to finance the project. JFKIAT was the first private, nonairline entity to manage an international air terminal in the United States.

Occupying 165 acres, JFKIAT controls the largest and most flexible terminal site at JFK. The 1.5-million-square foot terminal opened in May 2001 with two concourses (Concourses A and B) and 16 loading-bridge-equipped gates and an apron capable of accommodating up to 24 remotely parked aircraft. Terminal 4 is the largest international terminal in the New York area, with federal inspection services ("FIS") facilities capable of processing 3,200 passengers per hour, and provides the only 24-hour FIS facility at JFK.

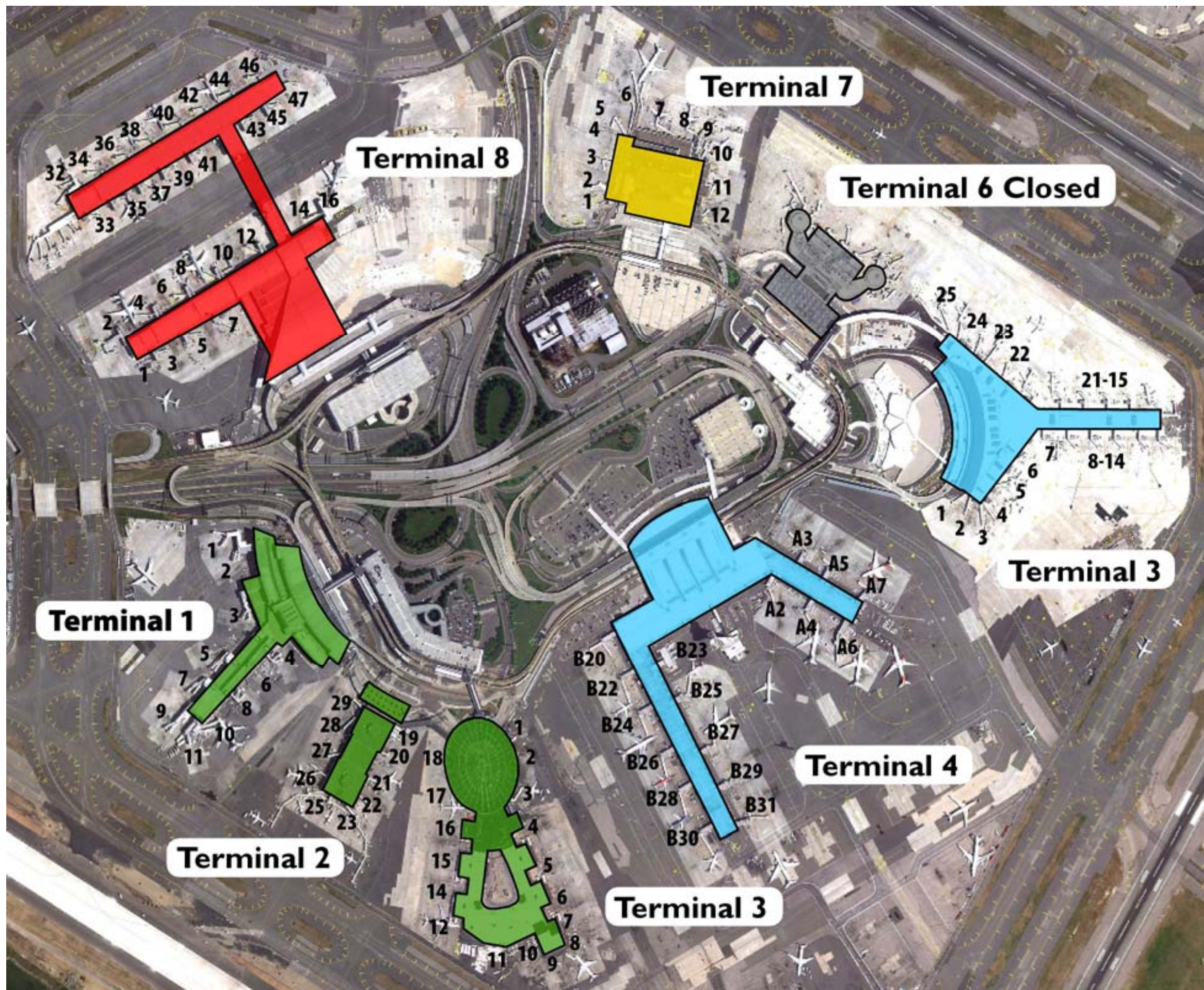
JFK's Central Terminal Area includes 8 unit passenger terminal buildings, of which 7 are currently in use. Figure 10.1 shows the passenger terminal buildings at JFK as of November 2010. Developments since the signing of the JFKIAT in May 1997 include (1) the opening of new Terminal 1 in 1998; (2) the opening of the $1.9-bilion AirTrain rail transit system in late 2002, which connects the central terminal area with subway and regional rail systems; (3) the redevelopment of Terminal 5 at a cost of $800 million, which opened in 2008; and (4) the redevelopment of Terminal 8 at a cost of $1.3 billion, which opened in 2007. As of November 2010, the Port Authority's Redevelopment Program for the central terminal area at JFK has resulted in modern passenger facilities at Terminals 1, 4, 5, 7, and 8, which primarily relied upon private investment given the Port Authority's substantial financial commitment to the AirTrain. As of November 2010, the JFK terminals consist of:

- Terminal 1 -- operated by an airline consortium of Air France, Japan Airlines, Korean Air, and Lufthansa German Airlines, collectively the Terminal One Group Airlines ("TOGA")

- Terminal 2/3 -- operated by Delta Air Lines
- Terminal 4 (former IAB site) -- operated by JFKIAT
- Terminal 5 -- operated by JetBlue
- Terminal 7 -- operated by British Airways with United Airlines as a major tenant
- Terminal 8/9 -- operated by American Airlines

Terminal 6 was closed upon the opening of the redeveloped Terminal 5 in 2008. The Port Authority has since approved plans to demolish Terminal 6 and use the site for remote aircraft parking or future terminal development.

Figure H.1. JFK Central Terminal Area



Source: Google Earth, accessed December 2011.

Terminal 4 was generally recognized in the industry as the preeminent example of nonairline, private sector participation in terminal development and operation, with benefits having been realized in increased operating efficiency, enhanced levels of service for passengers and airlines, and reduced operating costs.

In August 2010, JFKIAT, the Port Authority, and Delta Air Lines announced a $660 million expansion of Terminal 4 (the "2010 Expansion Project"), which includes an extension of Concourse B to include 9 additional loading-bridge-equipped gates, new airline lounges, centralized security checkpoints, a secure-side connector to Terminal 2, the demolition of Terminal 3, and expanded remote aircraft parking facilities. Construction is expected to begin in the fourth quarter of 2010, with all work to be completed within five years.

In 2010, in connection with the proposed redevelopment, Schiphol acquired the LCOR and Lehman ownership stakes to become the sole partner. Subsequently, Delta bought a non-majority, non-controlling stake in JFK-IAT in April 2010.

H.3.2 Objectives

After the election of George Pataki as New York governor in 1994, political support of privatization initiatives at state agencies increased. In this environment, the Port Authority[9] began considering involving private sector participation in its operations. The Terminal 4 redevelopment was identified as an attractive opportunity as its cost comprised approximately one-fourth of the cost of the agency's 5-year capital program and the Port Authority wished to preserve future funding capacity. Other large-scale construction projects were planned or in process at JFK, including the quadrant roadway reconfiguration and the AirTrain rail transit system, which was to connect the terminal complex with subway and regional rail systems. The financial and management resources required to implement these complex projects along with the redevelopment of Terminal 4 provided further encouragement for the agency to explore alternative project delivery methods. Finally, the IAB was operationally intensive, with approximately 230 Port Authority employees staffing the facility at the time.

In summary, the Port Authority's primary objectives in partnering with the private sector to redevelop the IAB in 1997 were:

- Preserving financing capacity
- Minimizing construction risk and management oversight
- Reducing operational responsibilities
- Delivering a functional terminal on time and on budget with no additional financing required by the Port Authority
- Improving operational efficiency and increasing terminal capacity by replacing exclusive-use arrangements with common-use arrangements and new pricing approaches
- Gaining public-private partnership experience for possible deployment to other agency operations

For the 2010 Expansion Project announced in August 2010, the Port Authority's objectives included:

[9] The Port Authority is a bi-state port district established through an intergovernmental contract between the states of New York and New Jersey. The governor of each state appoints 6 members to the Board of Commissioners, which oversees the Port Authority.

- Accommodating Delta and SkyTeam's growth plans, which is part of a larger goal for co-location of alliance partners
- Demolishing the functionally obsolete Terminal 3
- Ensuring JFK's continued preeminence as a premier port of entry into the U.S.
- Improving customer service and the passenger experience
- Minimizing the Port Authority's financial commitment in favor of higher priorities, in particular, the redevelopment of the World Trade Center site

H.3.3 Transaction and Development Timeline

A timeline for the planning, construction, and operation of Terminal 4 and related material events is as follows:

Table H.6 JFKIAT Terminal 4 Privatization Timeline

1993	Port Authority began planning and design studies for Terminal 4 redevelopment
July 1995	Request for qualifications issued for parties interested in operating the existing IAB and to construct and operate the new Terminal 4
December 1995	Request for proposals (RFP) issued
March 1996	RFP responses due
April 1996	JFKIAT selected as winning proponent
May 1996	Memorandum of understanding signed between Port Authority and JFKIAT and JFKIAT assumes operational responsibility
April 25, 1997	Closing of $934.1 million in Series 6 Special Project Bonds to finance Terminal 4 redevelopment
May 13, 1997	Execution of JFKIAT lease, JFKIAT assumes operation of IAB
May 1998	Terminal 1 opens at JFK; Air France, Japan Airlines, Korean Air, and Lufthansa relocate operations from the IAB to Terminal 1
May 8, 2001	Opening of the Terminal 4 central terminal building ("head house") with the principal facilities for processing arriving and departing passengers
August 10, 2001	Port Authority and JFKIAT agree to terms of lease amendment; Port Authority provides $172 million in subordinate completion financing
September 11, 2001	Terrorist attacks depress international airline travel demand; most U.S. airports, including JFK, closed for 2 days
March 2002	Terminal C international arrivals facility opens at Newark Liberty International Airport; federal inspection services facilities are capable of processing up to 1,500 passengers per hour
December 2003	AirTrain transit system opens at JFK, improving access to subway and regional rail systems
November 2004	City of New York and Port Authority execute extension to Port Authority's lease of JFK and LaGuardia airports through 2050
2007	Delta Air Lines begins negotiations with Port Authority and JFKIAT over Terminal 4 expansion

August 2007	American Airlines completes redevelopment of Terminal 8; the 1.6-million-square-foot terminal has 36 gates and includes federal inspection services facilities capable of processing up to 1,600 passengers per hour
October 2008	JetBlue opens new 26 gate Terminal 5 at JFK
April 2010	Schiphol USA acquires JFKIAT ownership stakes of LCOR and Lehman
August 11, 2010	Port Authority, JFKIAT, and Delta announce $660 million expansion of Terminal 4
May 2013 (anticipated)	Delta to relocate fully Terminal 3 operations to Terminal 4
May 2015 (anticipated)	Terminal 3 demolished; site redeveloped to accommodate remote aircraft parking

H.3.4 Competitive Bidding Process

The competitive bidding process was completed relatively quickly, with less than two years elapsing between the issuance of a request for qualifications ("RFQ") in July 1995 and the financial closing of the special facility bonds issued to fund the project in April 1997. The Port Authority was motivated to expedite the process due to the pressing need to replace the IAB amid increasing traffic and its desire to mitigate cost escalation risk.

In July 1995, the Port Authority issued the RFQ to operate the existing IAB and construct and operate Terminal 4. Ten of the eleven respondents were qualified to reply to the request for proposals ("RFP"), which was issued in December 1995. The Port Authority set up a data room for the bidders to review information compiled on the project. Four proponents responded to the RFP, and JFKIAT was selected as the winning proponent in April 1996. Bidders were required to bid on the Port Authority design (at approximately the 30% stage) but could also propose alternative designs. The main criteria used by the Port Authority to judge the proposals were (1) design, functionality, and ability to construct, (2) the operational plan, and (3) financial criteria, including no Port Authority funds and the use of non-recourse bonds. The Port Authority did not want to provide a backstop to any of the development ventures.

The winning bidder was a joint venture of:

- LCOR JFK Airport LLC ("LCOR") with a 40% stake
- Schiphol USA LLC with a 40% stake
- Lehman JFK LLC ("Lehman") with a 20% stake

LCOR JFK Airport LLC is owned by LCOR Inc. and LCOR Investment Corp. with core business activities related to real estate development and management. LCOR has been involved with a number of high-profile real estate projects. Schiphol USA LLC is a division of Schiphol International, the international arm of Schiphol Group, which is a Dutch company that owns Amsterdam Airport Schiphol, Rotterdam The Hague Airport, and Lelystad Airport. It also owns 51% of Eindhoven Airport and 19% of Brisbane Airport in addition to its ownership in JFKIAT. Lehman JFK LLC is an indirect and wholly owned subsidiary of Lehman Brother Holdings Inc., which went bankrupt in 2008. Lehman JFK LLC is not in bankruptcy.

Among the bidders, JFKIAT was judged the best in all categories as its proposal best demonstrated an understanding of what the Port Authority was trying to accomplish. In addition, JFKIAT was the only bidder that proposed to make an unconditional equity contribution ($15 million). The Port Authority's willingness to provide access to the tax-exempt bond market on behalf of the developers and the associated lower cost of capital dis-incentivized a large equity investment.

In May 1996—10 months following the issuance of the RFQ—a memorandum of understanding was signed between the Port Authority and JFKIAT. JFKIAT initiated a due diligence process thereafter, engaging outside consultants to audit financial and operational plans and to conduct legal and regulatory reviews. At the conclusion of the due diligence process, JFKIAT refined its plans for the development and operation of the facility. JFKIAT also continued to develop all construction documents and plans at its own risk (costing $33 million) before closing.

The lease between JFKIAT and the Port Authority for the operation of the IAB and the construction and operation of Terminal 4 was executed in May 1997 shortly after the closing of the special facility bonds issued to fund the project.

H.3.5 Stakeholder Interests

Labor. The Port Authority employed approximately 230 people at the IAB prior to the Terminal 4 project, which included operations staff, customer-service staff, and skycaps. The Port Authority required JFKIAT to interview existing staff for possible employment, but JFKIAT was not contractually obligated to employ any staff. The Port Authority guaranteed jobs in other facilities to those not absorbed by JFKIAT and required JFKIAT to include $4 million in project costs for the Port Authority's costs in realigning the IAB staff, which were mostly early retirement benefits. Labor interests included:

- Ensuring no decrease in salaries and benefits
- Not relinquishing years-of-service credited towards pension requirements
- Maintaining the stability and protections otherwise provided by government jobs.

In the end, JFKIAT contracted most services out to third parties in order to realize operating expense efficiencies and the expertise of specialized firms. A number of the Port Authority employees were hired by these third party contractors and many skycaps all went to work for a concessionaire.

Schiphol (JFKIAT partner). As the operator of one of Europe's busiest connecting hubs, Amsterdam Schiphol Airport, along with other airports, Schiphol had many years of experience in developing, managing, and operating airports. Anticipating the project to be the first of many in the United States, Schiphol's main interest in the Terminal 4 redevelopment was to gain U.S. experience that would position the company well for similar opportunities in the future. When negotiating the terms of the Terminal 4 expansion project, Schiphol also sought to establish good relationships with Delta, the transatlantic joint-venture and SkyTeam alliance partner with its primary tenant in Amsterdam, Air France-KLM.

LCOR (JFKIAT partner). LCOR had broad experience in public-private real estate partnerships, mainly government office buildings, and had built relationships with the Port Authority through a concession redevelopment project at the World Trade Center. Although prior to JFKIAT, LCOR

did not have any experience in the airport industry, it believed that the industry was primed for private sector involvement and that the industry represented a substantial growth opportunity. Like Schiphol, LCOR believed that the Terminal 4 project would provide high-profile experience that could be marketed in the future to other airports. Moreover, LCOR believed that the investment had minimal downside risk, on the basis that Terminal 4 would be the largest international terminal at a constrained airport serving the nation's largest city, and that any risk was spread among a diverse base of airline tenants. In this sense, LCOR viewed the terminal as a developer would view a spec office building in a strong real estate market.

After the project was completed, no opportunities for similar participation at other U.S. airports materialized and LCOR's interests became more financial in nature. The strong political support for the Terminal 4 expansion project resulted in pressure to extend to Delta preferential lease terms providing for cost-recovery rates and charges. Believing that the nature of the business opportunity would change, LCOR sold its ownership stake to Schiphol in April 2010.

Lehman (JFKIAT partner). Initially Lehman Brothers was on the team to be the managing underwriter for the original $934.1 million special project financing, but joined as equity partner after financing JFKIAT's predevelopment costs (totaling $33 million). Lehman generally acted as a passive partner in JFKIAT, ceding development and operational responsibilities to Schiphol and LCOR. The 2008 financial crisis resulted in the bankruptcy of Lehman Brothers and a desire to exit the partnership. The negotiations for the Terminal 4 expansion project provided an opportunity for Lehman to sell its stake to Schiphol in April 2010.

Airlines. The IAB had historically been served by a large number of foreign-flag airlines. While no single airline had a dominant share of passenger traffic at the IAB, 14 of approximately 45 airlines using the IAB maintained exclusive use leases in 1996 as a legacy of the era in which the facility was constructed. New entrant and other airlines not having such leases were therefore required to negotiate with lessee airlines; as such, their operational needs were typically given lower priority than those of the lessee airlines. Exclusive use leasing arrangements also created operational inefficiencies because gate, ticket-counter, and other space could not easily be shared among airlines operating at different periods of the day. The leasing arrangements at the IAB were by no means different from the arrangements at other terminals, which were generally operated by a single airline or small group of airlines, also requiring new-entrant and smaller airlines to negotiate with lessee airlines for accommodation.

Airline interests in the redevelopment of Terminal 4 were divergent, with lessee airlines generally preferring the rights afforded to them by exclusive-use leases and the non-lessee airlines generally preferring common-use leasing arrangements. Although all of the other unit terminals at JFK were developed and are operated by one or more airlines, no airline group proposed on the Terminal 4 redevelopment, reflecting the magnitude of the development cost and the lack of an anchor airline. Notwithstanding the divergent interests, airlines did have the following interests in common:

- Minimizing the disruption of IAB operations during the construction of Terminal 4
- Replacing the aging IAB with an operationally efficient terminal capable of accommodating forecast demand
- Having certainty with regard to the availability of gate and other facilities for their operations

- Minimizing increases in rates and charges
- Ensuring levels remained competitive with other JFK terminals
- Having the ability to enter into agreements whereby preferential rights such as gate assignments and lower rates and charges could be obtained in exchange for guaranteed activity levels
- Improving customer service and the passenger experience

USDOT and FAA. Involvement of the USDOT and FAA during the project was limited, with their primary interests being to ensure that the parties complied with relevant legislation, regulations, and policies. Chief among these were compliance with grant assurances, environmental regulations, and the rates and charges policy. Passenger facility charges (PFCs) were not used to fund the project so related regulations did not apply.

In January 1997, the FAA provided a categorical exemption from the requirement for an environmental assessment and approved an updated airport layout plan including the redeveloped terminal. In March 1997, the FAA consented to the demolition of the IAB, subject to the requirement that grant-funded facilities in the IAB were replaced with "like or superior" facilities.

Federal rates and charges policy requires that rates and charges levied on airlines for services and facilities at U.S. airports be "fair and reasonable" and that airlines cannot be subjected to "unjust discrimination" in fees and operating conditions, unless otherwise agreed to by the airline. Any airline has the right to challenge to the DOT a rates-and-charges regime that it believes does not meet these requirements.

In the official statement for the 1997 special project financing, JFKIAT stated its intention to use a market-pricing approach for rates and charges and to charge differential rates in peak periods. It also stated its belief that the proposed pricing structure complied with rates and charges policy because:

- Such an approach was used at airline-operated terminals at JFK
- Competition among terminals at JFK and Newark would keep rates constrained
- Airlines would have the option to use other terminals at JFK or Newark if they did not agree with the JFKIAT approach
- Each class of airline would be subject to the same rates and charges, with differential rates being charged commensurate with the differing financial and contractual commitments made by each class

While it was reported that one airline was unhappy with the level of the charges imposed and pursued informal lobbying of the Port Authority and state government officials, as of November 2010, no challenges have been filed with the USDOT.

H.3.6 Business Terms and Project Financing

JFKIAT entered into a lease with the Port Authority that was effective May 13, 1997, shortly after the financial closing of the special project bonds on April 25, 1997. The lease term was to expire on

the earlier of the date (1) 25 years after the date of beneficial occupancy of the new facility, or (2) the day prior to the date on which the Port Authority's lease with the City of New York for JFK expired ("City Lease"). The lease required JFKIAT to complete construction of the terminal by May 12, 2002, however, significant financial penalties kicked in if not finished by May 2001. At the time of lease execution, the City Lease was to expire in 2015; however in 2004, the City Lease was extended through 2050. The JFKIAT lease provided for accelerated amortization of principal in the case that the City Lease was not extended. With the extension of the City Lease, the JFKIAT lease for Terminal 4 was amended to expire on May 8, 2026.

Under the lease, the Port Authority covenanted that as long as JFKIAT was operating a 24-hour FIS facility at Terminal 4, it would not construct or operate itself, or permit another non-airline operator to construct or operate, a FIS station at the Airport through May 13, 2026, unless the additional FIS station was necessary to comply with federal requirements or unless the number of passengers using Terminal 4's FIS station exceeded its agreed-upon design capacity. JFKIAT believes that Terminal 4 has benefitted, and may continue to benefit, from this "Restrictive Covenant."

Under the terms of the lease with the Port Authority, JFKIAT is obligated to make rental payments sufficient to pay debt service on the special facility bonds, pay certain operation and maintenance expenses and ground rent to the Port Authority, and to make certain other payments and distributions from revenues available after the payment of debt service. Revenues consist of airline payments (passenger terminal charges, utility recovery charges, exclusive airline space rentals, aircraft parking fees, and ground handling concession fees), terminal concession privilege fees, and tenant parking fees. Revenues generated from airline users of Terminal 4 account for about 85-90% of total Terminal 4 revenues.

In April 1997, the Port Authority issued $934.1 million in special project bonds to finance construction by JFKIAT of the new Terminal 4, which consisted of demolishing the IAB and constructing the new Terminal 4, including a terminal building, terminal frontage roadway, and aircraft parking ramp. The bonds are secured by rental payments (i.e., amounts required to pay debt service on the bonds), the pledge of a leasehold mortgage, and certain other pledged assets of JFKIAT, and are not a general obligation of the Port Authority. JFKIAT makes facility rental payments from its net revenues (revenues less operating and maintenance expenses and ground rental to the Port Authority). The 1997 bonds received investment grade ratings of BBB+ by Standard & Poor's, A by Fitch, and BAA2 by Moody's. The bonds were insured by MBIA and oversubscribed by a factor of three.

In connection with the $172 million in completion financing provided by the Port Authority to JFKIAT, a lease amendment was executed in August 2001. Although JFKIAT initially asked the Port Authority to issue additional bonds to fund cost overruns, the Port Authority offered to provide a subordinate loan to expedite the financing and minimize the complexities of dealing with the various financial parties. The Port Authority also wanted to protect its landlord position in the "waterfall" from another creditor and improve upon the overall economics of the deal for itself. In particular, as a result of this financing and the associated amendment to the lease, the Port Authority retained a majority of the distributions after the payment of operating expenses, ground rent (to the Port Authority), debt service, reserve deposits, and the terminal and retail management fees to JFKIAT. In return, JFKIAT received a higher terminal management fee and higher retail management fee. Subsequent lease amendments were executed that modified the terms for the completion financing. As a result, financial returns to JFKIAT consist primarily of its share of

distributions after payment of operating expenses, ground rent, debt service, reserve deposits plus terminal and retail management fees.

Unlike the cost-recovery pricing methodology used at most U.S. airports, JFKIAT imposes differential pricing that recognizes the value to airlines of access to the facilities during peak periods and the value to JFKIAT of longer term, fixed lease commitments. These rates are generally set to reflect market-based competitive rates for rents and fees. Airlines have the option of entering into agreements of various terms (as short as 30 days and as long as 10 years) with JFKIAT, with those airlines that guarantee a minimum passenger volume for a longer period of time generally being charged lower rates. The lease requires JFKIAT to submit an annual strategic plan to the Port Authority, the process of which includes a joint review of the proposed pricing structure. Any agreement between JFKIAT and an airline with a term of more than 7 years requires written consent from the Port Authority.

In connection with the 2010 Expansion Project, Delta signed a 30-year "Anchor Tenant Agreement" with JFKIAT providing for the preferential lease of up to 16 loading-bridge-equipped gates. Delta's terminal use fees will generally be calculated using cost-recovery principles, as opposed to the traditional market-pricing approach used to date. A second series of special project bonds was issued in December 2010 to finance the 2010 Expansion Project.

In consideration for the 2010 Expansion Project, the Port Authority extended the Terminal 4 lease through the earlier of 30 years from the date of beneficial occupancy of the expanded terminal or December 2043. The amended lease also provides for an independent contractor to conduct a study of the physical condition of Terminal 4 prior to May 13, 2026 (the original expiration date), to identify any maintenance or other capital repairs that are necessary or appropriate for maintaining the requisite level of service at Terminal 4, and its competitive position as a passenger terminal, over the balance of the term of the Lease. JFKIAT will be obligated to undertake any such identified refurbishments and cooperate with the Port Authority to secure associated financing, including the possible issuance of additional Terminal 4 bonds.

H.3.7 Consequences

Development Experience. Terminal 4 was developed over the four-year period between 1997 and 2001, during which portions of the IAB remained in operation. As part of the competitive bidding process, JFKIAT developed a construction plan and further modified that plan as a result of the due diligence process. The plan included a construction staging schedule intended to minimize disruption to passengers and tenants. The original schedule projected date of beneficial occupancy of December 15, 2000.

As the developer of Terminal 4, JFKIAT engaged the following participants in the design and construction of the facility:

Contractor	Morse Diesel International, Inc.
Program manager	Fluor Daniel, Inc.
Design team	TAMS Consultants, Inc. Skidmore, Owings & Merrill Ove Arup & Partners Communication Arts Inc. Graphics Interior Design International

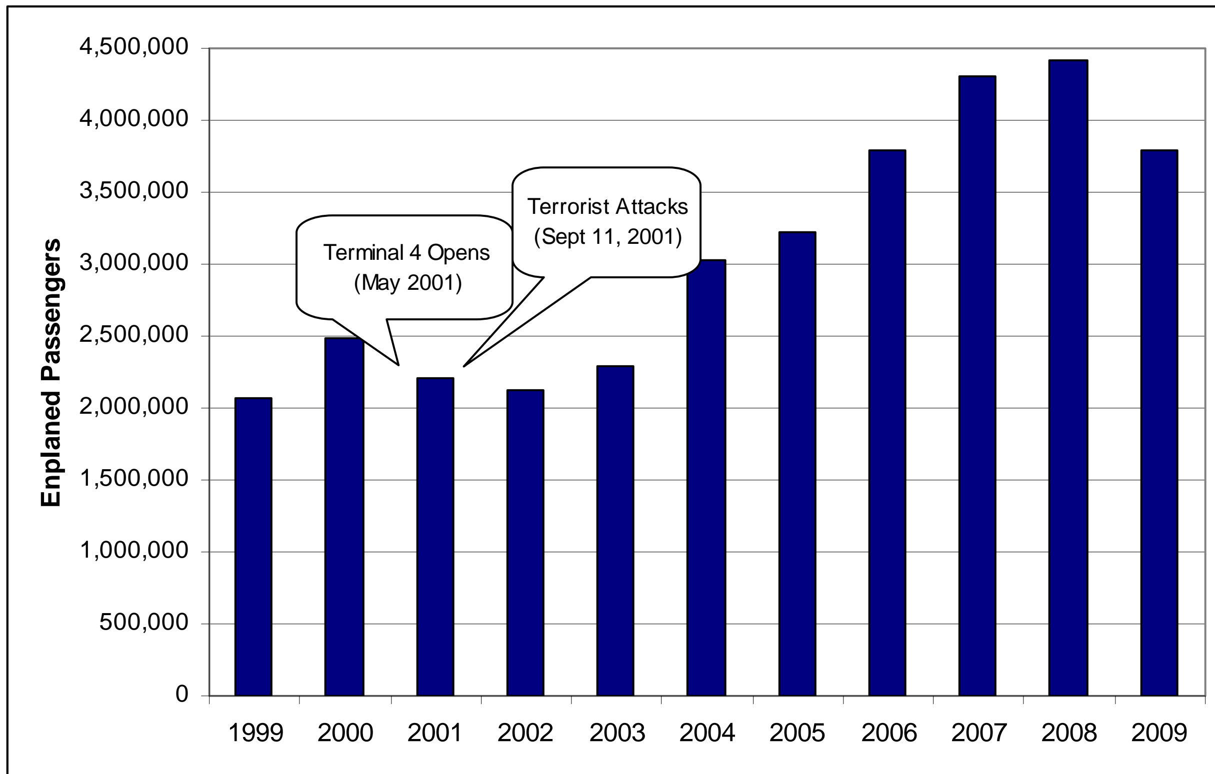
At financial closing of the special facility bonds, JFKIAT intended to enter into a guaranteed maximum price contract with Morse Diesel. JFKIAT was unable to enter into such contract due to the limited set of construction documents. The project was completed in May 2001 at a construction cost approximately 20% over the budgeted amount. (The final cost of construction was approximately $1,069 million, compared to an original estimate in 1997 of $876 million.) JFKIAT attributed the cost overruns to (1) staging costs, (2) unforeseen site conditions, (3) subcontractor disputes, and (4) architectural design features. JFKIAT was also highly motivated to complete the project by May 8, 2001 (the deadline in the lease) because upon the date of beneficial occupancy it could increase the per-passenger rates and realize significant increased revenues as well as avoid paying a significant penalty under the lease if not finished by then. Due to the loss of time dealing with the existing conditions, it cost more to accelerate the later stages of construction.

The cost overruns required that JFKIAT obtain completion financing, which was provided by the Port Authority through a $172 million subordinate loan as noted above.

Operational Experience. Since its completion in 2001, Terminal 4 has operated successfully, substantially improving operational efficiency compared with the IAB -- in large part due to the new state-of-the-art building -- and serving many airline tenants with diverse interests. Its operational and pricing structure has enabled it to respond more proactively to changes in the airline industry. As a full common use terminal, Terminal 4 was able to accommodate numerous airlines that operate at relatively low frequencies, thereby increasing utilization versus the IAB.

Terminal 4 has also captured an increased share of passenger traffic at JFK, with its 13.2% share of passengers enplaned in 1999 increasing to 19.9% in 2009. During the 10-year period, enplaned passengers at Terminal 4 increased an average of 8.2% per year, compared with an annual average of 3.9% for JFK as a whole. JFKIAT attributes this increase to the terminal's increased capacity and ability to accommodate new entrants. The low frequency airlines that are not affiliated with a major airline alliance generally prefer operating from Terminal 4 over other JFK terminals because it is not operated by an airline. While priority use rights are conferred to some contracting airlines, airlines operating from Terminal 4 have greater certainty that their flights will not be "bumped" due to the scheduling decisions of a landlord airline. Airlines also realize efficiencies in the sense that they can separately negotiate operating agreements with JFKIAT with provisions such as term and guaranteed traffic levels tailored to their needs, as opposed to negotiating a under less flexible terms with the airlines operating the other unit terminals.

Figure H.2. Historical Terminal 4 Enplaned Passengers



Source: *Preliminary Official Statement, the Port Authority of New York and New Jersey Special Project Bonds, Series 8, JFK International Air Terminal LLC Project*, November 15, 2010.

JFKIAT sets airline rates and charges to reflect market demand for the facilities it offers rather than use cost-recovery formulas like most U.S. airports. To enhance facility utilization, JFKIAT offers lower passenger charges for off-peak activity. To attract long-term occupancy, JFKIAT offers lower rates for signatory commitment. The key determinants of differential pricing are:

- ***Contract Status***: Airlines with a longer lease term commitment are offered lower unit charges, assigned higher priority for access to facilities, and permitted certain handling rights. Airlines with no agreement are assessed a premium.

- ***Off-Peak Operations***: Airlines are offered discounted charges for off-peak operations to encourage efficient use of facilities and to compete with similar pricing offered by other terminals during periods of low terminal operations.

- ***Volume Guarantees***: Airlines committing to minimum annual guaranteed payments are eligible for preferred contract status.

Most of the airline space in Terminal 4 is nonexclusive, with preference for use based on airline contract status. Signatory airlines have preference in the use of space relative to contract airlines, which, in turn, have preference relative to independent airlines.

Differential rates ranging from $15 to $60 per enplaned passenger are set for peak and non-peak periods and international and domestic use. JFKIAT initially used rates charged for the use of Terminal 1 (an 11-gate, airline-consortium-operated, common-use international terminal opened in 1998) as benchmarks in setting Terminal 4 use fees.

The peak-pricing approach used by JFKIAT provided some relief for airlines suffering financially as a result of the September 11, 2001 terrorist attacks, 2008 fuel crisis, and other industry turmoil. While contracting airlines were generally held to the terms of their agreements with JFKIAT, including provisions for guaranteed passenger volumes, some airlines were able to realize savings by moving flights from peak periods to "shoulder" off-peak periods without sacrificing the scope of service provided from JFK. Other airlines having month-to-month agreements were able to cancel service without financial penalty. While the September 11, 2001 terrorist attacks resulted in forecast passenger levels not being met after the terminal opened, activity recovered quickly enough such that by 2004 the expected passenger levels materialized.

Terminal 4 was designed to incorporate many of the concession planning and design principles used in the successful concessions at Amsterdam Schiphol Airport and certain other European airports. The terminal concession program provides approximately 11,000 square feet of duty free, 31,500 square feet of retail, and 17,500 square feet of food and beverage for a total of 60,000 square feet (not including storage and service areas).

Every passenger must pass through the retail concourse on the way to their gates. Unlike the old IAB and most other U.S. airports, all retail shops and restaurants were initially located prior to security to enable well-wishers and meeters/greeters to use the facilities. Because airlines require international passengers to check-in 2 hours in advance of their flight time, there is ample opportunity for shopping and dining prior to a lengthy international flight. The retail concourse provides the only substantial seating area prior to security screening, and serves as the principal waiting area for passengers until departure gates are posted to encourage maximum passenger dwell times.

Internal forecasts of concession revenues that were prepared during the planning process were not realized. JFKIAT attributes this shortcoming primarily to the (1) significantly worse-than-expected sales of duty free goods after the abolition of duty free sales for intra-European Union traffic in July 1999, (2) traffic declines after September 11, and (3) passenger behavior changes after September 11 due to longer security checkpoint times. With the increased security measures put into place following the September 11, 2001 terrorist attacks, passenger behavior has changed with reduced pre-security dwell times as the majority of passengers proceed directly to their departure gates after check-in. However, most concession outlets were located pre-security. This problem was partially addressed by adding concession outlets post security and will be addressed in a more comprehensive manner in the 2010 Expansion Project by consolidating and moving the security checkpoints before the main concession courtyard.

Table 10.7 summarizes recent historical airline and nonairline revenues per passenger for Terminal 4 as compared to the first year of operation by JFKIAT.

Table H.7. Historical Airline and Nonairline Revenues per Enplaned Passenger

	1997	2006	2007	2008	2009
Enplaned passengers (000)	3,239	3,789	4,312	4,415	4,552
Airline revenues (000)	$100,463*	$140,821	$163,183	$173,342	$186,459
Per enplaned passenger	$31.02	$37.19	$37,84	$39.26	$40.96
Nonairline revenues (000)	$17,403*	$26,840	$32,936	$34,670	$31,395
Per enplaned passenger	$5.37	$7.08	$7.64	$7.85	$6.90

* As estimated in April 1997.

Sources: *Preliminary Official Statement, the Port Authority of New York and New Jersey Special Project Bonds, Series 6, JFK International Air Terminal LLC Project*, April 25, 1997 and *Preliminary Official Statement, the Port Authority of New York and New Jersey Special Project Bonds, Series 8, JFK International Air Terminal LLC Project*, November 15, 2010.

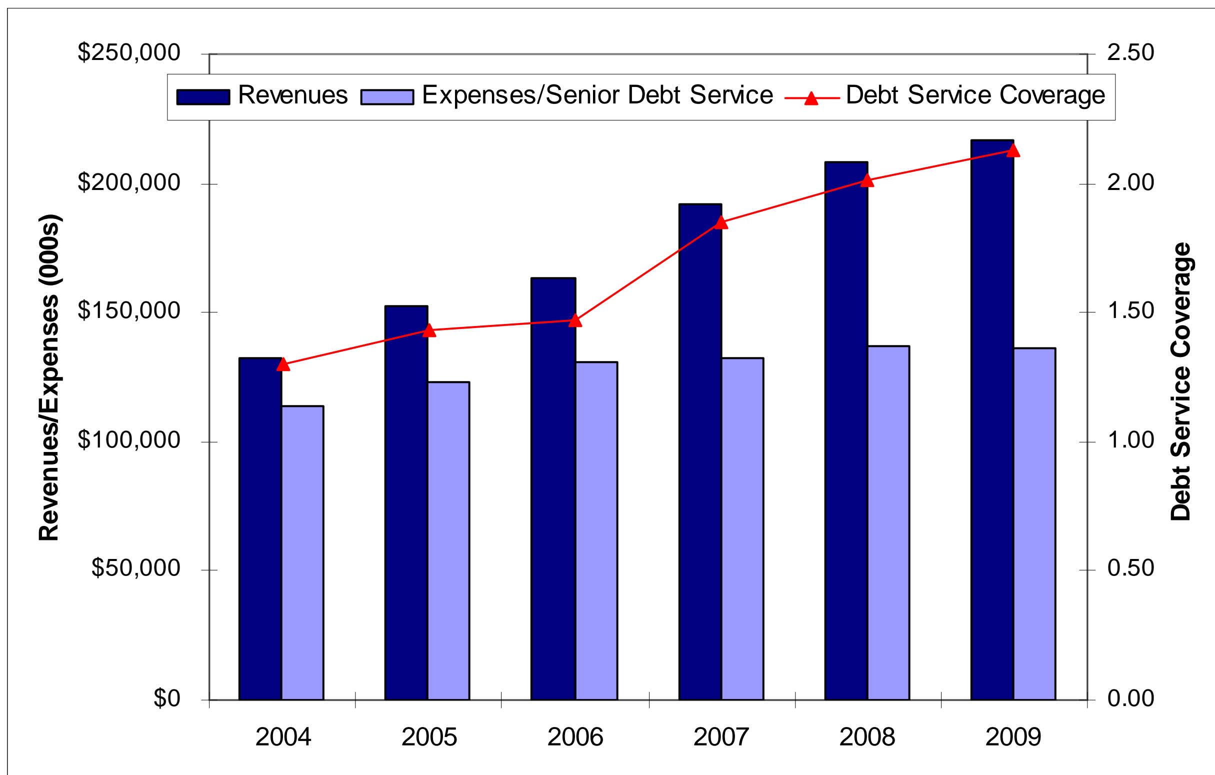
JFKIAT has realized savings in operating and maintenance expenses by reducing personnel, outsourcing functions (major maintenance, janitorial and custodial, security, etc.), and introducing efficient work processes. By outsourcing certain services that had traditionally been provided by the Port Authority, JFKIAT was able to reduce in-house headcount by almost 75% (from approximately 230 to 60). Other operating efficiencies such as a building automation system were built into the energy-efficient design of the new terminal. The ability to operate outside of Port Authority procurement procedures, employment pay scales and contracts, and political influence allowed JFKIAT in many cases to obtain more advantageous contractual terms than could have been obtained by the Port Authority. In the end, JFKIAT had a strong incentive to maximize passenger throughput, "run a tight ship" and "sweat the asset," as it would retain any excess revenues and operational savings. Unlike the Port Authority, JFKIAT had to pay sales taxes to New York City and the State of New York for outsourced labor and certain other expenses.

Under the prior residual-lease approach for the IAB, the Port Authority was not incentivized to control operating costs, as all operating costs were passed on to airline tenants. Operating expenses for Terminal 4 in 2005 (3 years after completion) were approximately $42 million compared to $54 million in 1997 for the IAB despite an approximate 7% increase in building square footage.

Terminal 4, which opened in May 2001, underperformed in the first two years of operations (2002-2003), reflecting the difficult operating environment in the early 2000s. The events of September 11, weak economic conditions, outbreak of Severe Acute Respiratory Syndrome (SARS), and Iraq war had a severe effect international traffic in the U.S. and at JFK. These unforeseen external factors significantly affected the project's operating performance. For example, total international passengers at JFK declined 18% between 2000 and 2003. However, since that time Terminal 4 has benefited from a strong recovery in passenger volumes, an associated increase in revenues, and the extension of the debt amortization period for senior and subordinate debt (from 2015 to 2025) as a result of the extension of the City Lease with the Port Authority in 2004.

As a result of the traffic declines in 2002 and 2003, debt service coverage on senior lien debt was 1.00x for both years, which was below the 1.25x rate covenant. In addition JFKIAT used $1.5 million in completion debt proceeds to pay a portion of debt service in 2002. Under the financing documents, the rate covenant violation would have been an event of default, but the bond insurer (acting behalf of bondholders) agreed to waive the covenant requirement through 2008 while a recovery plan was implemented. As shown in Figure H.3 below, debt service coverage improved to 1.30x in 2004, reflecting a 33% increase in passengers as JFKIAT held operating expenses flat. With the subsequent strong growth in passenger levels, debt serve coverage has increased consistently since 2004.

Figure H.3. Historical Revenues, Expenses, and Debt Service Coverage (in thousands, except debt service coverage)



Sources: Standard & Poor's Ratings Services, Port Authority of New York and New Jersey John F. Kennedy International Air Terminal LLC; Ports/Port Authorities, November 10, 2009, and *Preliminary Official Statement, the Port Authority of New York and New Jersey Special Project Bonds, Series 8, JFK International Air Terminal LLC Project*, November 15, 2010.

2010 Expansion Project. In 2007, the Port Authority, JFKIAT, and Delta began negotiations regarding the expansion of Terminal 4 to replace Delta's aging facilities at Terminal 3. (Similar redevelopment had been considered before, but plans were abandoned following the September 11 terrorist attacks.) As best described by Bill DeCota in 2008, the Port Authority's Aviation Director at that time:

> *"In the old days, we built all these small terminals, and today we are building these mega-terminals with a lot of common space used by many carriers. It's the best way to maximize the efficiency of space. It will be a very*

adaptable terminal to reflect the change that's happening in airports."[10]

In August 2010, the parties announced plans for a $660 million construction cost expansion, to include 9 additional loading-bridge-equipped gates and improvements to the central terminal, the creation of a new domestic baggage claim hall on the east side of the building, and the installation of an in-line baggage screening system. In consideration for the 2010 Expansion Project, the Port Authority extended the Terminal 4 lease through the earlier of 30 years from the Date of Beneficial Occupancy of the expanded terminal or December 2043.

The project will be financed with additional special project bonds on par with the 1997 special project bonds.

Under the terms of an agreement between JFKIAT and Delta, Delta will have preferential-use rights to the 9 new gates and up to 7 existing loading-bridge equipped gates and will pay rates and charges calculated according to cost-recovery principles (as opposed to the market-pricing approach). In addition, Delta would manage the 2010 Expansion Project design and construction.

In connection with the project, Schiphol acquired the ownership stakes of LCOR and Lehman in April 2010. In anticipation of the 2010 Expansion Project in April 2010, the Port Authority consented to Delta's acquisition of an indirect interest in JFKIAT and Delta paid the Port Authority a $9.4 million transfer fee. Delta's indirect ownership interest in JFKIAT gives it certain consultation and consent rights with respect to the management and operation of Terminal 4.

The 2010 Expansion Project is expected to be completed in May 2013. At that time, Terminal 3 will be demolished and replaced with an apron capable of accommodating up to 16 aircraft. Subject to obtaining the requisite FAA approvals, the demolition of Terminal 3 and apron redevelopment is to be financed with PFCs contributed by the Port Authority. The project is expected to be fully completed in July 2015.

On November 4, 2010, the JFKIAT bonds were downgraded to below investment grade status by Fitch. According to Fitch:

> *"Fitch views the construction risk and Delta counterparty risk as near-term rating constraints during the project's construction phase, considering cost estimates are not currently locked in due to the design-bid-build project management approach."*[11]

The downgrade to BB from BBB came in anticipation of the planned sale of $857 million bonds later in November for the Delta expansion.

With the 2010 Expansion Project and Delta's cost recovery rates, more than half of Terminal 4 has morphed into another airline-financed terminal like the others at JFK.

H.3.8 Lessons Learned

As noted earlier, Terminal 4 is generally recognized in the industry as a successful example of

[10] Bent Wilson, *Port Authority Reviews Future Of JFK Terminals 2, 3 And 4,* Aviation Daily, July 28, 2008.
[11] *Fitch Rates JFK Int'l Terminal Project $825MM Series 8 Bonds 'BB'; Dwngrs Outstanding Bonds to 'BB'*, Fitch Ratings, November 3, 2010.

nonairline, private sector participation in terminal development and operation. The project did not require any federal or state legislation such as the Airport Privatization Pilot Program to be implemented. There has not been a project of comparable magnitude completed in the U.S. since Terminal 4 opened in 2001. As a reflection of its general satisfaction with the conceptual model, the Port Authority is considering, among other options, using certain aspects of the Terminal 4 model in connection with a terminal expansion at Newark and the planned redevelopment of the central terminal building at LaGuardia Airport.

The project was a first-of-its-kind experiment and as a result has provided some lessons learned by the stakeholders, including:

- The ability to access tax-exempt financing made the Terminal 4 redevelopment viable. LCOR estimated the tax-exempt financing provided a roughly 30% discount on private financing.

- Although the Port Authority sought to attract private equity in the project, ultimately its access to the tax-exempt bond market on behalf of the developers and the associated lower cost of capital dis-incentivized a large equity investment that would have required higher returns for the developer. JFKIAT's contribution of $15 million was motivated by the Port Authority's desire that the consortium have "skin in the game."

- JFKIAT was able to successfully experiment with market-based pricing, which very few public airports use. In particular, after the downturn in traffic resulting from September 11 and SARS, as a private entity JFKIAT was able to negotiate special pricing with airlines that could not have been accomplished under typical public procurement rules.

- Normally in the U.S., airport terminals are subsidized by parking and rental car revenues given the large amount of public space. In this case, Terminal 4 had to stand financially on its own without these subsidies. As a result, the JFKIAT model is not universally transferable to other U.S. airports. It worked at JFK because of the inter-airport terminal capacity limitations, high user rate levels for competing facilities, high percentage of international traffic (which can support substantially higher charges), and ability to charge fixed, profit-based pricing to use the terminal. Therefore, the model may not be readily adaptable in other locations without some form of subsidy from other nonairline revenues, particularly parking and rental car revenues. This model is best suited to application at large, multi-airline airports with unit terminals.

- A frequently cited rationale for involving the private sector in facility development is to obtain construction and program management expertise and therefore mitigate the risk of cost overruns and schedule delays. While Terminal 4 was completed on-schedule, the final project cost was about 20% higher than the budgeted cost. One of the complexities in its development was the requirement to remain operational during construction.

- Because this transaction is essentially a cash flow deal -- meaning that all the value is derived from the residual cash flow -- both the Port Authority and JFKIAT's interests were well aligned because both benefited from the cash flow. JFKIAT was highly motivated to complete the project as quickly as possible, much like a traditional real estate developer.

- Risk avoidance in general is an overarching rationale for privatization. In the case of Terminal 4, however, one might question the magnitude of the "real" risk that was actually assumed by JFKIAT. JFKIAT only invested $15 million in equity, but did invest a great deal of time and effort in the venture as well as risk $33 million in predevelopment expenditures. Regardless of the financial viability of the project, the Port Authority in the end must serve the public interest of ensuring the busiest international terminal in the region remains operational. JFKIAT, on the other hand, could "walk away" if the operation in its judgment became unfeasible. Ultimately the main risk for the project rested with the bond insurer and bondholders not JFKIAT or the Port Authority.

- Unlike toll road projects where the term of the transaction is usually 50 years or more, the relatively short term for this transaction (initially 15 years) limited the amount of equity that could reasonably be bid. Given the limited amount of equity, the return on investment is quite large.

- The early years of the lease were the most vulnerable and the Port Authority played an important role in mitigating risk in these early years. When JFKIAT fell upon hard times after September 11 and SARS, in conjunction with the accelerated debt amortization period (prior to the extension of the City Lease) and the need for completion financing, the Port Authority stepped up to assist JFKIAT by amending the lease agreement and providing subordinate financing. Although JFKIAT felt it could access financing from the bond market, the financing provided by the Port Authority provided a "win-win" solution for both parties as JFKIAT had a credit rating at the time that was below investment grade. The level of cooperation provided by the Port Authority to JFKIAT demonstrated its commitment to the facility and desire for its success.

- The long-term lease meant that control over the site and the flexibility to respond to changing market conditions was relinquished by the Port Authority. While this factor was not important in the early years of operation, it became a more important consideration later on. From a customer service perspective, replacing Terminal 3 was a top priority for the Port Authority, and expanding Terminal 4 was the logical and most economically viable solution. However, the Port Authority only had indirect influence on the outcome of negotiations between Delta and JFKIAT, two parties with competing financial interests. In the end, Delta's interest to pay cost-recovery rates and Schiphol's interest to maintain a good relationship with Delta and its SkyTeam partners were met with Schiphol's purchase of LCOR's and Lehman's stakes in JFKIAT. Although short-term lease may be more appropriate to protect against industry uncertainty, a shorter term would be less attractive to private investors and harder to secure financing.

- Key to the success of the Terminal 4 project was the fact that there was no "anchor tenant," whose needs were driving facility design and development at the expense of other tenants. With no airline having a large share of traffic at the terminal, any organized opposition to the project was difficult. These dynamics have changed to some degree as a result of the Terminal 4 expansion project and Delta's preferential-lease status.

- The project has also been successful because it is one of several terminals at JFK that must compete for traffic with other terminals. This competition works to keep rates from becoming unreasonable and to incentivize JFKIAT to run an efficient facility with high

customer service standards. Competition between terminals minimizes the need for more heavy-handed regulation, as JFKIAT must compete for airline customers.

- JFKIAT also has a strong incentive to maximize the passenger throughput of the terminal based on the per-passenger pricing regime and the associated passenger-related concession revenues. JFKIAT is also incentivized to minimize operating expenses; however, maximizing revenues in a competitive environment requires high service levels so the incentives are well aligned for both the Port Authority and JFKIAT.

H.3.9 References

Delta Air Lines, the Port Authority of New York and New Jersey, and JFK International Air Terminal Unveil Plans for Enhancement and Expansion of Terminal 4 at JFK Airport, press release, Delta Air Lines, August 11, 2010.

Mayor Michael R. Bloomberg and Governor George E. Pataki Announce Closing of Multi-billion Dollar Agreement to Extend Airport Leases, press release, City of New York, November 29, 2004.

Official Statement, the Port Authority of New York and New Jersey Special Project Bonds, Series 6, JFK International Air Terminal LLC Project, April 25, 1997.

Preliminary Official Statement, the Port Authority of New York and New Jersey Special Project Bonds, Series 8, JFK International Air Terminal LLC Project, November 15, 2010.

Schiphol Buys Out Partners in JFK Terminal 4, The Windmill Herald, September 23, 2010.

John Stainback, *Case Study 6: JFK International Airport, Terminal 4—International Building, Jamaica, New York, Public/Private Finance and Development,* John Wiley & Sons, Inc., 2000.

Fitch Rates JFK Int'l Terminal Project $825MM Series 8 Bonds 'BB'; Dwngrs Outstanding Bonds to 'BB', Fitch Ratings, November 3, 2010.

David A. Sigman, LCOR, *JFK Terminal Four: Successful PPP in New York State*, A presentation to the TDP Symposium, March 8, 2006.

The Port Authority of New York and New Jersey Committee on Operations, *Minutes of Special, Interim Meeting*, August 5, 2010.

Standard & Poor's Ratings Services, *Port Authority of New York and New Jersey John F. Kennedy International Air Terminal LLC; Ports/Port Authorities*, November 10, 2009.

David Kagan, Assistant Director, Aviation, Port Authority of New York and New Jersey, phone interview, October 26, 2010 and November 8, 2010.

David Sigman, Executive Vice President, LCOR Incorporated, phone interview, October 19, 2010.

H.4 Boston Logan Terminal A

H.4.1 Background

The Massachusetts Port Authority ("Massport") is a multipurpose agency that owns and operates, among other facilities, Boston-Logan International Airport ("Logan"); Hanscom Field, a general aviation reliever airport; and Worcester Regional Airport. Logan is primarily an origin-destination (O&D) airport and has a diverse mix of carriers. In 2009, the airport accommodated 12,566,797 enplaned passengers of which 87.5% were O&D passengers and no airline accounted for more than 15% of the passenger share.

There are four unit terminals serving commercial passengers at Logan that provide a total of 98 gates:

- Terminal A with 22 gates (initially 18) and 7 regional jet parking positions, which was developed by Delta Air Lines and opened in March 2005
- Terminal B with 36 gates, which opened in 1976 with renovations completed by American Airlines in 1995 and US Airways in 1998 and 2000
- Terminal C with 27 gates, which opened in 1969 with renovations completed by Massport in 1987, United Airlines in 2002, and JetBlue in May 2005
- Terminal E with 13 gates, which opened in 1974 with renovations completed by Massport in 1997, 2002, and August 2008

The original Terminal A opened in 1969 and was sized and configured to accommodate traffic from that era. Eastern Airlines held a long-term lease on the facility that extended from 1969 through late 1994, which gave Eastern primary responsibility for the operation and maintenance of the 14-gate, 200,000 square foot facility. At Eastern's peak, Terminal A processed over 2 million enplaned passengers per year. Eastern filed for bankruptcy in March 1989 and ceased flying in January 1991. Due to a new inbound access roadway to Logan that was being constructed by the Massachusetts Highway Department as part of the new cross-harbor tunnel (Ted Williams Tunnel) and the associated right of way issues related to the Terminal A site as well as structural problems identified with the building, Massport decided to buy out Eastern's remaining leasehold interest in the terminal in 1992 and began studying options for its replacement.[12]

In anticipation of the opening of the new Ted Williams Tunnel and the associated land impacts to the airport, Massport embarked on a major $1 billion redevelopment of Logan called the Logan Modernization Program in the mid 1990s. After operating with the same basic terminal configuration for two decades, Massport identified three terminal development projects at that time – new replacement Terminal A, the US Airways project at Terminal B, and the international gateway project at Terminal E -- to expand terminal capacity from 85 to 98 gates. The Logan Modernization Program also included double-decking the on-airport roadway system, building a new parking garage, making improvements to the existing garage, building elevated and enclosed pedestrian walkways connecting the central garage to unit terminals, and refurbishing the central heating and cooling plants. After studying the potential to upgrade and renovate old Terminal A on an interim

[12] Not only was the facility undersized, but structural engineering studies at that time concluded that the useful life of the old Terminal A was uncertain and that it would be increasingly costly to maintain the structure.

basis prior to its replacement (as set forth in the long-term development plan), Massport realized it would be best to replace the facility.

H.4.2 Transaction Summary

With political pressure to privatize Logan and recognizing that the Terminal A project would require significant capital investment, Massport decided in 1996 to explore private sector involvement in the redevelopment of Terminal A. Initially, Massport explored a private developer approach for the replacement terminal, but due to state public bidding laws, and the private developers' requests "to shift risk to the Authority" or for "subsidies" such as a share of rental car commissions, this approach was deemed infeasible. Massport then began negotiations with Delta to develop the new terminal.

New Terminal A was developed under a special facility lease between Massport and Delta. Terminal A opened on March 16, 2005 with 18 jet gates[13] and 7 regional airline parking positions with Delta as the sole tenant. Terminal A includes a main terminal building and a satellite building that are connected by an underground tunnel and moving walkways. The terminal allowed Delta to consolidate all of its operations into one location to provide operational efficiency and room to expand. Delta, Delta Connection, Delta Shuttle, and Delta's subsidiary Song (now defunct) previously operated out of Terminals B and C.

The redevelopment project was largely funded with special facility revenue bonds issued in August 2001, which were secured solely by Delta and insured by Ambac Assurance Corporation ("Ambac"). When the lease was signed on August 16, 2001, the terminal was considered fairly well designed. After the terrorist events of September 11, 2001, Massport and Delta worked together to redesign the terminal to incorporate additional security features and to reduce costs.[14]

Shortly after the opening of new Terminal A, Delta filed for protection under Chapter 11 of the U.S. Bankruptcy Code on September 14, 2005. To assist Delta in its reorganization efforts and to avoid the potential for costly litigation, Massport, with the consent of the bond trustee and Ambac, agreed to restructure the original lease and bond trust agreement. Delta then signed an amended and restated 10-year lease dated July 1, 2006, reducing the number of aircraft gates it leases in Terminal A to 14 and the number of ground loading positions to 5. Massport subsequently leased 4 of the relinquished gates and 2 regional aircraft ground loading positions to Continental Airlines, under a 5-year lease agreement (that expires in November 2012). After Delta and Northwest merged, Delta leased the remaining gates in Terminal A.

Massport is not obligated to make the debt service payments on the Terminal A bonds. If pledged facility rentals and associated reserves are insufficient to make the debt service payments, the payments become the responsibility of Ambac under the terms of the bond insurance agreement.

H.4.3 Privatization Objectives and Motivations

Ideological Imperatives. When Governor Weld took office in 1991, the state's bond rating was near junk status, unemployment was nearly 10%,[15] and the state had just incurred several

[13] The gates were subsequently reconfigured to provide 22 jet gates.
[14] Dave Bannard, *Large Capital Projects*, AAAE Airport Magazine, June/July 2010.
[15] Wikipedia, *William Weld*, accessed November 15, 2010.

consecutive budget deficits. Given the state of affairs, Weld was committed to establishing Massachusetts as a leader in privatization and established a "Privatization Support Group" in the Administration and Finance Secretariat. As stated in 1992 by John R. Guardiano, the managing editor of Privatization Watch, a monthly newsletter published by the Reason Foundation:

"Weld is very much committed to the concept [of privatization] and is intent on actively implementing it...[Weld's effort in Massachusetts] "is the most ambitious attempt ever by any state governor to privatize state assets and service responsibilities."[16]

Among the various options explored, Weld and his aides tried to assess the potential benefits of selling certain state assets, including Logan. As governor, Weld had responsibility for appointing the 7 members of the Massport Board.[17] Given the political environment, Massport began considering alternatives for private sector participation in its operations. The redevelopment of Terminal A was identified as an attractive opportunity given its significant cost and Massport needed to preserve financing capacity for the Logan Modernization Program as well as its sizable airfield, sound proofing, major maintenance, and the other port facility improvements in its $3.7 billion FY 1995 – 2005 capital budget.

As noted later, the Port Authority of New York and New Jersey was also considering private sector participation in it operations under a similarly minded state administration.

Delta's Interests. As the largest carrier operating from Logan (in terms of passengers), Delta increased its share of the Logan passenger market from 16% in 1986 to 23% in 1998, when Massport started talking to Delta about Terminal A. Delta wanted to continue to expand its operations at Logan and consolidate all four of its product lines at that time – Delta (mainline domestic and international service), Song (its low fare business unit, which is now defunct), Delta Connection (its regional airline affiliates), and Delta Shuttle (service to New York LaGuardia and Washington National airports) -- in one building. Terminal A was the only site that had enough potential to accommodate all these products in one building. In addition, as the first terminal on the entrance road combined with new state-of-the-art facilities, Delta felt the new terminal would give it a competitive advantage over its competitors at Logan.

---

[16] Nation's Business, *The Governor's Massachusetts revolution - William Weld; privatization of state services - Cover Story*, August, 1992

[17] Massport Board members are appointed for 7-year terms, with the term of one member expiring each June 30. Weld served as governor from 1991 – 1997.

H.4.4 Transaction and Development Timeline

A timeline for the planning, construction, and operation of Terminal A and related material events are as follows:

Table H.8. Boston Logan Terminal A Privatization Timeline and Related Events

1992	▪ Massport began planning studies for Logan Modernization Program ▪ Eastern Airlines rejects its long-term lease of Terminal A in bankruptcy when Massport bought out the remaining interest
1993	▪ Massport studies potential for interim improvements to Terminal A
1995	▪ Construction of Logan Modernization projects began ▪ Massport identified its $3.7 billion FY 1995 -2005 Capital Program
1996 – 1997	▪ Massport studied development approach options for Terminal A ▪ Massport issued RFQ for private developer ▪ 7 development teams submitted qualifications ▪ 5 development teams short-listed ▪ Individual meetings with each short-listed team conducted ▪ Massport advised teams that major issues were being addressed
1998	Massport and Delta started discussing development of Terminal A
2001	Design documents developed
August 2001	Lease Agreement signed and Special Facilities Revenue Bonds sold
September 11, 2001	Terrorists attacked U.S. from flights originating at JFK and Logan
Fall 2001	Delta enters into GMP contract for construction services
May 2002	Old Terminal A closed and reconstruction commenced
March 16, 2005	Replacement Terminal A opened
September 14, 2005	Delta filed for Chapter 11 bankruptcy
Late 2005 – June 2006	Massport and Delta negotiated terms of a lease amendment for Terminal A
July 1, 2006	Effective date of Restated and Amended Lease for Terminal A
January 2007	Amended and Restated Lease and other financing documents submitted to bankruptcy court
March 2007	▪ Bankruptcy court approves amended lease and financing documents ▪ Massport takes back 6 gates and 3 regional parking positions from Delta
April 2007	Delta exited bankruptcy
November 2007	Massport entered into 5-year lease with Continental for 4 gates and 2 regional parking positions in Terminal A
March 2009	Delta re-leased the remaining gates in Terminal A

H.4.5 Exploration of Private Developer Concept

In the early 1990s, Massport undertook planning studies that culminated in the identification of the $1 billion Logan Modernization Program, which commenced in 1995. Although part of the overall redevelopment plans for Logan, the FY 1995-2002 Capital Program budget contemplated that funding to redevelop Terminal A would come from private sources or would be done on a non-recourse basis.[18]

Observing the developments of the Terminal 4 privatization at John F. Kennedy Airport (JFK), Massport decided to explore the potential for private development of Terminal A and issued an RFQ to potential developers in February 1997. Seven teams submitted qualifications and five were short listed. Massport conducted one-on-one focus sessions with the short-listed teams to solicit their input. On the basis of these sessions as well as additional financial and legal due diligence, Massport decided to let the solicitation die. It was decided to abort the process due to legal requirements under the state's procurement laws.

Under Massachusetts public bidding requirements, the "filed sub-bid law" required that various parts of the overall project be bid out to the 17 sub-contractor trades recognized by the state. Under this process, 17 different sets of plans must be drawn up for each trade and bid separately. A week after receiving bids from the designated trades, general contractors, who are ultimately responsible for the project, must submit bids selecting subcontractors from among the bidders. Then the general contractors are chosen on the basis of lowest bid rather than best overall package. As a result, while not technically bound to choose subcontractors with the lowest bids, as a practical matter, the general contractor had little choice.[19]

In order for Massport to offer tax-exempt conduit financing to the developers -- which all bidders said was necessary in the focus sessions -- Massport's legal advisors said it would have had to follow the state's public bidding requirements. Due to the filed sub-bid law, Massport could not make the selection of the developer without the sub bids, which essentially meant that Massport would have to do the design, bid the trades, and bid the general contractor before issuing the conduit debt. Essentially this left the developer with the task of operating the terminal, which defeated the purpose of the private development concept.

Another important factor was that the private developers requested shifting risk to Massport or "subsidies" of parking and rental car revenues, which Massport was not willing to give.

H.4.6 Negotiation of Delta Lease

Therefore, Massport decided to explore the potential for conduit financing with an airline tenant, which it had used before for the development of Terminal B in 1976 with the South Terminal Corporation (a Massachusetts corporation comprised of airline stockholders) and again in 1996 for US Airways' expansion and redevelopment of Terminal B. Massport's bond counsel advised that although the law was unsettled, the lease agreement with US Airways for the expansion and redevelopment of Terminal B was not a contract for the construction of a public building and therefore was not subject to the state's public competitive bidding requirements.

[18] Under non-recourse debt, the public entity issuing the bonds on behalf of the tenant is not financially obligated on the debt and the bondholders can look only to the tenant for payment.
[19] James Stergios, *Filed sub-bids stall construction reform*, Boston Herald Op-Eds, September 7, 1999.

Discussions between Massport and Delta commenced in 1998 and culminated in the signing of the Terminal A lease and the issuance of special facility bonds in August 2001. The negotiating process was lengthy and complex, in part to ensure that (1) the terminal's design and construction met Massport's goals and (2) provided Massport with the ongoing flexibility after the terminal's opening to maximize the utilization of the terminal and site.

H.4.7 Business Terms and Project Financing

The original lease, which was effective August 15, 2001, had an "initial term" and "extension terms." The initial term began on the opening day (March 16, 2005) and lasted 5 years. The extension terms provided for 20 automatic one-year extensions unless Delta was in default under certain provisions of the lease.

Following the substantial completion of the project, responsibility and control for Terminal A was returned to Massport and then Massport leased all the airline space in the terminal to Delta. After the opening of new Terminal A, Massport resumed responsibility for repair and maintenance of structural elements of the building (including roof and building systems) and maintenance of the common areas, the concession space, and gate holdroom areas while Delta was responsible for the maintenance and repair of its premises in the building (excluding the holdrooms) and systems unique to and exclusively serving Delta (e.g., loading bridges).

Under the terms of the original lease, Delta was obligated to:

- Make rental payments sufficient to pay debt service on the special facility bonds ("facilities rent")
- Pay Massport terminal rent calculated by Massport in accordance with a fully compensatory rate model covering all direct and indirect capital and operating cost allocations, including the unamortized cost of the old Terminal A
- Pay Massport an annual "maintenance reserve payment" equal to the airline share of building space times a percentage of the replacement value of the terminal.[20] Massport deposits the maintenance reserve payments into a "Terminal A Maintenance Reserve Fund" that is maintained and held by Massport and to be dispersed by Massport in its discretion for renewal, replacement, or reconstruction of the building or equipment, and for unusual or extraordinary maintenance or repairs, among other uses.

Unlike most special facility-backed terminal financings for airline tenants, this transaction gave Massport considerable leverage to take back facilities under certain circumstances, including:

- ***Preferential Gate Use***. Delta is subject to Massport's preferential gate use policy with certain exclusions.

- ***Recapture of Underutilized Gates***. Massport has the right to recapture one or more of the contact gates and certain related areas (including ticketing, baggage, and other operational space needed to conduct airline operations) in the event Delta is not using the

[20] The percentage of replacement value is equal to 0.5% for the first 10 years, 1.0% for years 11 through 20, and 1.5% for years 21 to 25.

gates at Terminal A to the same extent as the airport's overall domestic gate utilization. In the original lease, Massport had to wait until the 5th year to exercise this option. Under the recapture provisions, Massport must either (1) re-let the gates, (2) sublease the gates from Delta, or (3) defease or provide for defeasance of the allocable share of the bonds. Under the re-let and sublease conditions, Massport or the tenant using the space would be required to make monthly payments to the trustee in an amount to cover the allocable share of debt service and an amount equal to Delta's unamortized costs for project-related facilities not financed with bonds.

- ***Default Recapture***. The lease also allowed Massport to terminate the lease in the event of a Delta bankruptcy and replace Delta as its tenant.
- ***Relocation***. In the 10th year of operation, Massport had the right to relocate all of Delta's operations to a qualifying replacement premise on the airport. As a condition to this replacement, either Massport or any replacement tenant(s) that occupied Terminal A was to make monthly payments to the trustee equal to debt service on the bonds and Delta's unamortized costs for project-related facilities not financed with bonds.

Another feature of this special facility financing was that Massport retained control of and the revenues from the Terminal A concessions. (Massport was responsible for paying for the operating expenses associated with the concession space.)

The lease agreement required that the construction contract with the construction manager be in the form of a guaranteed maximum price (GMP) contract supported by payment and performance bonds. Also, the lease required that Delta complete the project within 5 years from the execution of the lease, or August 16, 2006.

In August 2001, Massport issued $498 million in special facilities revenue bonds to finance construction by Delta of the new Terminal A. The bonds are secured by (1) Delta lease payments, (2) a corporate guaranty provided by Delta, and (3) a 12-month debt service reserve fund, and are not a general obligation of the Port Authority. Delta's lease payments, called "Facilities Rent," was equal to all payments of principal and interest due on the bonds. When the bonds were issued, they received underlying investment-grade-level ratings of 'BBB+' by Standard & Poor's and 'Baa1' by Moody's. The bonds were insured by Ambac.

H.4.8 Project Design and Construction

The Terminal A project included a replacement terminal of 362,000 square feet, a satellite concourse of 284,000 square feet, and a 25,000 square-foot tunnel connecting the terminal and concourse. In addition, the project included demolition of the old terminal and construction of terminal access roads, aprons, utilities improvements, and an underground fuel system. The project also included a baggage system with inline screening and passenger boarding bridges. The project achieved LEED Certification as the first LEED-certified terminal in the world

Acting as the developer of the project, Delta was responsible for the awarding of contracts and the design, construction, acquisition and installation of the entire Terminal A project, except for extending the fuel hydrant system to the new terminal, which was the responsibility of the airline fuel consortium. Delta was responsible for completing all project elements even if sufficient bond proceeds were not available. Massport provided funds to Delta (or its contractors) for the airfield improvements related to the project (including various aprons, taxiways, and utilities), remediation

of underground fuel contamination (if any) at the project site, a new electrical substation serving Terminal A, a new above-ground passenger walkway connecting new Terminal A to the central garage, and certain roadways adjacent to the terminal.

Delta submitted the schematic design of the Terminal A project to Massport in June 2001, Massport approved the design in July 2001, and construction began in May 2002.

Construction was delivered using the construction manager-at-risk model. The $500 million Terminal A was completed 30 days ahead of schedule, slightly under budget, and without construction litigation, reflecting the high level documentation and communication between Massport and Delta as well as the incentives and penalties included in the legal documents. According to Massport's deputy chief legal counsel, this accomplishment was achieved as a result of:[21]

- Clear, well-understood agreements, including a development agreement, lease agreement, and GMP contract
- A shared understanding of the goals of the project and familiarity with the underlying contractual documents
- Regular communication among the key stakeholders
- Incentives for achieving goals combined with penalties for failure to perform

Because Delta was responsible for the project's design, Massport and Delta developed design guidelines to document the mutually understood minimum acceptable standards and that also addressed review and approval of plans, specifications, schedule, costs, and change orders. They also specified materials standards, sizing requirements, sustainability, and concession space.

The design guidelines also provided for a design review process. Therefore, even though the terminal was fairly well designed when the lease was executed, after the events of September 11, the project had to undergo a substantial redesign to incorporate additional security features, relocate concessions post security, and reduce costs. The design guidelines were instrumental in expediting the redesign process.

H.4.9 Delta Bankruptcy, Rating Actions, and Renegotiation of Financing Documents

Six months after the opening of new Terminal A, Delta filed for Chapter 11 bankruptcy. Even before filing for bankruptcy, Delta tried to persuade its SkyTeam Alliance partners -- Northwest and Continental -- to move into Terminal A to help share the expense, but both refused citing the significantly higher rental costs at the new facility as well as the costs to relocate from their current premises. Delta realized that the facility was too large for its operations and was determined to find a way to reduce its obligations.

True Lease vs. Disguised Financing. The legal agreements supporting special facility bond issues determine the rights and security interests of the issuer, the bond trustee, bond insurer, and the airport operator in the event of a bankruptcy by the tenant airline. In very general terms, if the

[21] Dave Bannard, *Large Capital Projects*, AAAE Airport Magazine, June/July 2010.

airline's payment obligations are evidenced in a loan or in a lease that can be construed as a loan (often called a disguised "financing" lease), then the airline can default on the debt. The lease-versus-loan financing distinction is significant because leases must be assumed or rejected and the debt must be paid when scheduled, whereas disguised financings often become unsecured claims. Debt under a true lease must be repaid if the company in bankruptcy assumes that lease and doesn't want to risk eviction from its facilities.

The Delta lease appeared to fit the parameters of a "true" lease as opposed to a "financing" lease. If the Terminal A agreement had been viewed as a true lease during bankruptcy, Delta would have had the choice of (1) affirming the lease and all its provisions or (2) rejecting the lease for the entire facility. If Delta had rejected the lease, they would not have had space to operate at Logan. Also, Massport would have had to find new tenants for the terminal, which would have caused considerable uncertainty for the timely payment of scheduled debt service through the re-leasing process. Even though Terminal A was needed to meet the then-current demand as well as future passenger levels, Massport's ability to find new tenants at a rental rate sufficient to cover the debt service on the special facilities obligations would have been challenging in the 2005 aviation environment. Massport was not legally required to pay debt service on the bonds, and did not assume the risk of interruptions in rental payments arising from changes in tenants.

Rating Actions. As noted above, when the bonds were sold in August 2001, they received underlying investment-grade-level ratings of 'BBB+' by S&P and 'Baa1' by Moody's. Due to the fact that the bonds were secured almost solely by Delta's rental payments[22] and as a result of Delta's deteriorating financial position in 2005, both agencies downgraded the debt. S&P downgraded the bonds to 'BBB-' in March 2005, and in July 2005 stated:

"We consider the new terminal to be both desirable and important to supporting the existing and future passenger levels at the Logan Airport, though rates are considerably higher at Terminal A than at other Logan terminal facilities. While the likelihood that Delta would immediately discontinue service at Logan upon filing bankruptcy is currently viewed as low, this event would introduce a significant level of uncertainty regarding Massport strategies to maintaining the facilities rent pledged to debt service, as well as Delta's significant longer term commitment to the Boston market and, specifically, to Terminal A. This uncertainty would be inconsistent with an investment-grade-level rating."[23]

Then one month later (August 2005) S&P downgraded the debt another 5 notches from 'BBB-' to 'B' based on the diminishing credit quality of Delta and kept the rating on CreditWatch with negative implications. S&P further lowered its rating on the bonds to 'CCC-' from 'B' on October 4 after Delta filed for bankruptcy protection (on September 14, 2005).

During bankruptcy Delta filed a motion and received approval to make interest payments due on the bonds through December 2005; however, Delta made it clear that it intended to reserve the right to dispute the proper characterization of facilities rent under the lease agreement.

[22] The bonds were also secured by the proceeds in the various funds established (including a debt service reserve fund equal to one year's principal and interest) and an unconditional guarantee of Delta Air Lines. However, under Chapter 11, Delta had the option during bankruptcy to reject the lease.
[23] Laura A. Macdonald, *Massachusetts Port Authority's 'BBB-' Special Facility Revenue Bonds Rating On Watch Neg,* Standard & Poor's Ratings Services, July 28, 2005.

"Following a similar legal strategy used by United Airlines at other U.S. airports, Delta is arguing that the facilities rent payments constitute pre-petition financing obligations that it cannot pay without court approval and should be resolved as claims in the Chapter 11 process."[24]

Delta was seeking to renegotiate the lease using the argument that the lease payments are not true lease obligations that must be paid on schedule for it to retain possession of Terminal A. This line of argument had been used successfully by United Airlines during its bankruptcy proceedings to enjoy beneficial occupancy of various facilities financed with special facility debt without paying debt service.

On January 1, 2006, Delta made only $5.4 million of a $9 million rental payment due. Ambac, which fully insured the bonds, provided the remaining amount due under the terms of its financial guaranty with Massport. Delta's decision to withhold $4 million of the payment was based on its position that it represented a debt owed prior to its Chapter 11 bankruptcy filing in September. Because Delta formally defaulted on the debt, S&P lowered its underlying rating on the bonds 3 more notches to 'D' from 'CCC-' on January 4, 2006. Moody's downgraded the debt to Ca at that time and later withdrew its rating in September 2006 following "*Moody's withdrawal of all ratings of Delta Airlines, Inc. due to the company's ongoing bankruptcy proceedings and the lack of reliable and consistently available information.*"

It should be noted that Massport's $1.1 billion of general revenue bond debt outstanding at that time remained unaffected by these actions on the non-recourse Terminal A bonds. Massport's debt was rated 'Aa3' by Moody's, 'AA-' by S&P, and 'AA' by Fitch with a stable outlook.

Renegotiation of Lease and Financing Documents. Delta eventually backed down and entered into negotiation with the various parties. Beginning in late 2005 and extending into mid-2006, Massport, Delta, the bond trustee, and Ambac negotiated amended terms to the Terminal A lease to avoid litigation over Delta's potential rejection of the lease. Through these negotiations it became clear that Delta did not want or need the full amount of space in Terminal A and wanted to relinquish some of it to Massport. In the end, Delta reduced its leased space in the terminal by approximately one-third and reduced the number of gates under its control from 22 to 14 as well as reserved the flexibility to return some additional space in 2007 and 2011. Delta's responsibility for the payment of the debt service on the bonds was reduced proportionately and Delta's guaranty of the bonds was terminated. In the "Amended and Restated Lease" the term of the lease was also reduced from 25 to 10 years. The bonds are now secured by a pledge of the "Pledged Receipts" received by Massport from the rental of airline premises in the terminal (as well as amounts in various project funds and accounts) and Delta's "settlement consideration" to satisfy its unsecured pre-petition claim, which was satisfied under Delta's plan of reorganization.

In January 2007, the parties submitted various documents to the bankruptcy court reflecting a complex restructuring of Delta's terminal lease and financing arrangements. The documents included a Settlement Agreement (between Delta Air Lines, Massachusetts Port Authority, Ambac Assurance Corporation, and The Bank of New York), the Amended and Restated Terminal A Lease, the Trust Agreement Amendment, the Escrow Agreement, and other related agreements. The

[24] Standard & Poor's Ratings Services, *Massport's Special Facility Rev Bond Rating Cut Three Notches To 'D' Following Missed Payment*, January 4, 2006.

bankruptcy court subsequently approved the agreements in March 2007 and in its order granting the motion in February 2007 said:

"The settlement and compromise reflected in the Settlement Agreement, is both fair and reasonable to, and is in the best interest of, the Debtors and their creditors, Massport, Ambac, the Trustee and the Bondholders and, in entering the Settlement Agreement, Delta, Massport, Ambac, and the Trustee have exercised their rights and powers and used the same degree of care and skill in their exercise as a prudent person would exercise or use under the circumstances."

In these agreements the parties acknowledged that the lease was a "true lease." Delta was required to reimburse Ambac for the $3.6 million debt service payment it had to make on January 1, 2006 and for Ambac's legal, consulting, and other out-of-pocket expenses associated with the bankruptcy. Also, Delta agreed to fund a $15,000,000 escrow account to be available in the event that Ambac is required to make payments to the bondholders under its insurance policy if there is a shortfall in "Pledged Receipts" available to pay debt service due on the bonds.

Under the revised agreements, Massport is required to use reasonable efforts to (1) re-let the Terminal A premises not occupied by Delta, (2) re-let any Terminal A premises subsequently surrendered by Delta, and (3) collect monthly payments of rent from replacement tenants. Massport pays to the trustee a portion of the re-letting proceeds from Delta and all other replacement tenants in accordance with a formula that was set forth in the original Terminal A lease. As before, there is no assurance that the amount of re-letting proceeds remitted by Massport to the trustee will be sufficient to pay the principal of and interest on the due on the bonds. The bonds remain special, limited obligations of Massport, payable only from Pledged Receipts. (It should be noted that the bondholders remain protected due to the guaranty provided by Ambac in August 2001 when the bonds were sold.)

The various layers of revenue and security established to pay bondholders under the settlement agreements includes:

- The allocable share of payments of rent by Delta under the amended lease
- The allocable share of re-letting proceeds paid by replacement tenants
- The approximately $39 million debt service reserve fund
- The $15 million escrow funded by Delta for Ambac's benefit in the event it is needed to pay debt service
- The $29 million unsecured claim that bondholders would receive in the form of a rental credit

Delta emerged from bankruptcy on April 30, 2007.

Subsequent Events. After Delta and Northwest merged, Delta leased the remaining gates in Terminal A and Northwest moved its operations into Terminal A.

More recently, Massport applied to use PFCs for a portion of the Terminal A debt service because the annual debt service is scheduled to increase substantially and because Massport wanted to mitigate this impact on Terminal A rentals.[25]

H.4.10 Lessons Learned

This hybrid single airline special facility financing had a number of unique characteristics and as a result has provided some interesting and instructive lessons learned, including:

- Despite the representations that developers and infrastructure funds are looking for opportunities to invest private capital in airport assets, as was the case for the JFK IAT project, the prospective developers contended that the Terminal A project could not be economically financed without significant access to tax-exempt debt or other airport revenues.

- The experience of Terminal A at Logan and Terminal 4 at JFK highlight the difficulties of financing terminal buildings, with their high capital and operating costs, without the higher-margin parking and rental car revenues. A terminal developed by an airline, such as Terminal A at Logan, may be more feasible as the airline may be solving to minimize its overall operating costs rather than seeking satisfactory commercial returns on its investment. In the case of Delta, it was able to consolidate its operations that had been spread over two terminals into one building thereby saving on labor and equipment costs.

- Each state has its own unique set of laws and regulations. When contemplating privatization options, it is important to undertake a comprehensive review of these laws. Given the unique public bidding requirements in Massachusetts, accessing tax-exempt conduit financing for private development was deemed infeasible. Once Massport determined that private developers needed the conduit debt, it had to seek other avenues for private participation in the project.

- When contemplating a special facility financing on behalf of an airline or other party, an airport owner should be careful to ensure that the lease is a single lease that fits the parameters of a true lease (as opposed to a financing lease).

- Logan is primarily an origin-destination (O&D) airport and has a diverse mix of carriers, with no airline accounting for more than 20% of the passenger share in 2010. Under this type of situation, an airport owner should consider the desirability of including gate and space take-back provisions, as used in the Terminal A lease, if using special facility debt. Also, an airport should evaluate the merits of maintaining the facility on behalf of the airline (and charging associated rent) and retaining control over the concessions (and associated revenues).

- With respect to the construction side of the project, the lessons learned are best summarized by Massport's deputy chief legal counsel assigned to the Terminal A transaction:

[25] Debt service on the bonds was structured so interest only was paid for the first 10 years and principal amortization started in (2011). The PFCs would be used to pay for debt service on the common areas of the building only.

Take the time to carefully and clearly document the parties' understanding before commencing the work, but provide for flexibility within that framework; ensure that everyone involved in the project understands what has been agreed upon; maintain continuous communication throughout the project; and craft a structure that aligns all parties' goals. By taking time upfront, significant time and money can be saved in the long run.[26]

- The lease required that Delta make annual maintenance reserve payments so that funds would be set aside for facility renovation, renewal, replacement, or reconstruction, and for unusual or extraordinary maintenance or repairs. This feature addresses concerns about a private tenant turning back a facility at the end of a long-term lease in poor condition. Funds in the Terminal A maintenance reserve account can be dispensed at Massport's discretion.

H.4.11 References

Official Statement, Massachusetts Port Authority Revenue Bonds, Series 1999, November 12, 1999.

Official Statement, Massachusetts Port Authority Revenue Bonds, Special Facilities Revenue Bonds (US Airways Project), Series 1999, October 14, 1999.

Official Statement, Massachusetts Port Authority Special Facilities Revenue Bonds (Delta Air Lines, Inc. Project), August 1, 2001.

Official Statement, Massachusetts Port Authority Revenue Bonds, Series 2005, May 5, 2005.

Official Statement, Massachusetts Port Authority Multi-Modal Revenue Bonds, Series 2008A&B, June 19, 2008.

Official Statement, Massachusetts Port Authority Revenue Bonds and Revenue Refunding Bonds, Series 2010, July 15, 2010.

Boston-Logan International Airport Terminal A Lease between The Massachusetts Port Authority and Delta Air Lines, Inc., August 15, 2001.

Boston-Logan International Airport Terminal A Amended and Restated Lease between The Massachusetts Port Authority and Delta Air Lines, Inc., July 1, 2006.

Settlement Agreement (between Delta Air Lines, Massachusetts Port Authority, Ambac Assurance Corporation, and The Bank of New York), December 15, 2006.

United States Bankruptcy Court Southern District of New York, *Debtors Consent Motion for Approval of the Amendment, Assumption, and Restructuring of Certain Agreements With Massachusetts Port Authority, Ambac Assurance Corporation, and the Bank of New York, as Trustee*, January 7, 2007.

United States Bankruptcy Court Southern District of New York, *Order Granting Debtors' Motion for Approval of the Amendment, Assumption, and Restructuring of Certain Agreements With Massachusetts Port Authority, Ambac Assurance Corporation, and the Bank of New York, as Trustee*, February 14, 2007.

[26] Dave Bannard, *Large Capital Projects*, AAAE Airport Magazine, June/July 2010.

Standard & Poor's Ratings Services, *Massachusetts Port Authority's 'BBB-' Special Facility Revenue Bonds Rating On Watch Neg*, July 28, 2005.

Standard & Poor's Ratings Services, *Massport's Delta Terminal Facility Bonds Rating Lowered Five Notches To 'B'; Remains On Watch*, August 18, 2005.

Standard & Poor's Ratings Services, *Massport's Special Facility Rev Bond Rating Cut Three Notches To 'D' Following Missed Payment*, January 4, 2006.

Moody's Investors Service, *Moody's Withdraws Underlying Rating on Massport's Delta Air Lines Special Facility Bonds*, September 27, 2006.

Yvette Shields, *Default on Delta Air's Logan Debt*, The Bond Buyer, January 5, 2006.

Yvette Shields, *Delta Escapes Its Boston Debt*, The Bond Buyer, December 19, 2006.

Dave Bannard, *Large Capital Projects*, AAAE Airport Magazine, June/July 2010.

H.5 Stewart International Airport

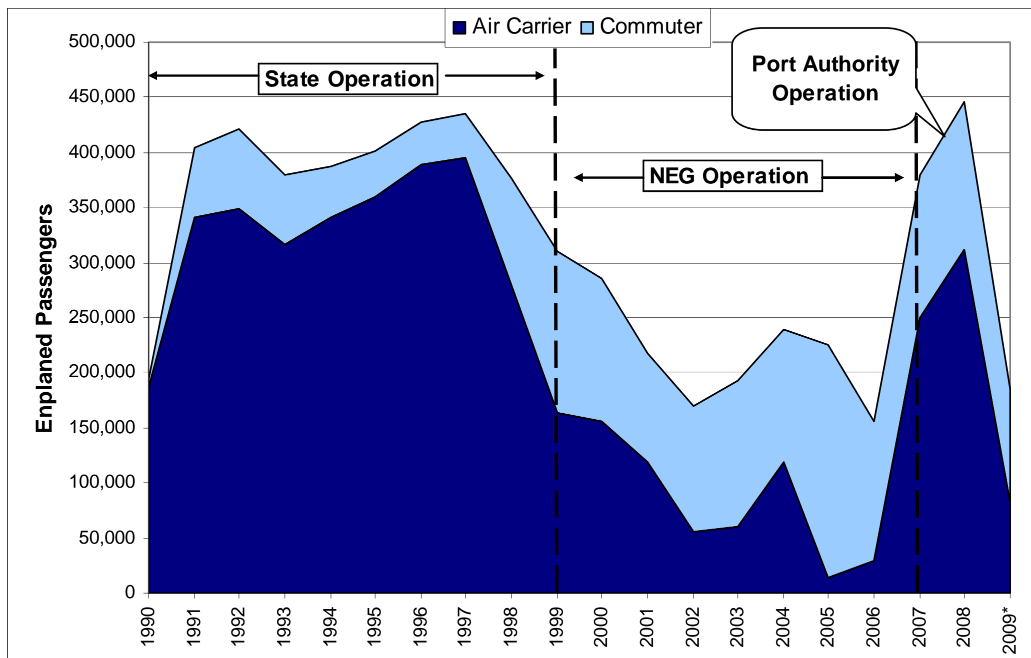
H.5.1 Background

Stewart International Airport ("SWF" or "Stewart") is a regional airport located in the central Hudson Valley area in the Orange County towns of New Windsor and Newburgh, approximately 60 miles north of New York City and 90 miles south of Albany. Its location adjacent to New York State Thruway I-87 and I-84, as well as its proximity to commuter and rail freight lines, make it a significant transportation asset to the region. The facility served as an Air Force Base until being deactivated in 1970 and turned over to the state of New York.

The airport occupies 2,452 acres and has two runways -- main east-west Runway 09/27 (11,817 x 150 feet)[27] and crosswind Runway 16/34 (6,006 feet x 150 feet) – and is capable of handling the world's largest commercial and military aircraft, including the A-340, B-747, and C-5A. SWF operates as a joint civil-military airport housing the 105th Airlift Wing of the New York Air National Guard on the Stewart Air National Guard Base, which occupies 267 acres, and the Marine Aerial Refueler Transport Squadron 452 of the United States Marine Corps Reserve. In 1997, a new two-level passenger terminal concourse with 7 jet boarding bridges and 38 ticketing check-in stations opened. In 1998, the terminal was redesigned to add concession space, car rental agencies, and other enhancements. In late 2010, a new Federal Inspection Services facility opened in anticipation of Mexican service starting in 2011.

In 1990, SWF began operation as a commercial passenger airport. SWF has had a volatile history in terms of passenger traffic as shown in Figure 10.4, reflecting the entry and exit of numerous airlines.

Figure H.4. Enplaned Passengers at Stewart International Airport



Source: Federal Aviation Administration Terminal Area Forecast, December 2009. 2009 traffic is an estimate.

[27] Due to displaced thresholds and other operational issues, the effective lengths of the runways are 9,817 feet for Runway 29 and 8,817 feet for Runway 27.

Airline entries into and exists from the SWF market include:[28]

- American/American Eagle: April 1990-July 2007 Chicago and Raleigh/Durham.
- United Express: August 1990-January 2003. Washington D.C., Toronto, Boston.
- U.S. Airways (including U.S. Air, U.S. Air Express and Allegheny Airlines): January 1991-Present.
- Delta Air Lines: 1991-2005 (served by Delta's affiliate Comair 1998 on) Atlanta, Bangor, Cincinnati. 2007-Present: Atlanta
- TW Express: April 1992-1994 Commuter service to JFK.
- Jet Express: July 1993-January 1994.
- AirTran: Oct. 1994-July 1998 Orlando; January 2007-Sept. 2008 Atlanta, Florida
- Carnival: Nov. 1994-1997 Fort Lauderdale.
- Midway: June 1995-September 2001 Raleigh-Durham.
- Business Express (Delta affiliate): May 1995-May 1996 Boston.
- Southeast Airlines: September 2002-Nov. 2004 Florida.
- TransMeridian Airlines: May-July 2003, Feb.-July 2004 Las Vegas; (also Los Angeles May-June 2003).
- Northwest: June 2004-2009, which then merged into Delta, and continued service to Detroit.
- Independence Air: September 2004-Oct. 2005 Washington D.C. and Florida.
- Pan Am Clipper Connection: June 30-September 6, 2005 Florida.
- Allegiant Air: October 2005-January 2007 Florida.
- JetBlue: December 2006-Present Florida.
- Skybus: January-April 2008 Columbus, Greensboro.

As of November 2010, only three airlines served SWF:

- JetBlue Airways to Orlando and Ft. Lauderdale
- Delta Connection to Delta's Atlanta and Detroit hubs
- US Airways Express to US Airways' Philadelphia hub

DHL, FedEx, and USPS also operated daily at the airport.

There are two discrete parts to this case study – the transition from state to private control in early 2000 and the subsequent conversion back to public control in late 2007.

In 1999, the airport became the first and only[29] airport to complete the Airport Privatization Pilot Program ("APPP") process. It was operated by SWF Airport Acquisition, Inc. ("SWFAA"), a subsidiary of UK-based National Express Group ("NEG"), under a 99 year lease with the state. NEG operated the airport from November 1, 1999 through October 31, 2007, when it sold the remaining 91 years of the lease to the Port Authority of New York and New Jersey ("Port Authority"). Because the Port Authority is a public agency and not a commercial entity, the airport was no longer eligible to continue in the APPP under Port Authority control and its participation in the program was terminated.

[28] Michael Randall, *Stewart Airport's seen plenty of ups and downs*, Times Herald-Record, November 21, 2010.
[29] As of November 2011.

H.5.2 Timeline for Stewart's Ownership and Control

The airport has had a long and unsettled history. Stewart was originally developed in the 1930s as a military base and remained under military control until it was deactivated as an Air Force base in 1970 and was deeded to the state. The state ceded ownership of the airport first to the New York State Metropolitan Transportation Authority ("MTA"), then to the New York State Department of Transportation ("NYSDOT") before deciding to privatize it in 1995 under a 99-year lease.

A summary of the key events during the airport's various ownership and management phases is shown in Table H.9.

Table H.9. Stewart Privatization Timeline

Early Development	
1930	▪ Samuel Stewart donated 220 acres of pasture land to the City of Newburgh for an airport
1934	▪ US Military Academy selected the site for a West Point airfield for cadet flight training
1942-1945 (WWII)	▪ Army used Stewart used as a flight training base and constructed numerous barracks and other buildings
1948	▪ Airport converted to an Air Force base
1970	▪ Stewart was deactivated as an Air Force base ▪ Orange County formed a task force to consider taking over Stewart and operating it as a commercial airport. County concluded conversion would be too expensive and decided not to participate in taking over the base ▪ U.S. government transferred 1,598 acres of land and improvements to the MTA under a Quitclaim Deed that required that the property be used for public airport purposes
State Operation	
1971	▪ The state 854 additional acres of property by condemnation under the New York State Highway Law ▪ Governor Rockefeller, seeing the potential for SWF's long runways to serve the supersonic transports under development at that time, had a vision and plan to convert SWF into the New York metropolitan area's fourth major airport, and tripled the airport's property using eminent domain powers ▪ Area residents fought the airport expansion causing the state to promise it would only develop the site for airport facilities ▪ SST supersonic transports development in the U.S. cancelled
1973	▪ Oil crisis and associated jet fuel increases and airline service reductions, caused some of the airport's original backers to question the economically viable of the airport ▪ State plans for airport development put on hold
1976	▪ State abandoned plans for airport development
1976 – 1982	▪ Site remained unoccupied
1982	▪ State transferred ownership of SFW from the MTA to the NYSDOT
1983	▪ In response to local concerns about SWF governance, the New York legislature created the SWF Airport Commission ▪ 105th Airlift Wing and 213th Engineer Installation Squadron of the NY Air National Guard moved into the airport (called the Stewart Air National Guard Base)
Mid – late 1980s	▪ Corporate jet hanger built by W.R. Grace became the first private tenant at SWF ▪ Industrial park was started ▪ Portions of undeveloped land (Stewart Properties or "the buffer") turned over to the New York State Department of Environmental Conservation ("NYSDEC") by the NYSDOT

1989	▪ SWF began operation as a commercial passenger airport
1990	▪ 50,000 square foot air cargo building and 300,000 square foot US Postal Service federal mail distribution facility opened
1991	▪ SWF becomes the first facility to receive funding under the FAA Military Airport Program ($5 million) ▪ SWF also received a $900,000 FAA grant to update the master plan, conduct an environmental review, and prepare a noise capability study. ▪ SWF received $13 million in federal funding for rehabilitation of the fuel farm, terminal parking ramp, part of its taxiway system and upgrades to the airside signage. And in 1992,
1992	▪ SWF received $3 million from the FAA Military Airport Program for terminal expansion
State Privatization Process	
1994	▪ Governor Pataki's New York State Council on Privatization began consideration of privatization; however, the APPP was not yet available
1995	▪ SWF levied a passenger facility charge
October 1996	▪ Federal Aviation Authorization Act of 1996 enacted, which established the Airport Privatization Pilot Program
June 1997	▪ State issued Stewart Airport Privatization RFP, which included options for adjacent undeveloped lands
September 1997	▪ FAA promulgated airport privatization regulations
October 1997	▪ Five groups respond to Stewart RFP ▪ NYSDOT filed a preliminary application for participation in APPP
December 1997	▪ FAA approved SWF preliminary privatization application
April 1998	▪ National Express Group named as preferred bidder with a bid of $35 million, but did not choose to lease the additional lands
January 1999	▪ Final privatization application filed with FAA
March 1999	▪ International Union of Operating Engineers representing the airport employees notified the FAA that Local 825 and NEG had reached an agreement covering both airport operations and maintenance employees
April 1999	▪ FAA published notice for 60-day public comment period
June 1999	▪ FAA conducted public hearing on SWF privatization
August 1999	▪ Orange County Building and Construction Trades Council and SWFA concluded a PLA for a 5-year term ▪ Stewart Airport Commission endorsed privatization lease
September 1999	▪ Lease is signed and copies were forwarded to the FAA, state comptroller, and state attorney general for approval
February 2000	▪ State attorney general completed lease review
March 2000	▪ State comptroller completed lease review ▪ FAA approved privatization application (March 30)
April 1, 2000	▪ Lease became effective and SWF became the nation's first commercial airport to be privatized under the APPP
NEG Operation	
Late 2000	▪ Management of 5,600 acres west of Drury transferred to NY Department of Environmental Conservation (DEC), which later created Stewart State Forest from the un-leased lands ▪ State commenced work on a new interchange on Interstate 84 at Drury Lane, the widening of Drury Lane, and a 4-lane east-west access road (International Boulevard) to address the airport's longstanding access problems
March 2007	▪ NEG sold East Midlands, Bournemouth, and Humberside airports to the Manchester Airport Group
November 2005	▪ To settle a lawsuit to allow development of the new SWF exit, 1,700 acres of the remaining buffer was added to the proposed Stewart State Forest and development restrictions were placed on the remaining 400 acres near the exit

Summer 2006	▪ NY State formally transferred ownership of the State Forest from DOT to DEC, and officially creates the Stewart State Forest ▪ New state-of-the-art control tower was commissioned by the FAA
NEG Sells Lease	
September 2006	▪ NEG announced plans to sell its SWF lease
October 2006	▪ NEG sent letter to the FAA informing it of its intention to solicit investors to purchase its leasehold interest at SWF
January 2007	▪ Port Authority voted to buy the SWF operating lease from NEG for $78.5 million for the 93 remaining years
May 2007	▪ New Jersey acting governor signed a bill to allow the Port Authority to take over SWF operations, matching the NY equivalent law
SWF Transferred to Port Authority	
July 2007	▪ Port Authority and NEG executed an Asset Purchase Agreement for the SWF lease ▪ NYSDOT announced a feasibility study of connecting SWF to the Port Jervis Rail Line at Salisbury Mills (three miles) to connect with Metro-North service. ▪ Port Authority and NJ Transit sponsored a $5.4 million West of Hudson Regional Transit Access Alternatives Analysis Study that will include mass-transit options for Stewart International Airport
October 2007	▪ FAA approved and consented to the Lease Assignment and consented to the Port Authority's assumption of NEG's federal obligations, including AIP grants, PFC records of decision, and surplus property; closing occurred on October 31, 2007 ▪ FAA determined that the Port Authority is a public agency and not eligible for the airport privatization program and terminates SWF's participation in the program
November 2007	▪ Port Authority takes over lease from NEG ▪ Port Authority announced $500 million in capital improvements at SWF over the next 10 years ▪ New airport Drury Lane interstate exit off I-84 and access road opened
July 2010	▪ Port Authority announced intention to spend $50 million at SWF by the end of the year for upgrades to attract new airlines and improve service, including runways, taxiways, deicing procedures, new parking facilities that recycle runoff water, energy efficiency lights, electrical infrastructure upgrades, and electrified jetways

H.5.3 Privatization Objectives and Motivations

A privatization initiative in New York State coincided with the development of the APPP.[30] In 1994, Governor George Pataki formed the New York State Council on Privatization, which considered a broad range of New York State asset and operation privatization alternatives. SWF was determined to be a good candidate for privatization. However, federal law at the time significantly restricted the state's ability to privatize SWF. Two other New York airport privatization initiatives were also identified at that time -- the private construction of JFK Terminal Four and the privatization of the Niagara Falls International Airport.

The primary motivations for the SWF privatization were to (1) leverage the expertise of the private sector to develop the underutilized airport to its fullest potential and (2) develop the real estate on the vast site to create jobs and economic development, which was a priority for the Hudson River Valley due to IBM and other large industrial concerns laying off workers and closing plants. The state thought that the adjoining undeveloped real estate (west of Drury Lane) had significant value; however, the economic climate and environmental concerns at that time did not align with the state's expectations.

[30] New York State commented in support of the development of the APPP.

Managing airports is not a "core business" for the state. The state only owned SWF and Republic Airport, a commuter airport on Long Island, and it assumed SWF ownership only after Orange County declined to pursue acquisition from the federal government when the Air Force Base was deactivated. Also, NYSDOT was continually funding SWF with no hope of financial return.

Upon the transfer of SWP to NEG in March 2000, there was resounding support for the transaction as evidenced by various key stakeholder comments, including:[31]

Governor George Pataki:
"Today is an historic day for New Yorkers because once again the Empire State is the national leader in new and innovative policies. With the eyes of the world on us, we have again returned government to its proper role of helping the private sector unleash its potential to create jobs and opportunities for the people. As we transfer Stewart to National Express Group, we are doing more than just turning over the keys. We are unlocking the door for the private sector to come in and provide the Hudson Valley region with better air travel services, greater economic development, and a strengthened tax base."
Ronald S. Lauder, Chairman of the New York State Research Council on Privatization:
"Today New York became the first state in the nation to privatize a commercial airport. With privatization cleared for take off, New York is again using the power of private enterprise to benefit air travelers and taxpayers. Governor Pataki is showing the nation there is a better way to improve airports. It's privatization. It works in New York and it can work across the country."
William Rollason, NEG chief financial officer:
"…Our goal is to make Stewart Airport the premier, state-of-the-art model of airport privatization that the rest of the country will want to emulate. We are committed to making this partnership between the public and private sectors work. Our number one priority is to bring the same level of high-quality service to the people of New York as we have already done with our transportation activities throughout the United Kingdom, Australia, and the rest of the United States"
Jim Wright, Chairman of the Stewart Airport Commission:
"Stewart will finally reach its potential as an economic generator for the mid-Hudson Valley region under private ownership. Governor George Pataki is to be commended for his initiative and courage in pioneering the privatization concept for Stewart Airport."
Mary Crabb, Newburgh Mayor:
"Once again Governor Pataki delivers for our region. The privatization of Stewart Airport is a long awaited opportunity to promote the region's economy. We are busy working to improve the conditions of our people and our city. This initiative of the Governor will provide momentum needed to achieve our goals. The future of the City of Newburgh is directly tied to the future and success of Stewart Airport."

Clearly, the parties felt that NEG would not only turn the airport around, but would also develop Stewart to its fullest potential under private management for the full 99-year lease, and that this would be a landmark transaction that would become a model for airport privatization throughout the country.

[31] New York State Department of Transportation Press Releases, *Governor Pataki Hands Stewart Airport Keys to National Express*, March 31, 2000.

H.5.4 Privatization Transaction Process

Prior to privatization and throughout the privatization process, NYSDOT contracted with Air Group International ("AGI") to operate the airport under a management contract. In addition, the parking operations were contracted to another private entity and NYSDOT leased the airport's cargo facilities. While the ownership of SWF resided with NYSDOT, a significant amount of SWF operations were outsourced to contractors.

The mechanics of the privatization process were handled by the Empire State Development Corporation ("ESDC"), an economic development agency of the state, and NYSDOT. ESDC and NYSDOT assembled a team of consultants that managed the privatization process under ESDC and NYSDOT project managers. The consulting team assisted with the development of the RFP, proposal evaluations, preliminary and final FAA applications, and lease negotiation.

The RFP called for a 99-year lease and gave the bidders the option of proposing on (1) the airport, (2) just the undeveloped land west of Drury Lane (approximately 5,600 acres), or (3) both. Some teams included proposals for the undeveloped lands and some did not. There was a significant amount of public opposition to the development of the undeveloped properties by local residents and environmental groups.

One of the conditions of the lease was to retain the State Troopers as the airport security to avoid labor issues. The bidders accepted this arrangement as the airport has territory in three jurisdictions, making the State Troopers a logical choice.

Five teams submitted proposals, which were reviewed and evaluated by ESDC, NYSDOT, and their consultants. There were four qualified bidders: NEG, AGI, LCOR/Rockefeller Group, and Johnson Controls. The bidders who proposed land development components offered only contingency deals. The state preferred firm commitments with guaranteed cash payments.

NEG was considered the clear choice on all evaluation criteria, and proposed to lease the airport through a subsidiary, SWF Airport Acquisition, Inc. NEG elected not to bid on the undeveloped land, and at the encouragement of environmental groups, most of the undeveloped land was set aside by the state under a "forever green" statute. As the Pataki administration was pro-environment, the lack of meaningful bids helped justify the political decision to set the land aside, which was subsequently converted to the Stewart State Forest.

There was a "best and final" offer process for the bidders, after which the gap between NEG and the other bidders widened. The evaluators found NEG's experience in previously privatizing the UK national bus service and three English regional airports highly relevant and transferable.[32]

In terms of the APPP process, the timeline was as follows:

- On October 23, 1997, NYSDOT filed a preliminary application for participation

[32] In June 1993, NEG acquired East Midland International Airport for £45 million ($US 68 million). It later acquired Bournemouth International Airport and Humberside Airport. However, NEG sold all three airports to the Manchester Airport Group for £241 million in February 2001 ($US 354 million). The Manchester Airport Group is a public authority so the transaction paralleled the later sale of the SWF lease to the Port Authority.

- On January 10, 1999, NYSDOT filed its final application for the privatization of SWF
- On February 16, 1999, in an effort to clarify certain parts of the application, FAA staff requested responses questions from NYSDOT and NEG
- On April 8, 1999, the FAA published a Notice of Receipt of Final Application in the Federal Register
- On June 12, 1999, a public meeting was held
- On March 30, 2000, the FAA issued its Record of Decision approving the privatization application and approved the requested federal exemptions

As noted above, the FAA published a notice in the Federal Register and held a public meeting on the SWF privatization. The FAA received 96 comments in response to the notice from elected officials, civic organizations and citizen groups, businesses, labor unions and contractors, economic development organizations, environmental and noise groups, and private citizens. The table below summarizes the major comments received.

Summary of Written Comments on Privatization Summarized from FAA-03-14961-6 (24)[33]

Pro	Con
Beneficial economic impact on the surrounding region	Possible adverse impact on the environment
Enhance capital investment, improve air service and customer amenities, and attract jobs and businesses	Increase in airport traffic
Increase the tax base and provide a financial return on long-term government investment	A 25-30 year lease term would be more appropriate
Help solve the capacity problems at the other three NY airports	

NEG took over operation on April 1, 2000.

The privatization process, which began in 1994, took almost 4 years from its announcement in January 1996 until NEG took over the airport in November 1999. However, because SWF was the first airport to go through the APPP process, the framework for the APPP was developed through the advancement of the SWF process, which was later followed by the city of Chicago in the Midway transaction. According to a participant in the privatization process, the FAA was supportive, responsive, and proactive in finding solutions throughout the process.

H.5.5 Privatization Transaction Summary

Payments. NEG proposed an "Initial Lease Payment" of $35 million and annual payments equal to 5% of gross income that were projected to be begin on or about the 10th anniversary of the lease. The amount and timing of payments to NYSDOT was as follows:[34]

[33] U.S. Department of Transportation Federal Aviation Administration, *Record of Decision for the Participation of Stewart International Airport in the Airport Privatization Pilot Program*, March 31, 2000. See in particular, Attachment Six FAA Response to Comments Regarding the Participation of Stewart International Airport in the Airport Privatization Pilot Program.

Table H.10. Summary of NEG Financial Terms

Payment	Timing of Payment	Amount of Payment
First lease payment	Commencement of lease	$24 million
Second lease payment	Secured by a letter of credit at lease commencement and to be paid the earlier of completion of the airport access road or 10th anniversary of the lease commencement	$5 million plus interest
Third lease payment	Secured by a letter of credit at lease commencement and to be paid upon NYSDOT's completion of environmental remedial action as outlined in the lease	$6 million plus interest
Annual payments	Commencing on the earlier of the 10th anniversary of the lease commencement date or when total passenger traffic reaches 1,380,000	5% of gross airport income

No Revenue Diversion. After being accepted under the APPP by the FAA in December 1997, NYSDOT began negotiations with the airlines. Under the APPP, in order for the state to apply lease revenues from the transaction for general state purposes, the lease must receive the approval of both 65% of the airlines operating at SWF and airlines representing 65% of the annual landed weight. This provision gave the SWF carriers at that time (American, Comair, Midway, United Express, and US Airways Express) considerable bargaining power. The airlines declined to approve NYSDOT's request for an exemption to use airport revenue for general purposes because they were concerned that granting the exemption for SWF would establish a precedent that could be used in the privatization of larger airports.

Therefore, when filing its final APPP application for SWF, NYSDOT did not request an exemption under 49 USC 47134 (b)(l) of the APPP for use of airport revenue for general purposes. NYSDOT stated its intent to use both the $35 million initial payment and the 5% of gross annual payments starting on the 10th anniversary of the lease for airport purposes, including:[35]

- $2.5 million ($500,000 per year for 5 years) for capital and operating costs at its other airport, Republic Airport in Farmingdale, NY, which is owned and operated by NYSDOT and is part of the local airport system.
- $24.7 million for reimbursement for capital contributions and operating expenses incurred in the preceding 6 years that do not constitute prohibited revenue diversion. These funds were spent to construct projects including the water and sewage distribution systems for SWF and Republic Airport.[36]
- $2.5 million for the costs (1) incurred as a result of the privatization initiative, (2) ensure continued operation of the airport in the event of default by the lessee, (3) general lease oversight costs, and (4) completion of capital projects.
- $2,150,000 for future capital projects at SWF.

[34] *Agreement of Lease Between NYSDOT and SWF Airport Acquisition, Inc.*, September 24, 1999.
[35] U.S. Department of Transportation Federal Aviation Administration, *Record of Decision for the Participation of Stewart International Airport in the Airport Privatization Pilot Program*, March 31, 2000; and New York State Department of Transportation, *Final Application Under the Airport Privatization Pilot Program*, January 8, 1999.
[36] At the request of the FAA, an audit was performed by Watson Rice LLP, Certified Public Accountants, dated December 1, 1999, contracted by the state, which verified that $24,777,793 was spent for airport purposes.

- $8.5 million towards the new on-airport roadway in connection with the planned new freeway exit.

Airline Rates and Charges. NYSDOT said in its final application that NEG intended to freeze the current signatory rates and charges at the 1998 levels (other than for capital expenditures) until a 5% equivalent reduction in these fees is achieved relative to changes in the consumer price index. Once this reduction is achieved, the fees imposed on the air carriers just prior to the transfer (i.e., in 1998) would not increase faster than the rate of inflation (unless agreed to by 65% of carriers pursuant to APPP regulations), other than for the funding of new capital development after the transfer. In addition, in connection with the proposed 5-year Capital Improvement Plan prepared by NEG, NEG expected to include a reasonable rate of return (including the cost of capital and risk premium) on capital expenditures for the airside and adjust the landing fee rate accordingly.

However, with respect to the airline rates and charges, in its Record of Decision approving the privatization, the FAA said:[37]

"*The FAA interprets 49 U.S.C. § 47134(c)(4) to require approval of 65 per cent of the carriers serving SWF (calculated based both on absolute number and on landed weight) for airport rate increases greater than the rate of inflation and not as a result of capital improvements. SWFAA proposes to maintain existing air carrier rates at 1998 price levels until increases in the consumer price index reflect a 5% reduction for fees not attributable to increases due to capital investment.*"

"*We would expect SWFAA to establish aeronautical fees in consultation with SWF's aeronautical users, in accordance with FAA's Policy Regarding Airport Rates and Charges. (See 61 FR 31994, par. 1. I,et seq.).*"

In sum, while the state and NEG thought it was reasonable to include the cost of capital in the airline rates over and above allowances for inflation without having to seek airline approval, the FAA said that rates could not increase faster than the rate of inflation without airline approval.

NEG Rate of Return. The Quitclaim Deed was also modified to allow NEG to earn a reasonable rate of return on its investment and risk in operating the airport over the lease term. NEG planned to increase airport revenue from non-aeronautical sources through new concession and property rental income to (1) fund ongoing airport operations and the airport's capital improvement program and (2) provide NEG with a return on its investment (estimated to be between 3% and 35%). Although the FAA granted this exemption, it said the exemption was not unlimited and could only be available after NEG met its obligation for investment in airport operations and capital development under the grant assurances and the lease. FAA also said:

"*Compensation in excess of this range would be subject to review for compliance with requirements for use of airport revenue under § 471 07(b) and the obligation under the grant assurances that aeronautical rates and charges be fair and reasonable.*"[38]

Capital Improvement Program. The final application included a 5-year indicative capital improvement plan ("CIP") of $48.6 million with NEG's share as $10.2 million. The remainder was

---

[37] U.S. Department of Transportation Federal Aviation Administration, *Record of Decision for the Participation of Stewart International Airport in the Airport Privatization Pilot Program*, 2003.
[38] U.S. Department of Transportation Federal Aviation Administration, *Record of Decision for the Participation of Stewart International Airport in the Airport Privatization Pilot Program*, March 31, 2000.

to come from AIP grants, passenger facility charges, and charges to airport tenants.

Assignment of Lease. In the lease, NYSDOT reserved the right to approve any assignment of the lease and prohibited NEG from selling the lease for a period of 5 years. NYSDOT also retained the right to re-enter and operate the airport in the event NEG were to interrupt airport operations after filing for bankruptcy and other events of default.

Labor. Under the APPP statute, any collective bargaining agreements covering airport employees that are in effect on the date of the sale or lease of the airport cannot be abrogated by the sale or lease. Therefore, NYSDOT required NEG to develop a plan offering existing NYSDOT employees at the airport the option to remain in the employment of NYSDOT or to receive an offer of employment with NEG.

NEG reached an agreement with the International Union of Operating Engineers (representing the airport employees) covering airport operations and maintenance employees. In addition, NEG concluded Project Labor Agreement (PLA) with the Orange County Building and Construction Trades Council, which provided:[39]

- NEG enter into a PLA for an $8 million runway re-surfacing project.
- For a 5-year period, all major construction projects over $1 million undertaken by NEG will be performed under a PLA. For all projects under $1 million, local contractors with labor agreements will be used.
- A labor advisory board will be established consisting of representatives from NEG and labor to consider projects for a PLA and eligible contractors with labor agreements.
- A Harmony Clause encourages all tenants, concessionaires and customer organizations undertaking construction on the airport to hire contractors employing union labor.

Community. Section 401 of the State Transportation Law established the Stewart Airport Commission ("SAC") to advise the NYSDOT Commissioner on matters relating to the operation, management, and financing of the airport.[40] SAC remains the principal source of contact between the airport and the community on airport matters through its regular public meetings and its noise subcommittee. The SAC is advisory only and has no governance authority over the airport. Commission membership includes the NYSDOT Commissioner, the elected heads of the 3 surrounding counties and 10 appointed representatives of the local communities. The Commission initial goals were and continue to be to (1) improve passenger air service and (2) contribute to the region's economic development. Under the lease, NEG was required to meet on a regular basis with SAC.

H.5.6 Experience Under Private Control

Shortly before the beginning of the lease term in November 1999, NEG approached NYSDOT asking to be relieved of its lease obligations. Apparently, NEG had already started thinking about getting out of the airport business to focus on its core business in the bus and rail sectors, and in

[39] U.S. Department of Transportation Federal Aviation Administration, *Record of Decision for the Participation of Stewart International Airport in the Airport Privatization Pilot Program*, March 31, 2000.
[40] The SAC was created by the New York legislature in 1983 in response to local concerns about SWF governance.

February 2001 sold its only other airport operations (3 airports in England). NYSDOT refused the request and NEG proceeded as contracted to take over SWF operations. However, the SWF transaction prohibited the sale of the lease to another party for 5 years, or until November 1, 2004.

NEG hired an experienced airport manager to run SWF who was not an employee of NEG but was a contractor. The airport manager continued in that position until the airport lease was taken over by the Port Authority and reported to NEG's U.S. subsidiary, which was a large bus operation. SWF had to perform as a competitive business enterprise within the NEG family of companies. Ongoing corporate investments and initiatives had to be justified by reasonable expectation of a satisfactory financial return over the life of the investment. Potential SWF investments also had to compete with potential rail and bus investments within NEG's capital portfolio. Beyond the lease commitments, investments at SWF had to be as good as or better than alternative NEG investments.

NEG took over operations roughly 10 months before the terrorist events of September 11, and managed SWF during a difficult period for regional airports. It competed successfully for AIP grants and worked to attract real estate development and airline service, including JetBlue and AirTran (which subsequently exited the market).

In its August 2004 report to Congress on the status of the APPP, the FAA compared the capital plans and net revenues of SWF under NYSDOT and NEG control. Regarding the 5-year CIP, the FAA concluded that NEG proposed (1) $4.3 million more than most recent NYSDOT CIP, (2) reduced its reliance on federal and state grants, and (3) proposed a private capital contribution as summarized below.[41]

Table H.11. Comparison of Capital Plans under NYSDOT and NEG

(millions $)			
Funding Source	**NYSDOT**	**NEG**	**Variance**
AIP grants	$39.9	$29.0	($10.0)
State grants	2.0	--	(2.0)
Passenger Facility Charges	2.3	9.2	6.9
Local funds	0.1	--	(0.1)
Private operator		0.1	0.1
Tenant		10.3	10.3
Total	$44.3	$48.6	$4.3

In terms of the profits from airport operations, the FAA concluded that despite a steady decline in passengers after NEG took over operation -- between 1999 and 2003 passengers declined 38% from 309,948 to 193,436[42] -- NEG's profit was similar to that achieved by NYSDOT under its last full year of operation, which was likely a result of operating efficiencies achieved by NEG.[43]

[41] U.S. Department of Transportation, Federal Aviation Administration, *Report to Congress on the Status of the Airport Privatization Pilot Program*, August 2004.
[42] Federal Aviation Administration, *Terminal Area Forecast*, December 2009.
[43] U.S. Department of Transportation, Federal Aviation Administration, *Report to Congress on the Status of the Airport Privatization Pilot Program*, August 2004.

Table H.12. Comparison of Financial Performance under NYSDOT and NEG

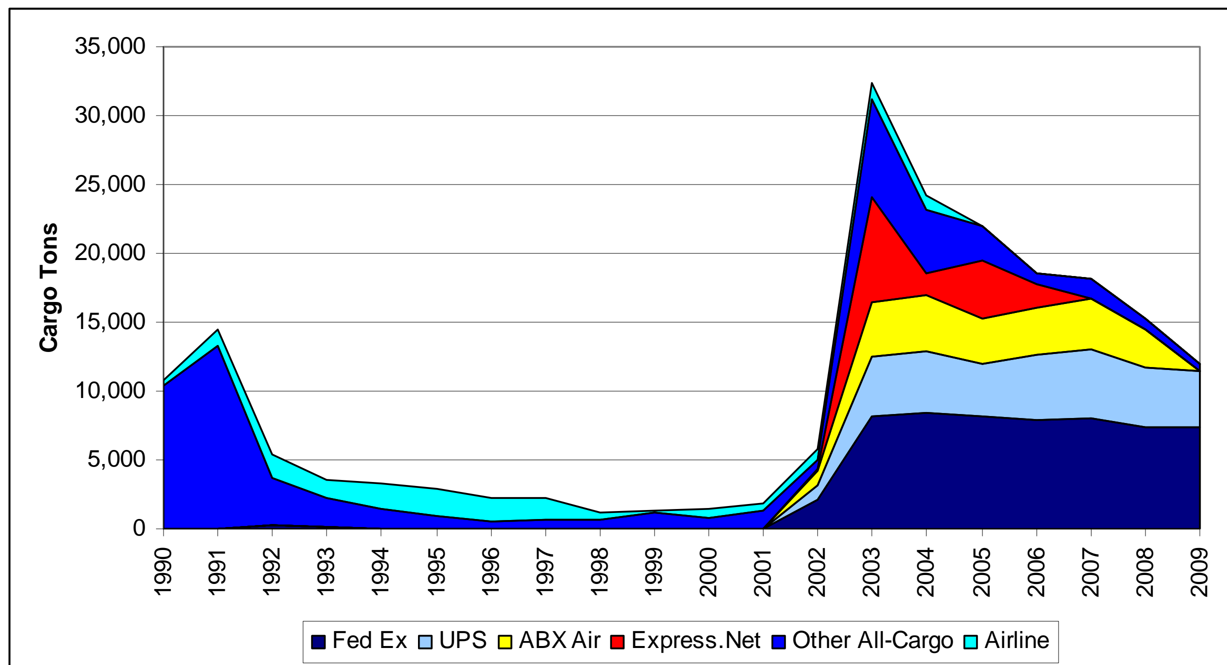
Year (Operator)	Operating Revenue	Operating Expenses	Operating Profit(Loss)
1999 (NYSDOT)	$8,205,223	$6,314,768	$1,890,455
2000 (NYSDOT & NEG)	5,989,413	7,118,342	(1,128,929)
2001 (NEG)	7,568,238	5,715,135	1,853,103
2002 (NEG)	7,052,516	5,633,610	1,418,906
2003 (NEG)	7,775,485	6,243,846	1,531,639

Although the SWF privatization did not materially improve passenger air service, it did continue economic development activity related to the airport and was able to accelerate construction projects relative to public operation. For example, the FAA also noted in its report to Congress:[44]

- According to NYSDOT, NEG improved the airport's relationship with the business community in its effort to support regional growth. For example, NEG partnered with a major real estate developer to promote the airport and a 260 acre, 2 million square foot office park on land adjacent to the airport. NEG also executed a lease with General Electric to build a $24 million corporate aviation center at SWF that allowed GE to move its operation from Westchester County Airport to SWF.
- NYSDOT officials also reported that private funding of the airport's environmental cleanup allowed the work to be performed faster than under state control.

NEG also competed successfully for AIP grants and was successful in attracting freight service back to the airport as shown in Figure H.5.

Figure H.5. All-Cargo Tonnage at Stewart International Airport by Carrier



Sources: U.S. DOT, Schedules T100 and 298C T1.
Note: Includes enplaned and deplaned freight and mail.

[44] Id.

NEG signed deals to develop a hotel, private jet hangars, and a new cargo facility. It also renovated the terminal and brought in new vendors. However, when NEG announced it was planning on selling its leasehold interest in September 2006, Jim Wright, chairman the Stewart Airport Commission, best summed up the community's position:

"Real estate development is fine, but what Stewart needs is flights. Many more flights. We need someone to jump-start the airport. We've got to get more passenger service in here."[45]

H.5.7 Sale of the Lease to the Port Authority

As noted earlier, shortly after signing the lease, NEG made a strategic decision to exit the airport business to focus on its core bus and train businesses. It sold its UK airport interests. However, the lease forbid NEG from selling the lease for 5 years, or until November 1, 2004.

As the lease sale prohibition period wound down, NEG commenced private talks with potential acquirers. The Port Authority was interested in acquiring the lease, but Governor Pataki preferred that it stay in the hands of a private operator. It was reported that NEG had negotiated a potential deal with a private entity when Governor Spitzer's administration took office and he reversed the private operator policy and allowed the Port Authority to enter the bidding process.

Realizing that the region needed additional capacity beyond what investments at its three New York area airports could provide (which had been projected to reach capacity by 2020), the Port Authority made a strategic decision to bid on the SWF lease to develop Stewart into a reliever airport for the region.

As noted by Governor Spitzer in January 2007:

"We will continue to make major investments at J.F.K., Newark and La Guardia, but eventually we are simply going to run out of room. Stewart International Airport will provide much-needed relief for our three major airports, greatly reduce delays and help us prepare for inevitable population and passenger growth."[46]

The decision by Governor Spitzer was important to the return of SWF to operation by a public authority and the end of the privatization period. Without a change in policy direction in the governor's office, the airport lease would likely have been sold to another commercial operator instead of the Port Authority.

Before the Port Authority settled on SWF, it studied several other alternatives to help alleviate congestion and ease delays at the New York-New Jersey metropolitan-area airports, including Long Island Islip MacArthur Airport and Westchester County Airport.

On September 29, 2006, NEG publicly announced plans to sell its SWF lease. NEG had signed deals to develop a hotel, private jet hangers, and a new cargo facility at SWF. On October 5, 2006, NEG sent a letter to the FAA informing it of its intention to solicit investors to purchase its leasehold interest at SWF.

On January 25, 2007, the Port Authority voted to buy the SWF operating lease for $78.5 million for the 91 remaining years. The Port Authority reportedly offered more money than the other deal

---

[45] Tim Logan, *Stewart loses operator, National Express opts to drop its lease*, Times Herald-Record, September 29, 2006.
[46] Patrick McGeehan, *4th Major Hub for Air Traffic Moves Ahead*, New York Times, January 25, 2007.

NEG was considering in return for the additional time required for the Port Authority to make the governance adjustments to allow them to acquire the SWF lease.[47]

On July 17, 2007, the Port Authority and NEG executed an Asset Purchase Agreement for the SWF lease. The price was $78.5 million and included paying off a $2.8 million dollar letter of credit from the original NEG lease for environmental remediation work that the state had not finished.

The state consented to the lease assignment and the TSA approved the amended Airport Security Plan[48], which allowed the FAA to approve and consent to the lease assignment and the Port Authority's assumption of NEG's federal obligations, including AIP grants, PFC records of decision, and surplus property instruments of conveyance on October 31, 2007. At the same time, the FAA terminated the exemption granted to waive the requirement to repay federal grants and to earn compensation from the operation of SWF under private operation. In addition, the FAA determined that the Port Authority was a public agency and not eligible for the airport privatization program. The FAA therefore terminated SWF's participation in the pilot program.

The Port Authority took over SWF operations on November 1, 2007. It took just over a year from NEG's public announcement of its intent to sell the lease until it closed the purchase with the Port Authority. The Port Authority had put a shadow management team in place at SWF well in advance of the takeover. The Port Authority now has a Port Authority employee team managing the airport and a contractor for all operations -- AvPorts, which also operates Teterboro Airport for the Port Authority. In general, many of the airport operations employees have largely stayed intact throughout the several iterations of operators (state, NEG, Port Authority).

At the time of the closing and takeover, the Port Authority had approved more than $17 million for parking and roadway improvements for Stewart.

Almost coincident with the Port Authority's takeover of SWF in late 2007, the new airport Drury Lane interstate exit off I-84 and access road opened, improving access to the airport.

H.5.8 Operational Experience Under Three Regimes

Keeping in mind numerous factors have influenced the operational experiences of the state, NEG, and the Port Authority -- including those outside the control of the airport operator -- the following table shows a snapshot of the operations under the three regimes. It is also important to note the short history for operation under Port Authority control. Airport development is a lengthy process that is implemented incrementally over many years. (The transition years of 1999 and 2007 were excluded from the analysis because there were two different managers during each of those years.)

[47] At that time the Port Authority's bi-state charter limited its operations to a zone that extended 25 miles in all directions from the Statue of Liberty. In 1967, lawmakers in Albany passed a bill allowing the authority to have one airport outside that zone in each state. But New Jersey never passed its own version of that legislation until May 3, 2007.
[48] Because the TSA is a separate federal agency, the FAA needed TSA's approval to the security plan as a condition to the sale of the lease.

Table H.13. SWF Average Annual Performance in Three Time Periods

Metric	1996-1998 NYSDOT	2000-2006 NEG	2008-2009 Port Authority
Enplaned Passengers	387,886	205,888	288,987
Cargo Tonnage	1,886	15,368	13,605
Aeronautical Operating Revenue ($000)	$2,600	$2,684	$3,513
Non-Aeronautical Operating Revenue ($000)	$4,601	$4,799	$4,586
Total Operating Revenue ($000)	$7,201	$7,482	$8,099
Total Operating Expenses ($000)	$5,953	$5,967	$14,757
Operating Revenue Less Expenses ($000)	$1,248	$1,515	($6,659)
Total Capital Project Expenditures ($000)	Not reported*	$4,929	$14,423

* Although not reported on the FAA Form 127 data base, the state constructed the 7-gate concourse and ticketing lobby, which opened in 1997, and made other terminal improvements in 1998.
Sources: Passengers and Cargo: US DOT Schedules T100 and 298C T1. Financial: FAA Form 127.

As noted earlier, passenger traffic has been particularly volatile at SWF. A string of airlines have come and gone in both good times and turbulent times. Despite the downturn in traffic that started in 1998 at SWF and accelerated after September 11, 2001, NEG managed to maintain relatively stable aeronautical revenues due to the fixed terminal rents and the growth in cargo landing fees. Although parking and rental car revenues dropped significantly reflecting the falloff in passengers, NEG countered these declines with increases in land and non-terminal rentals. NEG's operating revenues, operating expenses, and net revenue were comparable to those under state operation. In terms of capital improvements, the state opened a new 7-gate passenger concourse in 1997 and in 1998 added concession space, car rental agencies, and other enhancements to the terminal. NEG's capital expenditures at SWF averaged $5 million per year; however, this was less than the approximately $10 million per year proposed in its 5-year CIP.

The Port Authority took over operation of the airport in November 2007 just as the global economic downturn was starting.[49] Stewart was hit hard by the recession. Skybus went out of business in April 2008, AirTran exited the airport in September 2008, and the four remaining airlines cut back their schedules. Nevertheless, the Port Authority invested heavily in its first few years of operation relative to NEG in an effort to develop the underutilized facility. For example, operating expenses more than doubled while revenues increased modestly resulting in a negative cash flow for the first two years. In addition, by the end of 2010, the Port Authority was expected to have made about $50 million in infrastructure improvements. Also, the Port Authority has been in active discussions with air carriers seeking new services at Stewart and implemented an air service incentive program.

The Port Authority's subsidy to the airport, which was funded from other operations, was substantial. After just three years of operation, by November 2010, the Port Authority had:[50]

- Completed a new Federal Inspection Services facility (in preparation for the Mexican charter service that is starting in 2011, and plans to build a permanent facility as part of the upcoming terminal expansion.

[49] The National Bureau of Economic Research announced in December 2008 that the US economy has been in recession since December 2007.
[50] Jamie Simon, *PANYNJ Celebrates 3 Years Since Acquiring Stewart*, Airport Revenue News, November 11, 2010.

- Implemented several parking customer service initiatives, including 800 new parking spaces, pay-on-foot stations in the terminals, an express pay lane, and additional entrances and exits.
- Realigned and rehabilitated roadways, replaced roofs, and improved the taxiway edge lighting systems.
- Added new customer care representatives, new wayfinding signs, baggage carts, extra seating in the baggage-claim and gate areas, and expanded bus service to the Beacon Train Station.
- Put in place a Stewart Sustainability Plan.

H.5.9 Lessons Learned

SWF's entry and exit from the APPP provided a first-of-its-kind experiment and as a result has provided some interesting and instructive lessons, including:

- As demonstrated under other case studies, strong political commitment was necessary to achieve privatization. The reason the initial privatization process succeeded was because Governor Pataki was a strong political champion.
- Navigating through the APPP process takes considerable time and resources. It took 34 months from the time NYSDOT submitted its preliminary application to the FAA until the FAA issued its record of decision approving the transaction. The process included preparing the preliminary APPP application, developing the RFP, evaluating the responses, selecting an operator, drafting and negotiating the complex lease terms, preparing the final APPP application, managing public participation, securing local approvals, and building political support. In considering the timeline, it is important to remember that there are both federal and local requirements. In the case of the SWF privatization, local approvals were required from labor groups, the state attorney general, and state controller, among others. It is important to remember, too, that this was the very first such transaction in the U.S., undoubtedly adding to the length of time required.
- For-profit private companies must make strategic decisions in the interests of their shareholders, which may not always be in the best interests of the airport community. After operating the airport for 7 years, NEG was no longer interested in investing resources in airports. NEG exited the airport industry and concentrated on its core rail and bus businesses. There was no appetite to invest seed money into the airport because NEG was looking for an immediate financial return. As a result, total operating revenue remained flat at best during the NEG operation. NEG fulfilled its lease requirements, but the original enthusiasm and energy for the business waned, and the state was disappointed that additional investments did not materialize. There is no guarantee that the private airport operator will achieve financial success, retain interest in the business, or be successful in its execution. Therefore, the challenge in structuring a successful transaction is to align the interests of the private company with the appropriate incentives.
- NEG paid $35 million in lease payments and $10 million in capital contributions at SWF. It did not materially improve SWF's financial performance during its tenure, in part due to the significant cutbacks in air service after September 11, and in part due to the realignment of the company's strategic priorities. It is likely that NEG did not realize the return on its investment as expected during its operation of the airport. In addition, NEG was facing a

5% of gross income lease payment beginning on the 10th anniversary that would further dilute its earnings. NEG sold the lease after 7 years of operation to the Port Authority for $78.5 million, allowing it to recover its investments and realize a significant capital gain, which was not plowed back into airport improvements.

- One of the intentions of the APPP was to evaluate the potential for new private sector investment in airports through privatization. Indeed NEG invested $10 million of its own funds into SWF capital development, but it also received a significant return on that investment and its $35 million lease payment from the sale of the remaining leasehold interest.
- While there was significant economic development associated with SWF during the privatized period, the community's principal goal of improved air service was not achieved. There is only so much a regional airport operator can do to entice sustainable air service. Some believe that the Port Authority has considerably more leverage to entice airline service at SWF due to its control over JFK, LaGuardia, and Newark airports, and its ability under federal law to potentially cross-subsidize the facility. However, this remains to be seen.
- One of the reasons NEG's bid was considered the most attractive was due to its plans to operate express bus service between New York City and SWF similar to the services it operates linking the London airports. It was expected that the SWF bus service would stimulate low fare service from the airport; however, the bus service plan was never implemented.
- SWF was improved on the margin by NEG due to the new leases and commercial development; however, SWF was a problem before, during, and after privatization – enplaned passenger traffic peaked in 1997 at 435,000, troughed in 2002 after September 11 at 170,000, peaked again in 2008 at 446,000, only to crash again in 2009 to 187,000. Neither privatization nor public operation is a panacea for an airport that lacks demand.
- The state's 5-year prohibition from selling the lease worked well. It was designed to prohibit the bidder from flipping the airport for a profit shortly after the transaction.
- The Port Authority has the resources and capacity to make large investments in SWF to implement a long-term vision without expecting short-term financial returns. It does not have to justify its SWF investments and initiatives on a current business basis. As such, the Port Authority has the flexibility to implement a long-termer vision of SWF as a significant reliever airport for the greater New York area by making the infrastructure improvements and offering the marketing and financial incentives to achieve this vision.
- The state appeared to be a disinterested absentee landlord owner of SWF during its control of the facility and the Stewart Airport Commission had no governance authority. A more local governance structure, such as ownership by the county, towns, or airport authority, may have been more involved in airport operations and management.

H.5.10 References

Governor Pataki Hands Stewart Airport Keys to National Express, Press Release -- New York State Department of Transportation, March 31, 2000.

Stewart International Airport, Wikipedia, accessed October 2010.

Michael Randall, *Stewart Airport's seen plenty of ups and downs*, Times Herald-Record, November 21, 2010.

Judy Rife, *Port Authority approves Stewart Airport buyout*, Times-Herald Record, January 26, 2007.

Port Authority of NY and NJ website, *Airlines (serving Stewart Airport)*, accessed November 2010.

Agreement of Lease Between NYSDOT and SWF Airport Acquisition, Inc., September 24, 1999.

New York State Department of Transportation, *Final Application Under the Airport Privatization Pilot Program*, January 8, 1999.

U.S. Department of Transportation Federal Aviation Administration, *Record of Decision for the Participation of Stewart International Airport in the Airport Privatization Pilot Program*, March 31, 2000.

U.S. Department of Transportation, Federal Aviation Administration, *Report to Congress on the Status of the Airport Privatization Pilot Program*, August 2004.

Patrick McGeehan, *4th Major Hub for Air Traffic Moves Ahead*, New York Times, January 25, 2007.

David L. Bennett, FAA Director of Airport Safety and Standards, Letter: *Transfer of Stewart International Airport*, October 31, 2007.

Port Authority of New York and New Jersey, , *Governor Spitzer, Port Authority, Hudson Valley Officials Mark First Day of PA Control of Stewart International Airport*, Press Release Number: 94-2007, November 01, 2007.

Ken Cushine, Frasca & Associates, consultant to the New York State Department of Transportation and principal consultant to the New York Empire State Development Commission, phone interview, September 24, 2010.

Jim Wright, Chairman the Stewart Airport Commission, phone interview, October 4, 2010.

H.6 Chicago Midway Airport

H.6.1 Transaction Background

The proposed long-term lease of Chicago Midway International Airport ("Midway") to a private firm was by far the largest proposed airport privatization in the U.S. and was posed to be a landmark transaction as the first privatization of a major commercial airport in the U.S. The FAA accepted the City of Chicago's application in the fall 2006 to reserve one of five spots under the 1996 Airport Privatization Pilot Program ("APPP") that allows airports to enter into long-term operating leases to private entities. Midway took the one slot allowed for a large hub airport.[51] In addition, the city was the only applicant in the history of the APPP that was able to secure airline approvals for its application, which is needed for the city to use the lease revenues for non-airport purposes.

Midway is a large air carrier hub airport owned and operated by the city and is located about 10 miles southwest of downtown Chicago. Midway encompasses approximately 840 acres and handled 8,468,470 enplaned passengers in 2009. According to ACI-NA, Midway was the 27th busiest airport in the U.S. in 2009 measured in terms of passengers. As of October 2010, five airlines provided scheduled passenger service to the airport – AirTran, Delta, Frontier, Southwest, and Porter Airlines (a Canadian carrier). These airlines provide primarily low fare, point-to-point domestic service. As of May 2010, Midway was Southwest's largest station where it accounted for approximately 85% of the passengers.

The City also owns and operates Chicago O'Hare International Airport, which is the primary airport serving the Chicago area and the 4th busiest in the world measured in terms of passengers (32,047,097 in 2009). O'Hare is located approximately 18 miles northwest of downtown. Midway was the principle airport serving the Chicago area prior to the opening of O'Hare in 1962.

In 2004, the city completed the Midway Terminal Development Program, which included the construction of a new passenger terminal with 3 concourses, 43 gates, and 43,000 square feet of space for concession operations. The new terminal replaced an outdated 27-gate facility. This major redevelopment of the airport was financed primarily with revenue bonds of which a portion is backed by PFC revenues. Midway also has 4 parking areas with over 13,500 parking spaces, including approximately 3,000 in a garage connected to the terminal, and an elevated terminal roadway system.

In addition to the nearly $1 billion in improvements made by the city for the new, state-of-the art terminal in 2004, the runways were also resurfaced between 1990 and 1997, and an inline baggage screening system was commissioned in 2007. Other than new rental car facility to be financed with Customer Facility Charges ("CFC"), the city identified only "modest" capital expenditure requirements remaining at the time the RFQ was issued in February 2008, including cyclical airfield rehabilitation, soundproofing homes and schools surrounding the airport and improving existing security but no major expansion projects.

[51] The FAA defines a "large hub" airport as an airport that handles more than 1% of all domestic enplanements.

Table H.14. Key Traffic and Financial Indicators[52]

Type of Airport	Origin & Destination (O&D)
FY2009 Enplanements	8,468,470
5-Year Enplanement CAGR 2004-2009	-2.3%
2009 vs. 2008 Enplanement growth	2.9%
2010YTD vs. 2009YTD (July) Enplanement growth	4.8%
% O&D vs. Connecting, 2009 (5 YR AVG)	66.7% (69.7%)
Largest Carrier by Enplanements, 2009 (share)	Southwest (84.9%)
Airline rate-making methodology	Residual
Airline Cost per Enplaned Passenger, 2009	$9.58
Airline Rates and Charges, 2010 budget	$82.3 million
Airline Rates and Charges, 2018 forecast	$130.5 million
CAGR in Airline Rates and Charges – 2010-2018	5.9%
Airline Cost Per Enplanement, 2010 budget	$11.38
Airline Cost Per Enplanement, 2010 budget	$14.34
Outstanding Revenue Bond Debt, 2010	$1,474.1 million
Net Debt Service After PFCs/CFCs/BAB, 2010 budget	$35.0 million
Net Debt Service After PFCs/CFCs/BAB, 2018 forecast	$55.7 million
Debt per O&D Enplaned Passenger, 2009	$189
Bond Ordinance Debt Service Coverage, 2009	1.31x
Days Cash on Hand, YE 2009	411
PFC Rate per enplaning passenger, 2010	$4.50
CFC Rate per transaction day, 2010	$3.75

H.6.2 Objectives

The city began exploring the privatization of Midway Airport soon after it announced its $1.83 billion 99-year lease of the Chicago Skyway Toll Bridge System in October 2004, a deal considered the first long-term, major public-private partnership involving an existing asset in the U.S. and which closed in January, 2005. Subsequently, the city entered into a long-term lease on its downtown parking garages in a $563 million deal which closed in December, 2006. In February, 2009, the City also leased its parking meter system for $1.15 billion. While the Midway privatization was motivated by the success of the Skyway transaction, and both the Chicago Skyway and parking garage transactions proved to be uncontroversial, the unpopularity of the parking meter lease (at least in the early days as discussed in Task 4) may serve to stall the re-launch of Midway.

The primary motivation for the Midway transaction was to get "value out of the airport" by leasing the airport on a long-term basis to a private operator and using the proceeds for the city's unfunded pension liability, infrastructure improvements, and other general fund purposes. As best expressed by city's chief financial officer Paul Volpe in a statement:

"Just as with the long-term lease of the Chicago Skyway, if we successfully conclude this transaction, the taxpayers of Chicago will benefit through a substantial payment to the city that we can use to enhance quality of life for our residents."[53]

As stated in the February 2008 Request for Qualifications ("RFQ"), the city's primary objectives were:

---

[52] Sources: Moody's Investor Services, *Moody's concludes Watchlist and Confirms the A3 Rating on Chicago Midway Second Lien Bonds; Assigns A3 to Series 2010B,C&D Bonds*, Global Credit Research, September 24, 2010; City of Chicago, *Preliminary Official Statement, Chicago Midway Airport Second Lien Revenue Bonds*, September 29, 2010, and other sources.
[53] Yvette Shields, *Chicago Issues RFQ for Midway Airport*, The Bond Buyer, February 14, 2008.

Protect the Public Interest

- *Maintain the highest levels of public and passenger safety and security*
- *Protect the public interest within the context of seeking value for the City and the airlines*
- *Establish a new framework of rates and charges that provides lower and more predictable rates for airlines operating at the Airport*
- *Improve the competitive position, service quality, growth prospects and efficiency of Midway Airport for the benefit of Chicago residents, airlines and other users*

Risk Adjusted Value Optimization

- *Maximize sale proceeds*
- *Ensure that future Airport development is safe, functional, efficient and delivered when necessary*
- *Minimize the City's exposure to residual risks and liabilities from the process*

Fair and Transparent Process

- *Protect the reasonable interests of current and future airline users*
- *Ensure fair and equitable treatment of existing Airport employees*
- *Ensure a smooth transition from public to private management in a timely manner*

H.6.3 Transaction Process Summary and Timeline

Summary. In 2005 the city secured state legislation to extend the airport's exemption from property taxes to a private owner, which paved the way for the transaction and committed the city to use 90% of the net proceeds to finance infrastructure work or up to 45% of the net proceeds to shore up the city's $9 billion (at the time) unfunded pension liability. These commitments were needed to secure the support of the powerful Chicago Federation of Labor. In October 2006, the city secured the only large-hub slot under the APPP. In February 2008, the city secured airline approvals for its APPP and immediately issued an RFQ for bidders. Bids were received on September 30, 2008 two weeks after Lehman Brothers Holdings collapsed (September 16), which triggered the global credit crisis. When the private consortium was unable to come up with the full up front rent payment under the lease (purchase price) of $2.521 billion in April 2009, the deal fell through and the consortium had to pay a $126-million breakup fee to the city, of which $75 million had been posted as collateral after city council approved the lease. Since that time, the FAA has granted the city's requests for more time to complete the deal through a series of extensions to maintain its spot in the APPP. In its January 2010 filing, the city told the FAA that it "intends to complete the privatization process at the earliest practical date" but noted that "the pace and direction continues to be dictated by conditions in the global credit and capital markets." The city indicated that talks could resume with the highest bidder or other qualified bidders, or the city could put the airport out for bid again.

Timeline. A summary of the transaction timeline is as follows:

Table H.15. Chicago Midway Airport Privatization Timeline

2005	City engaged Chicago Federation of Labor in discussions regarding the privatization.
May 9, 2006	Illinois governor signed legislation allowing the extension of the property tax exemption to a private owner, thereby allowing the city to lease Midway Airport for maximum value.
September 16, 2006	City submitted its preliminary application for participation in the APPP to the FAA.
October 3, 2006	FAA accepted MDW's preliminary application.
October 2006	City started negotiations with the airlines on an agreement.
November 15, 2007	City and Southwest Airlines sign memorandum of understanding
February 13, 2008	City solicited request for qualifications (RFQ) from interested operating firms or investment groups. The interested parties provided documentation that described their qualifications to serve as the airport sponsor.
February 13, 2008	City and airlines concluded negotiation of a 25-year Airport Use Agreement
March 31, 2008	City received six responses to the RFQs.
September 30, 2008	City selected Midway Investment and Development Corporation ("MIDCo") to operate the airport under a 99-year lease. The consortium comprised Vancouver Airport Services Ltd., Citi Infrastructure Investors, and John Hancock Insurance Company. The City will receive an initial payment of $2.521 billion for the right to lease the airport.
October 8, 2008	Chicago City Council agreed to the $2.521 billion deal to lease Midway Airport to a private operator and the city executed the Concession and Lease Agreement (CLA) with MIDCo.
October 14, 2008	FAA received Midway's final application for review and approval.
October 21, 2008	60-Day Public Comment and Review Period began.
November 8, 2008	FAA held a public meeting in Chicago to receive public comments.
December 22, 2008	Public Comment Period closed. The FAA announced plans to complete its review of the application by the end of this year.
January 12, 2009	FAA issued a statement saying that the final review of the privatization application cannot be completed because critical financial documents have not been submitted. The statement says that Midway Investment & Development Company LLC plans to finalize its financial agreements with plans to close on or about April 1.
April 1, 2009	FAA granted its 1st extension to the City to provide additional information.
April 6, 2009	The original closing date for investors to secure financing is pushed back six months so investors can have more time to raise the necessary finances
April 20, 2009	City terminated the CLA with MIDCo because of its inability to finance and make the upfront rent payment.
February 1, 2010	FAA granted its 2nd extension to the City to provide additional information.
April 30, 2010	FAA granted its 3rd extension to the City to provide additional information.
July 31, 2010	FAA granted its fourth extension to the City to provide additional information.
November 30, 2010	City must provide an update to the FAA on its progress

H.6.4 Stakeholder Approvals

Labor. The city won the support of unions by ensuring that current employees would be offered jobs with similar pay and benefits in any lease. The city's commitment to use the net proceeds to fund pensions and infrastructure also helped. The Illinois legislation that allowed the city to lease Midway requires the private operator to pay employees "*an amount not less than the economic equivalent of the standard of wages and benefits enjoyed by the lessor's employees who previously performed that work*." In addition, the private operator and the city must offer employment "*under substantially similar terms and*

conditions" to municipal employees working at the airport. There is also a labor neutrality and card check agreement covering unrepresented workers.[54]

Community. In order to maintain Midway's property tax-exempt status under private operation, the city had to negotiate with the state legislature. The tax-exempt status was considered necessary for the transaction to be economically viable and as such was a front-end activity. In addition to the labor protections noted above, the state legislation also:

- Required that at least 90% of the proceeds from the lease be used for infrastructure construction and maintenance and for contributions to the municipal employee pension funds.
- Prohibited the expansion of any of the Midway runways.[55]

In its final application, the city reported its efforts to consult with airport users and its efforts at community outreach as follows:

Table H.16. Chicago Midway Community Outreach

Date	Meeting	Subject of Meeting
April 24, 2008	Midway Noise Compatibility Commission	Briefing on the Lease
June 24, 2008	Concessionaires, FBOs and rental cars agencies	Briefing on the Lease
May 2, 2008	Chicago Convention and Tourism Board	Briefing on the Lease
September 4, 2008	Chicago-Gary Regional Airport Authority	Briefing on the Lease and concerning the impact of proposed transaction on the Chicago-Gary Airport Interstate Airport Compact
Second Wednesday of each month	Monthly meeting of Midway Airport that includes concessionaires, fixed base operators and others involved in airport operations	Briefings on the Lease
October 6 and 7, 2008	Chicago City Council Committee Meetings	Consideration and approval of Lease
October 8, 2008	Chicago City Council Meeting	Consideration and approval of Lease
November 8, 2008	FAA Public Hearing	APPP Application

At the public hearing for the APPP application, there was only one question raised by the public. This person wanted to make sure that general aviation would continue to be accommodated at

[54] In 2006, the Illinois General Assembly enacted Public Act 94-750, which provides for certain requirements that must be satisfied in connection with the privatization of Midway. These requirements relate to labor relations and employee protections; continued compliance with applicable ordinances governing contracting with minority-owned and women-owned businesses, prohibiting discrimination and requiring appropriate affirmative action; and application of the net proceeds of the privatization by the city.
[55] The airport is located in a densely developed section of the city, including residential development. Also, in December 2005, a Southwest Airlines aircraft slid off a runway at Midway while landing in a snowstorm and crashed into automobile traffic, killing six-year-old boy.

Midway. The meeting was adjourned after no other questions taking only 25 minutes, which were almost entirely presentations.

Airlines. Under the APPP, in order for the city to apply lease revenues from the transaction for general city purposes, the lease must receive the approval of both 65% of the airlines operating at Midway and airlines representing 65% of the annual landed weight. This provision gave all Midway carriers, especially Southwest with 84.4% of the passenger market share in 2008, considerable bargaining power.

After being accepted under the APPP by the FAA in late 2006, the city began negotiations with Southwest Airlines. Southwest's vice president of properties, Bob Montgomery, admitted to having a "healthy skepticism" of the privatization because he was concerned that the city's goal was to sell a long-term interest in the airport with little concern for the interests of airlines or passengers. However, because the city had been a "good partner," Southwest agreed to the talks with the city. Montgomery said:

"*We were concerned. We investigated the European model and its problems because it doesn't result in lower costs and developed a laundry list we thought we needed to resolve. We also felt that Midway was already so well- run by the city and we had just successfully finished expansion projects. We didn't want to mess it up. The city did great work in listening to us and coming up with creative solutions.*"[56]

The transaction stalled as Southwest sought to leverage its position as the top airline at Midway to gain a share of the transaction's profits and secure other favorable financial terms. After the city shared an outline of the financial details of a possible lease that included controls on rate increases, Southwest hired Citibank to analyze the plan. Subsequently Southwest sent a letter to the city in February 2007 stating that "*While new information could change our minds, presently we believe that privatization is threatening to the interests of [Midway] and the airlines and passengers who rely upon it.*"

Eventually, Southwest dropped its request for a share of the profits, but secured an agreement that would generate millions of dollars in net present-value savings for itself and the other airlines serving Midway. Specifically, the deal won airline approval because it would:

- Cap airline rates and charges at a level below total 2008 charges and freeze rates for the first six years. It should be noted that the residual airline rates that were in effect at that time did not include amortization of principal on the bonds issued to finance the terminal redevelopment. Therefore, the airlines would have been able to lock in very favorable rates before they spiked. Airline cost per enplanement (CPE) ranged from $3.38-$7.55 from 2004 - 2009, with the high occurring in 2009. However, the budgeted CPE in 2010 increased sharply to $11.39, which had been planned due to the deferral of principal amortization and expiration of the application of Letter of Intent grants to debt service. The airport also projected CPE to increase sharply again in 2011, to $14.63, but remain near that level through 2018.
- Limit future rate increases to inflation for the remainder of the 25-year use agreement.
- Grant the airlines approval rights for capital improvement costs to be included in airline rates (i.e., the cost of ongoing capital projects would be added to annual airline charges only after airline approval).

[56] Yvette Shields, *Airports Poised for Privatization*, The Bond Buyer, June 18, 2008.

- Provide strong operating and service performance standards, including a capital asset maintenance plan, capital improvement program report, and five-year capital improvement program that must be developed on an annual basis by the private operator and submitted to the city and the airlines for approval by the city and a majority in interest by the airlines. These reports would define and describe the planned rehabilitation, replacement, and reconstruction capital requirements
- Transfer the risk of operations and maintenance costs from the airlines to the private operator.
- Give the airlines sign off rights on the bidders' qualifications.

Not only would the transaction have provided the airlines considerable net present value savings (especially in the near term), but it would have also would have provided stable, predictable rates and charges, which is one of the airlines' biggest concerns. Under the existing residual ratemaking methodology, airline rates and charges can vary based on external events outside the control of the city (e.g., amount of service provided by the airlines) and airlines (inflation, unfunded government mandates, etc.).

The airlines also wanted to maintain the Midway Airlines Terminal Consortium (MATCO), which was formed to operate and manage the terminal airline equipment and systems, including pre-conditioned air systems, aircraft ground power-400Hz system, passenger loading bridges, potable water cabinets, baggage handling systems, MUFIDS, battery charging, security checkpoint equipment, and aircraft fueling systems.

In February 2008, the city reached a preliminary agreement with 5 of the 7 airlines serving Midway at the time – Southwest, Delta, AirTran, and ATA (which pulled out of Midway a few months later) and Frontier, which together accounted for 97% of the passengers. At the time the final application was submitted in October 2008, 4 of the 5 airlines then serving the airport (Southwest, Delta, AirTran, and Northwest) had signed and approved the Airport Use Agreement. Only Frontier had not signed the Airport Use Agreement (even though it signed the preliminary understanding and expressed support for the transaction) because it was in bankruptcy at the time and had not yet received approval from the bankruptcy court to sign the agreement.

Bob Montgomery announced: "*With the city, Southwest welcomes the opportunity to increase our collective knowledge about airport privatization in a manner that hopefully produces a mutually beneficial outcome for both the city and the airlines*." The use agreement would have extended through 2033, with five-year renewals afterward. The current agreement expires in 2012.[57] The Southwest representative leading the negotiations, Amy Weaver, commented:

"The [proposed Midway privatization] deal was a win-win for both the airport and the airlines. Airlines are the key value drivers at MDW, and we believe the deal addressed our fears. We negotiated guarantees that controlled costs and protected operations. And, the City of Chicago was able to get the assurances needed, as well. As we negotiated the agreements, the city and the airlines collaborated to address their respective concerns, so that both sides felt comfortable moving forward. . . . Even though privatization has not happened at MDW yet, I believe privatization in America will fly. The process to privatize MDW worked on all levels—airport, airlines, city government, and federal government. It has set the pace, process, and expectations for future U.S. privatization discussions."[58]

[57] Yvette Shields, *Chicago, Southwest Reach Preliminary Lease Understanding*, The Bond Buyer, November 16, 2007.
[58] Amy Weaver, *Southwest Airlines says Midway indicates privatization can fly in the United States*, HNTB Aviation Insight, Spring 2010.

Erin O'Donnell, Managing Deputy Commissioner of Chicago Midway International, said the transaction would not have happened without Southwest Airlines in charge because Southwest was "able to think outside the box."[59]

General Aviation. As required under the APPP, and as reflected in the proposed lease with MIDCo., the percentage increase in fees imposed on general aviation aircraft could not exceed the percentage increase in fees imposed on the Midway air carriers.

Potential Bidders. The city also met several times with potential bidders to learn about their interests and concerns to design a solicitation that met their needs. Through these discussions, it was determined that the city would need to maintain the police and fire functions for Midway to mitigate the risks perceived by the potential bidders.

H.6.5 RFQ Highlights

After receiving airline approval for the lease with the 5 airlines, the city released its RFQ to companies or teams interested in competing for the long-term concession and lease under the terms agreed to by the airlines. Highlights of the proposed RFQ included:

- The private operator would be granted the exclusive right to operate Midway and to collect all revenues associated with the operation of the airport, including aeronautical, concession, rental car customer facility charges, passenger facility charge ("PFC") revenues and federal grants, subject to restrictions imposed by the FAA.
- As per the state legislation, private investors who lease Midway would be guaranteed property tax exemptions; however, runways could not be expanded beyond the current boundaries and all city workers directly employed at Midway must be offered substantially similar jobs at comparable pay.
- The private operator would have to comply with the city's minority-owned and female-owned business (MBE/WBE) requirements and applicable federal disadvantaged business enterprise (DBE) participation requirements, in its contracting activities during the term of the lease.
- The Chicago Police Department would continue law enforcement activities and the Chicago Fire Department would still have responsibility for fire, medical, and other airport emergencies.
- The private operator would also be bound by all the conditions provided under the 25-year Airline Use Agreement, including those noted above.
- The proposed term of the lease was "at least 50 years."[60]
- The city would be responsible for completing certain capital projects and the private bidder would be responsible for all other capital expenditures for the term of the lease.

The $4.50 PFC per enplaned passenger is currently used to offset debt service before calculating annual rates and charges. The PFC would be permitted to be collected by the private operator (even though the revenue bond debt would be retired by the city.) Regarding PFCs, the city said in its final application:

[59] Remarks during panel entitled *Destination Privatization: The Future of Public/Private Partnerships* at the AAAE National Airport Conference in San Diego, September 21, 2010.
[60] In the final bid solicitation document, the lease term was fixed at 99 years.

"The City is requesting that all of its PFC collection and use authority at Midway…be transferred to MIDCo. MIDCo will apply PFCs collected under this authorization to pay debt service on approximately $820 million principal amount of indebtedness incurred by MIDCo and that will refinance an equivalent principal amount of bonds previously issued by the City to finance PFC-approved projects at Midway. The City will file an amendment to its existing PFC application to provide for the use of such PFCs to pay MIDCo debt in the foresaid amounts in accordance with the terms of the new MIDCo debt."

H.6.6 Qualified Bidders

Six groups interested in competitively bidding to enter into a long-term lease for Midway submitted qualifications:

- Abertis Infraestructuras SA of Barcelona, Spain, Babcock & Brown Group of Sydney, Australia, and GE Commercial Aviation Services of Stamford, Conn.
- AirportsAmerica Group, consisting of Carlyle Infrastructure Partners LP of Washington, D.C.
- Chicago Crossroads Consortium, consisting of Macquarie Capital Group Ltd. and Macquarie Airports of Sydney, and Macquarie Infrastructure Partners and Macquarie Infrastructure Partners II of New York.
- Chicago First Consortium, consisting of HOCHTIEF AirPort GmbH and HOCHTIEF AirPort Capital GmbH & Co. of Essen, Germany, and GS Global Infrastructure Partners I LP (an investment fund run by Goldman Sachs) of New York.
- Midway Investment and Development Corp., consisting of YVR Airport Services Ltd. Of Vancouver, Citi Infrastructure Investors of New York, and John Hancock Life Insurance Co. of Boston.
- Morgan Stanley Infrastructure Partners of New York, Aeroports de Paris Management of Paris, and HMSHost Corp. of Bethesda, Md.

The city eliminated one of the six teams that had submitted qualifications and two teams decided to withdraw, leaving three teams expected to submit bids: Chicago First Consortium, Midway Investment and Development Corp., and Morgan Stanley/Aeroports de Paris.

There was strong interest in Midway from Australian and Canadian retirement funds as well as international infrastructure funds. As described in more detail in Appendix G, airports and other infrastructure assets fit the long-term investment criteria for retirement and infrastructure funds due to the stable returns and low inflation risk.

H.6.7 Winning Bidder

The consortium of investors led by Citigroup Inc., a unit of Vancouver International Airport, and John Hancock Life Insurance Co. submitted the highest bid ($2.521 billion) to lease Midway. The winning consortium was called Midway Investment and Development Company LLC ("MIDCo"). The city did not disclose the size of bids from the other pre-qualified bidders or how many were submitted. However, it was rumored that the $2.521 billion bid was considerably higher than the second-best offer.

At first some city council members expressed concern that the asset could attract more interest and a higher bid during a stronger economic cycle, but the city's CFO, Paul Volpe, reassured city council

with comparisons of earnings ratios. In particular, Volpe said MIDCo's bid equaled roughly 28 times the annual earnings ratio of Midway -- a level that "exceeded" the city's original expectations two years earlier when the finance team was assembled. He said it also exceeded the 23 to 24 earnings multiple generated in other recent overseas airport transactions. The city council voted 49-0 to approve the lease agreement.

Under terms of the lease, MIDCo was required to post $75 million in "earnest money" initially, which increased to 5% of the transaction, or $126 million, when city council approved the lease.

The city said it planned to use the $2.521 billion as follows:[61]

- $1.196 billion would be used to retire or defease outstanding Midway revenue bonds, pay for transaction costs and expenses, and pay a portion of the capital costs for projects the city agreed to complete (including land acquisition, residential sound insulation)
- $225 million would be deposited into a fund that together with associated interest earnings would be used to fund police, fire, and emergency services to be provided by the city at Midway
- The remaining amount (approximately $1.1 billion) would be used for general city non-airport purposes

The city would also transfer certain operating reserves to MIDCo. For example, regarding the PFC revenues from the $4.50 per enplaned passenger PFC, MIDCo said approximately $50 million of existing PFC reserves would be transferred from the City to MIDCo and the PFC revenues would be used for debt service on $820 million of debt and FAA-approved projects. In addition, the $3.75 per car rental day Customer Facility Charge (CFC) would be used for capital expenditures for a new Consolidated Car Rental Facility ("CCRF") and operating costs for the CCRF. The city would transfer the approximately $20 million of existing CFC reserves to MIDCo.[62]

MIDCo, which was a Delaware limited liability company, was comprised of the following equity sponsors: [63]

- 89.34% owned by Citi Infrastructure Partners, LP ("CIP"), a fund managed by Citi Infrastructure Investors ("CII") – the infrastructure investment center within Citi Alternative Investments ("CAI"). CII is a United Kingdom investment partnership managed by a wholly-owned, indirect US subsidiary of Citigroup Inc., the U.S. based global financial services company ("Citi"). A wholly-owned US subsidiary of Citi is the manager and general partner of CII, and a number of institutional limited partners are passive investors in CII.
- 2.91% owned by YVR Airport Services Ltd. ("YVRAS"), which is a Canadian subsidiary of and equally owned by the Vancouver Airport Authority ("YVRAA") and CIP Airports, LP (an affiliate of CII).
- 7.75% owned by John Hancock Life Insurance Co. (JHLI) – a $60 billion investment portfolio managed in Boston, with 10% dedicated to transportation. JHLI is an indirect, wholly-owned US subsidiary of Manulife Financial Corporation, a publicly-traded Canadian corporation.

---

[61] City of Chicago, *Second Supplement to the Final Application*, March 5, 2009.
[62] MIDCo, *FAA Presentation -- Chicago Midway International Airport*, December 12, 2008.
[63] Id.

MIDCo planned to enter into a long-term management advisory services agreement with a wholly-owned US subsidiary of YVRAS.

In a presentation to the FAA in December 2008, MIDCo disclosed how it planned to make the upfront payment of $2.521 billion due to the city upon the financial closing:[64]

- MIDCo's capital structure will include third party senior bank debt and shareholder capital (comprised of a combination of subordinated debt loaned to MIDCo by its members and cash contributions of ordinary equity provided by MIDCo's members)
- Shareholder capital will comprise at least 50% of MIDCo's initial capital structure
- Under the debt financing documents, all available revenues (excluding revenues PFC revenues and grant monies which are restricted by their terms for other specific purposes) will be applied in the following priority of "waterfall payments":
  - first, to pay operation and maintenance expenses, capital expenditures, certain general and administrative expenses, and amounts necessary to replenish previously tapped reserve funds to their required levels, among other things;
  - second, to make interest payments when due on MIDCo's senior debt, including interest rate hedge obligations with respect to such debt; and
  - third, to prepay principal on MIDCo's senior debt with certain of any remaining excess revenues
- Only after satisfaction of the required "waterfall payments" could MIDCo use any further remaining excess revenues to make payments in respect of the shareholder capital
- MIDCo's senior and subordinated debt will be secured by a pledge of its interest in the Concession and Lease Agreement (CLA), among other things

H.6.8 The "Secret Sauce"

A number of people have expressed skepticism on the ability for MIDCo to be able to make a profit given the amount of the bid, the rate caps under the airline use agreement, the relatively well-developed terminal retail program, the operating efficiencies introduced by the city in 2009, the limited potential for land development, and limitations on passenger throughput growth due to the prohibition on runway expansion and lack of land for terminal expansion. When asked about this issue, YVRAs commented "that's the secret sauce." During a presentation to the FAA, MIDCo said operating expense savings were expected to come from the following:

- Lower costs for shared services presently provided by the city – MIDCo anticipated its costs for providing these services would be less
- Reduction in amortization costs because MIDCo planned to buyout certain equipment
- Energy savings based on technical advisors report and operations review
- Savings on insurance costs based on a quote from Aon
- Contractual efficiencies
- Efficiencies on procurement and purchasing functions
- Elimination of privatization process costs and certain other costs historically expensed and not capitalized by the city

MIDCo also said revenue enhancements were expected to come from:

[64] Id.

- Expansion of concession facilities in the central triangle, retail street walkway, check-in hall, pre-security and in baggage claim areas, and various other locations throughout the terminal and outside
- Opportunity to rationalize underperforming stores and new offerings
- Better management of the concession program, including pricing and promotion programs, brand and promote the retail experience, and monitoring the experience and coaching underperformers

Aeronautical revenues would consist of:[65]

Airline Base Contribution	$45mm per year based on the Airport Use Agreement
MATCO Revenues	Revenues based on pass through of operating costs for common-use airline equipment such as bridges, FIDS, fuelling system fees, etc.
Other	Hangar and FBO leases based on long term leases between MIDCo and tenants
Airline CapEx Recovery Contribution	Revenues based on recovery of the MII approved capital program in line with Airport Use Agreement

As noted earlier, job security for all Midway employees was an important objective for the city. Therefore, MIDCo was required to offer jobs to all of the 240 direct Midway employees, of which approximately 95% were represented by collective bargaining agreements. The offer must be no less than the current salary, but the private operators were not expected to match the city's relatively robust benefit plan. For any employee that declined, the city was obligated to find a job in its roughly 30,000 person work force. It was estimated that 18% of the employees said they would take the MIDCo offer. Most of these were employees who were already locked into the Chicago pension plan. Those that were close to retirement wanted to stay with the city.

H.6.9 Global Credit Crunch Prevents Financial Closing?

In the context of the global financial crisis, MIDCo was unable to raise the entire purchase price for the lease by the city's deadline in April 2009, and as a result forfeited the $126 million in earnest money it posted to the city. Citi disclosed that financing was expected to consist of about $1 billion in equity (90% from Citi, 7.5% from John Hancock and 2.5% from YVRAS), about $800 million in bank debt, and the balance to come primarily Citi's limited partners, who had rights of first refusal. The LPs, which included the Alaska Permanent Fund Corp., the Abu Dhabi Investment Council and the Netherlands' PGGM, said they ran out of allocatable capital due to the dramatic drop in the equity markets by the time of the financial closing in April 2009. An attempt to fill the gap with convertible instruments failed to attract takers.

Speculations on why the deal collapsed range from it being just another victim of poor credit markets to there being a problem securing the equity given the aggressive bid price. Nevertheless, it would appear that that the highly leveraged environment that existed before the global markets collapsed had fueled unrealistic prices and expectations for some underlying assets whose values

[65] Id.

have since waned, including Midway. As noted earlier, the $2.52 billion bid translated into an EBITDA multiple of 28x and might now be viewed as a high-water mark for airport valuations in the U.S. London City Airport achieved a 30x multiple on the sale to GIP/AIG in 2007 and the failed 40x multiple valuation of a 60% stake in Auckland International Airport by Dubai Aerospace Enterprise also in 2007 was the highest ever and an outlier.

The city applied the $126 million breakup fee as follows:

- $13 million was used to reimburse the city for costs associated with the privatization process
- $33 million redeemed general obligation debt of the city
- $40 million was transferred to the city's corporate fund
- $40 million was transferred to a reserve fund to be paid to the city's corporate fund in equal amounts for 2010 and 2011

H.6.10 Next Steps

The city must file quarterly reports in order to retain its hub privatization slot under the FAA's pilot program. In its supplemental filings with the FAA on January 29, 2010 and most recently on July 30, 2010, the city said:

"*The City is in continuing deliberations regarding the completion of the Midway Airport privatization. The pace and direction continues to be dictated by conditions in the global credit and capital markets. The City intends to complete the privatization process at the earliest practicable date. The City will report back to the Federal Aviation Administration by November 30, 2010 on further developments with respect to the process to select a private operator.*"

In October 2010, the city issued $251 million of second-lien Midway International Airport bonds to refund outstanding commercial paper and wrap up financing for a new consolidated rental car facility. The 2010 bonds were structured to pay interest only through 2015 with principal amortization beginning in 2016 to minimize the near-term impact of the new debt on airline costs. The structure was also designed to leave the city flexibility in the event it resurrected plans to privatize the airport.[66] By the time the 2010 bonds were sold in October 2010, traffic had recovered materially since its slump in 2008. Midway was one of a few airports in the nation to experience traffic growth in 2009 (2.9%), and traffic had increased nearly 5% for the first 6 months of 2010.

As of September 2011, Chicago retains its slot with the FAA. Although Mayor Daley said he wanted to resurrect the deal when market conditions improved, he decided not to seek re-election (in February 2011) and not pursue a Midway lease for the balance of his remaining term. Chicago's new Mayor Rahm Emanuel wants to leave the door open to the Midway privatization and has asked the FAA to preserve its approved slot under the pilot program. Emanuel has said a number of times that he has no plans to try again — at least in the near term — to pursue a Midway lease. He also said that he wants a strict policy on future leases in place before considering any future leases. Nevertheless, the city submitted the required application to preserve the spot by the July 31 deadline. According to a spokesperson for the Mayor:

"The mayor believes that any monetization of the city's assets must meet an extremely high threshold to ensure it benefits the taxpayers. His view on this has not changed. The mayor has no

[66] City of Chicago, *Preliminary Official Statement, Chicago Midway Airport Second Lien Revenue Bonds*, September 29, 2010.

plans to resurrect [the Midway lease] in the short term until we establish an open process and can ensure all revenue generated from the deal is protected for long-term investment."[67]

If so, it is unknown whether the ultimate deal will be different than the one that nearly was inked.

H.6.11 Lessons Learned

People involved with the Midway transaction trumpeted its merits and "win-win" proposition to all stakeholders. They believe the only reason the transaction failed to reach financial close was due to the collapse of the debt and equity markets.

Others have expressed concerns about the precedents set in terms of the amount of the bid proposal of the winning bidder and the favorable provisions in the airline agreement. They fear that other policy makers will expect to realize the same multiples (28 times revenues) and that the airlines will see the Midway lease as the benchmark for future privatization transactions even though the conditions are different for every airport.

The lessons learned from this transaction include:

- A successful APPP application process requires strong political support and leadership. The city of Chicago had that in Mayor Richard M. Daley. There was also a very supportive administration in Washington, D.C., and there was political momentum from the large bid on the Skyway deal.
- Going through the APPP is a lengthy, complex, and time-consuming, process and can be an expensive process. The rewards to the airport owner can be potentially large, but success is not guaranteed. Any public sponsor should consider the level of effort, expense, and risk before applying
- Privatizing an airport under the APPP in the U.S. is far more complicated than privatizing toll roads or parking facilities given the highly regulated environment, complexities involved in operating an airport, the pace of technological changes affecting airports, and the multiple approvals needed -- including the FAA, TSA, Committee on Foreign Investment in the United States (if the sale or lease of the airport is to a private operator that is a foreign entity[68]), labor, and airlines (if revenue is to be used for non-airport purposes) in addition to the local approval requirements (e.g., city council).
- It is important to include in the airport's privatization team technical advisors given the extensive and complex legal, financial, operational, and regulatory issues involved in the airport industry. The city had very capable external advisors and engaged airport staff productively in the operational issues.
- The goals for the privatization should be clearly articulated. The city's goals were always transparent and well-articulated, which helped eliminate resistance to the transaction.

[67] Yvette Shields, *Chicago's Emanuel Wants FAA to Leave Program Slot Open*, The Bond Buyer, August 8, 2011.
[68] Due to the lack of airport privatization in the U.S. most of the potential bidders tend to be global infrastructure specialists.

- It is important to estimate the expected net proceeds early in the process to know if the transaction can yield positive benefits. The city retained financial advisors to run various scenarios to assist it in making the decision to go forward with the transaction.
- The public sponsor needs to get key stakeholders on board early, including labor and airlines, to maximize the potential for success.
- Transparency and public outreach are important. The FAA sets up public dockets that contain valuable information, but local residents often are not aware of this resource. In the case of Midway, where homes are as close as 30 feet from the airport boundary, the local community was very supportive because the local community understands the economic value of the airport.[69]
- Maintaining property tax exemptions under private operation of a long-term lease is important for the economics of the deal or would otherwise need to be reflected in the valuation of the airport.
- Oversight and performance standards are important to include in the operator's concession lease and they should be coordinated with the airlines. The operator must be held accountable.
- The length of a lease needs to be considered carefully. Initially it was expected that the Midway lease would be for "50 years or more" as U.S. accounting rules dictate that, for expenses to be deducted by the lessee, the length of the lease needs to equate to the remaining economic life of the asset, and this deal that was approved for a term of 99 years to maximize the up-front lease payment to the City. The level of equity investment is tied to the term, which falls off dramatically with shorter terms. On the other hand, with long-term leases it is important to ensure the operator does not neglect the asset in the final years of the lease. This is why the Midway operator was required to prepare a capital asset maintenance plan, capital improvement program report, and five-year capital improvement program each year and submit them to the city and the airlines for approval.
- The city was not in a position to offer tax-exempt financing to the bidders, which is one way to substantially lower the amount of financing needed by private investors (as shown in the JFK IAT case study). This is because in order to qualify for the federal tax exemption, the asset must be governmentally owned, which means the term of the lease cannot be greater than 80% of the useful life of the asset. As noted above, privatization models push for longer terms. In addition, under IRS regulations, tax exempt bonds cannot be used to acquire existing assets unless at least 15% of the proceeds are used for rehabilitation expenditures for buildings associated with the property.[70]
- Privatization through the APPP is not a solution for every airport. It was used by the City of Chicago because it allowed for the net proceeds paid up-front under the lease to be used "off airport." However, and as best expressed by Amy Weaver of Southwest Airlines who participated in the Midway transaction "The APPP outlines a practical, effective process for privatization. Airports, airlines and any other players need to remember that each privatization deal is unique…The pilot program is flexible enough to accommodate…unique

[69] Interview with Erin O'Donnell, Managing Deputy Commissioner of Chicago Midway International, September 20, 2010.
[70] 26 USC 147 - Sec. 147. Other requirements applicable to certain private activity bonds.

qualities."[71] One of the reasons the airline rates could be frozen for the first six years at Midway was because the city had just completed a major terminal redevelopment program and the APPP rules provides airlines with negotiating leverage.

H.6.12 References

Local Government Facility Lease Act, Illinois Public Act 094-0750 (Senate Bill SB2872, 94th Session)

Yvette Shields, *Chicago, Southwest Reach Preliminary Lease Understanding*, The Bond Buyer, November 16, 2007.

Yvette Shields, *Chicago Issues RFQ for Midway Airport*, The Bond Buyer, February 14, 2008.

Yvette Shields, *Six Teams Want to Run Chicago's Midway*, The Bond Buyer, April 2, 2008.

Yvette Shields, *Airports Poised for Privatization*, The Bond Buyer, June 18, 2008.

Robert W. Poole, Jr., *Airport Privatization Continues, Fitch Notwithstanding*, Airport Policy News, Reason Foundation, Issue No. 38, September 2008.

Robert W. Poole, Jr., *Six Teams Seek Midway Airport Lease*, Airport Policy News, Reason Foundation, Issue No. 34, April 2008.

MIDCo, *FAA Presentation -- Chicago Midway International Airport*, December 12, 2008.

Mari Fagel , *Should Daley Lease Midway*?, Medill Reports - Chicago, Northwestern University December 09, 2009.

Chicago to reignite Midway Airport privatisation? Who will bid?, Centre for Asia Pacific Aviation, January 11, 2010.

Vyvyan Tenorio, *Midway wasn't far enough*, The Deal Magazine, February 19, 2010.

Moody's Investor Services, *Moody's concludes Watchlist and Confirms the A3 Rating on Chicago Midway Second Lien Bonds; Assigns A3 to Series 2010B,C&D Bonds*, Global Credit Research, September 24, 2010.

Standard & Poor's RatingsDirect, *Chicago, Illinois, Chicago Midway International Airport; Airport; Joint Criteria*, September 28, 2010.

FitchRatings, *City of Chicago, Illinois, Chicago Midway Airport; Airport; Joint Criteria*, October 5, 2010.

City of Chicago, *Preliminary Official Statement, Chicago Midway Airport Second Lien Revenue Bon*ds, September 29, 2010.

FAA, *FAA News – Fact Sheets on Midway Airport Participation in Airport Privatization Pilot Program*, various issues.

FAA, *Airport Privatization Pilot Program, Chicago Midway International Airport, Public Meeting,* minutes to meeting on November 8, 2008.

City of Chicago, *Chicago Midway International Airport, Request for Qualifications, First Long-Term Concession and Lease for a Major Airport in the United States*, February 2008.

City of Chicago, *Airport Use Agreement*, February 13, 2008.

[71] Amy Weaver, *Southwest Airlines says Midway indicates privatization can fly in the United States*, HNTB Aviation Insight, Spring 2010.

City of Chicago, *Chicago Midway International Airport Concession and Lease Agreement*, October 8, 2008.

City of Chicago, *Final Application – Airport Privatization Pilot Program*, October 9, 2008.

City of Chicago, *Second Supplement to Final Application*, March 5, 2009.

City of Chicago, *Third Supplement to Final Application*, January 29, 2010.

City of Chicago, *Fourth Supplement to Final Application*, April 30, 2010.

City of Chicago, *Fifth Supplement to Final Application*, July 30, 2010.

Amy Weaver, *Southwest Airlines says Midway indicates privatization can fly in the United States*, HNTB Aviation Insight, Spring 2010.

H.7 Morristown Municipal Airport

H.7.1 Airport Background

Morristown Municipal Airport (MMU) is a general aviation airport that is owned by the Town of Morristown and has been managed and developed by DM AIRPORTS, LTD. ("DM"), an affiliate of the DeMatteis Organizations, since 1982 under a comprehensive long term lease. It is located in Hanover Township in Northern New Jersey at the intersection of Route 24 and Columbia Turnpike. DM promotes that MMU is "27 stoplight-free miles to Manhattan" and 18 miles from Newark Liberty International Airport ("EWR") to highlight its proximity to New York City.

MMU is the second busiest public-use general aviation ("GA") airport in the State of New Jersey. It serves all types of GA activity including business/corporate, recreational, and flight training, as well as many leading New Jersey and national corporations, such as Honeywell. MMU is designated as a reliever airport by the FAA in its National Plan of Integrated Airport Systems (NPIAS). Under this designation, the airport serves as an alternate facility for GA traffic that would otherwise operate at EWR, thereby enhancing capacity, safety, and efficiency at EWR. As such, MMU is a key component of the New Jersey transportation system, and an important contributor to local, regional, and statewide economic development.

The airport occupies 637 acres and has two runways -- Runway 5/23 (5,998 feet. x 150 feet) and Runway 13/31 (3,997 feet x 150 feet).

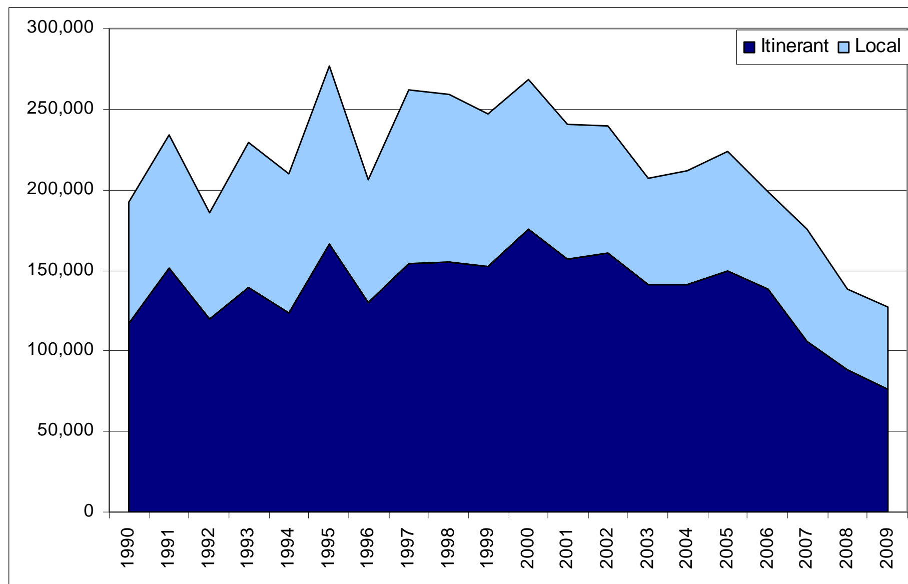
Figure H.6. Morristown Municipal Airport

Photo: Courtesy of DM AIRPORTS LTD.

MMU provides services for businesses located in Morris County. Approximately 50 of the nation's Fortune 500 companies are either headquartered or have major facilities in the county. Major area employers include: Accenture, ADP, AT&T, Atlantic Health Systems, Automatic Switch Company, BASF, Bayer Consumer Care, , Deloitte & Touche, Honeywell, Howmet (an Alcoa business), Jersey Central Power & Light, Johnson & Johnson, Kraft Foods, Novartis, Pfizer, Inc, PricewaterhouseCoopers, Realogy Corporation, State Farm Insurance, Transistor Devices, Inc., Tiffany & Co., United Parcel Service (UPS), Verizon, Wyndham Worldwide, and Wyeth. Morris County provides a prime location within close proximity to New York City and MMU provides all the aviation amenities required to maintain a flight department.

In 2009, MMU handled 127,224 aircraft operations, with the majority being itinerant. As shown in Figure H.7, there has been an almost steady decline in aircraft operations since 2000, reflecting the impact of the terrorist events of September 2001, the economic recession, increases in fuel costs, and the national decline in general aviation activity. In particular, the decline in aircraft operations reflects declines in flight school activity.

Figure H.7. Aircraft Operations at Morristown Municipal Airport



Source: Federal Aviation Administration Terminal Area Forecast, December 2009, and FAA monthly operations for calendar year 2009.

Similarly, the number of aircraft based at MMU peaked in 1995 at 416 and has declined almost steadily since that time also reflecting national trends. However, DM expects that the number of based aircraft has stabilized. Although MMU caters to all types of general aviation, there is a relatively high proportion of high-end general aviation aircraft based at MMU as shown in Table H.17.

Table H.17. Based Aircraft at Morristown Municipal Airport

	Single	Multi	Jet	Helo	Turbo	TOTAL
West Tie Down	75	5	0	0	0	**80**
Private Hangars	39	10	7	2	3	**61**
Corporate Tenants	31	1	58	8	4	**102**
TOTAL	**145**	**16**	**65**	**10**	**7**	**243**

Source: DM AIRPORTS LTD. September 2010.

MMU competes primarily with Teterboro Airport and Westchester County Airport for business. Teterboro Airport is also a general aviation reliever that is owned and operated by the Port Authority of New York and New Jersey and located approximately 12 miles from midtown Manhattan in the New Jersey Meadowlands. Westchester County Airport is located in White Plains, NY along the border between Westchester County and Greenwich, CT. In addition to servicing scheduled commercial passenger service, Westchester County Airport is one of the most active business aviation facilities in the county. As a result, DM is highly incentivized to provide strong customer service at reasonable prices to its clientele.

Unlike most general aviation airports, MMU has special aviation enhancements due to the high-end users of the airport, including:

- Air Traffic Control Tower (which is staffed by the FAA and open between 6:45 a.m. to 10:30 p.m. seven days a week)
- Aircraft Rescue and Fire Fighting (24 Hour Index B Aircraft Rescue Coverage)
- U.S. Customs & Border Protection (User Fee Facility operated by Morristown Airport Customs Association)
- Noise Abatement Office

Other airport facilities and providers include:

Function	Provider
FBOs	Signature Flight Support FTC FBO, LLC
Flight Schools	American Flyers Best In Flight Certified Flyers II
Aircraft Maintenance	Syrek-Mee Aviation
Organizations and Clubs	150th Aero Club Morris Aero Club Skywagon Flight Club Civil Air Patrol
Fuel Farm	DM AIRPORTS LTD.

H.7.2 Privatization Objectives and Motivations

In 1981, after operating the airport unprofitably for many years, the town had accumulated over $2 million in debt for airport capital improvements even though its infrastructure was in a state of disarray. The airport's corporate users were threatening to leave because the airport and the FAA was threatening to close the facility if upgrades were not made. The town recognized it did not have the talent on staff to run the airport properly and looked to a private company to operate and manage it on their behalf, pay off the debt, and make the necessary capital improvements to appease

the FAA and tenants.

After careful consideration, the town concluded that the airport could be better operated and developed by a private entity. The town studied various proposals and considered several potential developers to run the airport.

Seeing the potential for commercial development on and around the airport, the DeMatteis Organization[72] formed D.M. Airport Developers, Inc. -- which later was renamed DM AIRPORTS LTD -- and entered into a 99-year lease with the town to operate, manage, and develop the airport. At the time, DM had plans to develop property for commercial, hotel, office, industrial and/or manufacturing purposes. However, subsequently, wetland limitations and the taking of 11 acres of airport property for expansion of Route 24 eliminated the expected potential for commercial land development.[73] Although DM had the option to terminate the long-term lease due to this land taking, it concluded that it could continue to successfully operate the airport without this developable property.

DM paid off the airport long term debt, made substantial upgrades to the airport with the aid of federal and state grants, and turned the airport into an economic catalyst for the town and the region.

H.7.3 Lease and Management Structure

The Agreement of Lease between the town and DM was entered into in December 1981 with a term of 99 years commencing on May 1, 1982 and extending through April 30, 2081. Under the long-term lease, the town granted the full management and development control of the airport to DM in return for DM (1) paying annual rent to the town, (2) paying all outstanding airport debt service when due, and (3) undertaking all capital improvements. As such, DM has wide discretion and is responsible for making decisions regarding the development of MMU (i.e., capital improvement projects) and managing its operation, which includes among other things, negotiating leases, handling staff and services, and setting rates, fees, and charges. The only residual airport controls retained by the town are the signing of airport grants and approval of site plans, but the town is obligated to mutually cooperate with DM in securing such approvals. DM retains all revenues derived from its operation of the airport.

The base annual rent, which is paid in equal monthly installments to the town, is tiered as follows:

May 1, 1982 – April 30, 1983	$30,000
May 1, 1983 – April 30, 1984	$40,000
May 1, 1984 – April 30, 1985	$50,000
May 1, 1985 – April 30, 1986	$75,000
May 1, 1986 – April 30, 1993	$100,000

The base annual rent is then adjusted every 5 years beginning in May 1993 based on the change in the CPI (for New York, N.Y.– Northeastern N.J.) using 1988 as the base year (and subject to specified caps). The annual rent is intended to cover the town's costs associated with the airport

[72] The DeMatteis Organization is a family-owned organization with construction and real estate companies that has headquarters in Elmont, New York and Morristown, New Jersey. Its companies provide general contracting, construction management, design-build contracts, and interior construction and renovation.
[73] As a result of the land taking, DM's annual base rent was abated slightly. In addition, there was a negotiated settlement on the value of the land that was taken, which was shared approximately 80% by the town and 20% by DM.

under DM's operation, which consist of police services, auditing, and grant administration.

The lease also obligated DM to pay "Additional Rent" in amounts equal to the town's annual debt service payments on the outstanding debt incurred by the town for airport capital improvements prior to the commencement of the lease term.

The 99-year term of the lease was deemed necessary for DM to recover its payment of the town's outstanding airport debt and its investment in upgrading existing facilities and constructing new ones. DM also has responsibility for all airport repairs, maintenance, and operations (except police services which are provided by the town) and compliance with all governmental regulations. In addition, DM is responsible for obtaining at its own cost all site plan approvals and zoning approvals and permits for airport development airports with the full cooperation of the town.

The lease gives DM great flexibility in carrying out its charge of operating the airport as a public airport subject to all applicable laws, regulations and agreements, including compliance with FAA grant assurances. As stated in the lease:

"Lessee shall assume the responsibility for and shall perform all repairs and maintenance of the Airport, and shall at all times keep the Airport in reasonably clean and orderly condition and appearance, take reasonably good care of the Airport, maintaining the same at all times in reasonably good operating condition, and as may be reasonably required by any governmental authority having jurisdiction… Lessee's sole responsibility hereunder shall be to maintain the Airport in reasonably good operating condition subject to deterioration caused by wear and tear."

The lease also gives DM the right to mortgage all or any portion of its interest in the lease (without the town's consent) to obtain the most favorable financing needed for airport development. In addition, the lease is assignable "without restriction of any kind."

Airport users pay fees and charges directly to DM and DM assumes the risk involved in covering both operating and capital costs out of those revenues.

The lease served as a model for the Stewart lease under the Airport Privatization Pilot Program (APPP).

H.7.4 Stakeholders

Labor. When DM took over operation of the airport in 1981, there were approximately 35 employees on the airport payroll. The maintenance and operations staff was offered positions by DM, but most of the senior employees moved to positions within the town government to maintain their municipal status and pension benefits.

Local Government. The management contract has served the Town of Morristown well. The town's only responsibilities for the airport are police protection, emergency medical response, grant administration and audits, and site plan approvals. DM converted a facility in a state of disrepair into an economic engine by investing in the airport's infrastructure and providing a high level of service to the users. This arrangement has also worked well for Hanover Township, where the airport is located, because DM must pay land taxes to the township unlike a municipal operator.

Community. DM is responsible for all interactions with the community with regard to the airport. Morris County views MMU as a critical community asset for retaining and attracting business.

Therefore, the Morris County Freeholders[74] established an Airport Advisory Committee in 2003 to interact with DM and MMU tenants, which meets on a bi-monthly basis (but only if there is business to discuss). Although this committee has no jurisdiction over the airport or DM, it has been instrumental in bringing together residents, pilots, government officials, and airport personnel to address noise issues at MMU, among other issues. It also helps DM to build goodwill with the community.

Most recently, the Airport Advisory Committee has been concerned about aircraft delays experienced at MMU due to the congested airspace and interactions with Newark Liberty International Airport. In order to attract new business to the area, the Airport Advisory Committee wants to explore the viability of MMU as an asset and what can be done regarding the departure delays. The committee is interested in supporting the airport regarding initiatives in Washington that could be used to benefit operations and reduce MMU delays.

Although the airport is owned by the Town of Morristown, it is located in Hanover Township. DM pays land taxes and improvement taxes to Hanover Township. Typically, public airport owners and operators do not pay property taxes. Therefore, the township derives incremental tax revenues as a result of this business model.

According to the 2008 Economic Impact Study, MMU supports over 1,550 jobs and $243.6 million in economic impact and, in aggregate, is the second highest tax payer in Hanover Township. The Airport generates over $13.3 million in State and local taxes and provides incomes in excess of $72 million to New Jersey residents.

DM actively engages the neighboring community through various channels on a voluntary basis. For example, since 2000, DM has provided annual scholarships to 16 local college-bound high school graduates each year in the amount of $1,250 that may be used for tuition, books, or other eligible fees. In addition, DM sponsors every three years a full-scale emergency response exercise that is designed to simultaneously test the emergency operations plans for MMU, the town, and Morristown Municipal Hospital. It provides training for area firefighting and rescue personnel for mutual air response. DM also helps sponsor the free Hanover summer concert series.

DM also developed and administers a voluntary noise abatement program through the MMU rules and regulations. DM employs a dedicated Noise Abatement Officer who along with members of the Morristown Aviation Association monitors the program and encourages pilots to comply. Although the airport is located in a densely populated area, there are only a few people who complain regularly.

Tenants. DM also actively engages airport tenants through various channels. The Morristown Aviation Association ("MAA") is an association of mostly airport tenants and some transients that was established to provide a forum for tenant interaction. DM jointly sponsors a periodic publication on airport updates with the MAA and the Morristown Airport Pilots Association.

As noted earlier, MMU also has U.S. Customs & Border Protection services for international flights. Because MMU does not have sufficient volume to justify a federal agent being assigned to the airport, the tenants decided to set up a user fee association to pay for one. DM administers the user

[74] In New Jersey, county legislators are called "Freeholders."

fee service on behalf of the Morristown Airport Customs Association. Tenants and transients pay to clear with higher rates for transients and nonmembers. Entities who clear frequently often become a member of the Association. The cost includes the fee for the federal agent, building rent, utilities, and a dedicated, secure internet line, none of which are a cost responsibility of DM.

The tenants also decided they wanted ARFF even though MMU is not a Part 139 airport[75] and ARFF is not required because of the high-end aircraft they use. Like customs, ARFF is not a cost responsibility of DM, but instead is funded by a surcharge on fuel flowage per gallon. However, DM puts out to bid and administers the ARFF contract. The FAA funded 95% of the cost of the ARFF station through an AIP grant as well as 95% of the cost of the first ARFF vehicle (up to Level A). The tenants paid for the cost of a second vehicle through the fuel flowage surcharge because the FAA said it would not support a Level B service.

In sum, DM maintains three separate sets of financial records – one for its own responsibilities and one for each of the user fee systems for the Morristown Airport Customs Association and ARFF.

A bi-monthly E-Newsletter called Morristown Airmail is published jointed by DM, MAA, and the Morristown Airport Pilots Association that summarizes airport news, projects, events, and issues as well as community aviation-related issues and outreach.

FAA. DM is the primary interface with the FAA and other federal agencies. The only role that the town plays is to execute grant agreements as the airport sponsor. DM is responsible for identifying Airport Improvement Program (AIP) grant projects, providing the Airport Capital Improvement Program (ACIP) input to the FAA for the 5-year capital plan, preparing and submitting the grant applications, project implementation, project management and controls, project accounting, and grant closeout.

DM also is responsible for all grant compliance unlike airports that are operated under management contracts where this responsibility remains vested with the public sponsor.

H.7.5 Consequences

Airport Management Team. Initially the DeMatteis Organization contracted the management and operation of the airport to an airport management company (Avco) because DeMatteis did not have this expertise. Avco hired airport professionals to operate and manage the airport on behalf of DM. However in 1992, after having achieved stability within the airport management team and with Avco desiring to exit the airport management business, DeMatteis allowed the contract to expire and hired the airport management staff to work directly for DM. There has been little staff turnover at DM since that time. In November 2010, there were 28 professionals on DM's management team plus an independent contractor for security.

Capital Improvements. Airport capital improvements are funded with AIP grants, state grants, tenant financing (via long term leases), and/or DM capital contributions.

Most of the capital development performed by DM has been accomplished using federal and sometimes state airport grants. DM has been quite successful in securing federal and state grants,

[75] Although not required, some large GA airports do have 139 certificates, which greatly affects staffing and operating expenses.

including a $5 million American Recovery and Reinvestment Act of 2009 (ARRA) grant for taxiway rehabilitation, which is funded 100% by the FAA. For all other AIP funded improvements, the FAA participates at 95% of the eligible cost of the project and the state often provides half of the local match (2.5%).

When DM took over operation of the airport, the existing sole fuel farm on the airport was in a state of disrepair. DM contracted with Exxon in 1989 to finance, build, and maintain a new Jet A and Avgas fuel farm and become the fuel supplier. Because the airport is located in Hanover Township and because the township refused to permit more than one fuel farm (given the wetland constraints), DM operates the fuel farm servicing the airport's large tenant base and two fixed base operators (Signature Flight Support and FTC FBO).[76] When Exxon's 20-year lease expired at the end of 2009, the ownership and maintenance responsibility for the fuel farm reverted to DM. DM then entered into a 7-year fuel supply contract with Ascent Aviation Group, Inc., which is Phillips 66 Aviation's largest general aviation fuel marketer. DM wholesales fuel to the FBO's and corporate tenants who have a direct lease with them, which includes a fee to cover its liability, operation, and maintenance of the fuel farm.

DM constructed at its own cost the airport administration building and acted as developer for two hangar facilities for tenants. DM is planning a major repair of the fuel farm in the next few years.

Operations. DM employs 28 people on a full-time basis and hires seasonal workers in the summer and winter on a part time basis to assist with the administration and operations. DM performs a great deal of the airport operations and services with its own staff, but also contracts out several services, including:

- Aircraft Rescue Fire Fighting is contracted to Rural/Metro Corporation for 24/7/365 staffing
- Engineering consultants assist with AIP grant application preparation
- The security coordinator is an independent contractor[77]

The Morristown police department has the primary obligation to provide police services to MMU, which is done in consideration of the rent DM pays to the town.

Revenue Base. As a private company, DM does not disclose financial data, but was willing to share information on revenue sources. The vast majority of DM's revenues are derived from rentals, which are less subject to traffic volatility. For 2010, the share of revenues consisted of:

Tenant & Tie Down Rents:	66%
Fuel Sales (net)	25
Landing Fees	8
Miscellaneous Revenue	1
	100%

As noted earlier, given the competition for high-end GA services in the New York City

[76] Although FAA grant assurances do not allow monopolies (e.g., a single fuel farm) on any airport developed with federal grant assistance, the assurances specifically allow one exception; if the airport sponsor provides the service itself.
[77] Several members of DM's operations staff have completed the Airport Security Coordinator course and have the designation in compliance with TSA regulations.

metropolitan area, DM is highly incentivized to provide strong customer service at reasonable prices for its clientele. For example, in 1991 one of the MMU three FBOs (Jet Aviation) decided not to renew its lease at the end of its term and instead consolidate its operations at Teterboro. DM spearheaded a redevelopment of the Jet Aviation site that had old, worn down facilities, which were torn down and replaced with a new, modern hangar. When another FBO site was being redeveloped, DM issued an RFP for a flight school and a new building was constructed so the flight schools were not displaced.

Regional Economic Asset. Over the first 28 years of operations (1982 – 2010), DM has:

- Implemented capital improvements and provided the necessary facilities and services to meet aviation market demand
- Improved customer service at the airport by providing superior facilities and services at competitive rates
- Helped organized, manage, and participate in tenant customer service programs (e.g., the U.S. Customs & Border Protection and ARFF services)
- Marketed the airport's desirable location and high-end facilities to retain and attract customers for the benefit of the local economy
- Transformed MMU into a financially self-sustaining, competitive facility for the region
- Elevated MMU's position to be one of the two premier general aviation airport in northern New Jersey, with Teterboro as the other
- Fostered strong community relations by promoting the airport and engaging its tenants, the Morris County Freeholders, the local chamber of commerce, and other stakeholders
- Established a corporate identity for the airport through participation in aviation trade association events and conferences and marketing efforts, including its user friendly website
- Turned MMU into an economic engine for the town and the region

By contrast, as noted earlier, under the town's operation, the FAA was threatening to shut the airport down due to its state of disrepair.

H.7.6 Lessons Learned

It is important to note that the Morristown privatization occurred before the FAA promulgated its revenue use policy and before the creation of the APPP. Therefore, it is not reasonable to expect to be able to repeat this experience because the federal rules concerning, for example, the transfer of management responsibility and the use of rent proceeds and the private operator's compensation, are much stricter now.

Nevertheless, the comprehensive long term lease of MMU was a first-of-its-kind experiment and as a result has provided some interesting and instructive lessons learned, including:

- Similar to the JFK IAT Terminal 4 project, the MMU long term lease did not require any special federal or state legislation (such as the Airport Privatization Pilot Program). In fact, it demonstrates that significant privatization can be accomplished within the existing regulatory framework.

- However, like the JFK IAT Terminal 4 project, there appears to be special circumstances that make the MMU experiment successful, in particular the demand for high-end general aviation users. Although DM has been approached by several other airports, DM has declined these offers because the market was not there for a viable business opportunity, suggesting that the business climate in Morristown is somewhat unique.

- The DeMatteis Organization learned that once a professional staff was in place and successfully operating the airport it was no longer necessary to contract out the airport management and therefore was able to save money by no longer having to pay the annual management fee.

- According to DM, privatization allows for a more efficient and effective way to operate the airport. Decisions can be made in a timely manner. Moreover, bureaucracy, politics, and competing funding priorities do not factor into the business decisions. Unlike the Indianapolis management contract, DM is not required to adhere to local municipal procurement regulations, which allows for greater operating efficiencies and speedier delivery of services.

- Due to the nature of the agreement (in particular its term and development responsibilities), DM pays land and improvement taxes to Hanover Township. Typically, public airport owners/operators do not pay property taxes. Therefore, this type of privatization allows a local municipality (other than the owner) to derive incremental tax revenues.

- Community outreach is important for airports. Although not mandated in the lease, DM actively and successfully engages the community and its tenants. This is an area for possible improvement in a lease in the event the lessee was not as committed to the airport and its rapport with the community.

- The lease does not include specific oversight and performance standards. This would typically be included in a long-term lease or management contract of this type. However, given the competitive nature of high-end general aviation use in the New York metropolitan area, DM is incentivized to provide a high level product.

- The term of a long-term agreement, where the public sponsor grants full management and development control to the operator under in return for the operator undertaking full capital improvements, needs to be considered carefully. Where significant airport development is anticipated, the term of the lease should be related to the length of time needed by the operator to recover its investment. In this case it was felt that a 99-year lease was needed due to DM's obligation to defease the $2 million in outstanding airport debt and make the necessary improvements to the airport. Whether a 99 year lease is necessary or appropriate for a similar deal should be carefully considered. DM pays a relatively modest annual rent for the privilege of retaining all airport fees and charges in return for taking on the risk to cover operating expenses and capital expenditures (net of grants) out of those revenues.

- The form of compensation – upfront lump sum vs. annual rent – is also something to be carefully considered and evaluated. The town decided to take the annual rent to cover its cost to provide continuing police, emergency medical, and grant administration services for the airport. By comparison, the city of Chicago opted for an upfront payment and set aside funds for its ongoing obligation to provide police and fire protection for Midway Airport.

- The lease does not have definable requirements for maintaining the airport other than "maintain the Airport in reasonably good operating condition subject to deterioration caused by wear and tear" and there is no obligation to set aside funds towards the end of its term to make sure the asset is in good condition when the lease expires. For example, under the proposed 99-year Midway lease the operator was required to prepare a capital asset maintenance plan, capital improvement program report, and five-year capital improvement program each year and submit them to the city and the airlines for approval. While DM has done a good job maintaining the airport after 28 years of stewardship, there could be stronger requirements in the lease about maintaining the airport in the later years of the term.

H.7.6 References

Maria S. Renner, A.A.E., Sr. Director, Operations & Government Affairs, DM AIRPORTS, LTD, phone interview and email correspondence, November 2010.

Town of Morristown, Lessor, with D.M. Airport Developers, Inc. Lessee Agreement of Lease, December 28, 1981.

DM AIRPORTS, LTD., *Morristown Municipal Airport Community Information Guide*, January 2010.

DM AIRPORTS, LTD., *Emergency Response Exercise*, October 19, 2010.

Morristown Municipal Airport website, accessed November 2010.

R. A. Wiedemann & Associates, Inc., *Morristown Municipal Airport Economic Impact Assessment, Executive Summary*, 2008.

Federal Aviation Administration, *Airport Master Record*, accessed October 21, 2010.

Morristown Aviation Association, *Minutes, Board of Trustees Meeting*, October 7, 2009.

H.8 Sydney Airport

Sydney Airport is Australia's busiest airport (with 33m passengers in 2009) the only major airport serving Sydney – the country's leading commercial and business center, and a major international gateway as well as being 28th airport busiest in the world. Sydney is served by 40 international airlines and 9 domestic and regional airlines.

The airport is located 8km south of Sydney's central business district with a catchment area of 6 million people, on a constricted 907 hectares site. Sydney has two parallel runways extending north-south into Botany Bay on reclaimed land and another runway east-west. The three terminals (two domestic and one international) combined have the capacity of about 65 million passengers per annum.

Sydney Airport is the operation base for Quantas serving all major international and domestic destinations including Jetstar, Quantas's low-cost carrier. Other major carriers are Virgin Blue, Air New Zealand, British Airways, United Airlines, Singapore Airlines and other major Asian and Middle Eastern Airlines.

Table H.18. Key Financial Information, 2009-10 [78]

Aeronautical revenue ($'000)	$83 841
Non-aeronautical revenue ($'000)	58 249
Increment in fair value of investment property ($'000)	7 182
TOTAL REVENUE ($'000)	149 272
Total expenditure ($'000)	70 875
Operating profit ($'000)	79 297
Profit after tax ($'000)	9 402

H.8.1 Transaction Background

Until 1987 over 80 airports in Australia were owned and operated by the Commonwealth Government. The Government tried to devolve ownership to local authorities for some airports through measures such as the Aerodrome Local Ownership Plan. This was successful for Cairns Airport in 1980. However through this policy there was still a large degree of Government subsidies needed and the financial burden increased. As a result, in June 1986, the Australian Government ("Government") established the Federal Airports Corporation ("FAC") as a Government Business Enterprise[79] for the ownership and operation of the 23 Australian airports serving the major capital city airports, the secondary airports in those cities, and the major regional airports, including Sydney Kingsford Smith Airport ("Sydney Airport").

By the early 1990s, the Government's economic policy moved towards privatization or private participation in all Government Business Enterprises. The Airport Privatization Program began in April 1994 when the Government announced its intention to privatize 22 FAC owned airports (Cambridge Airport was sold in 1993). A year later a decision was made to lease each airport by way of individual trade sales to private entities in two phases. In 1996, two acts were passed by Parliament to facilitate the privatization of these airports – the Airports Act 1996 and the Airports

78 Airport monitoring report- Price, financial performance and quality of service monitoring, 2009-10, Australian Competition & Consumer Commission

79 Government Business Enterprise is a wholly Government-owned unlisted public company.

Transitional Act 1996. The Airports Transitional Act was of particular importance, as it facilitated the lease of these airports to private sector operators.

The privatization of airports in Australia was divided into 3 phases:

- Phase 1 -- Melbourne, Brisbane and Perth airports (July 1997)
- Phase 2 -- comprised 8 major airports (Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, and Townsville) and 7 regional airports (June 1998)
- Phase 3 – Sydney Airport (June 2002) and 3 smaller airports in the Sydney region (December 2003)[80]

In March 2001, the Government announced its intention to dispose of its 100% interest in Sydney Airport by means of the trade sale of a concession with a total length of 99 years.. The process was iunterrupted , however, as a result of the disruptions to the aviation sector and to financial markets caused by the events of September 11, and the collapse of Ansett Airlines, the second largest domestic Australian operator (after Qantas) with some 40% of the traffic. The process was resumed in March 2002, and the sale to the Southern Cross Airports Corporation was announced in June 2002..
The Southern Cross Airports Corporation was led by Macquarie Airports (40% interest). Other consortium members included the Macquarie Airports Group (12% interest), Ferrovial (20% interest) and Hochtief (15% interest).

An important condition of the sale of Sydney Airport was that the Southern Cross consortium was given the first right of refusal, with a duration of 30 years, to build and operate any second major airport within 100 kilometers of the Sydney Airport.

H.8.2 Objectives

As part of the privatization of Sydney Airport, the Australian Government formally announced the objectives of the sale, which were as follows:

- Optimize sale proceeds within the context of the broader Government sales and policy objectives.
- Minimize the Commonwealth's exposure to residual risks and liabilities.
- Ensure that the airport lessees have the necessary financial and managerial capabilities to operate and provide timely investment in environmentally appropriate aviation infrastructure at Sydney (Kingsford Smith) Airport.
- Ensure the sale outcome is consistent with relevant airport legislative, regulatory and policy requirements, including environmental, foreign investment, competition, access and pricing policies.
- Ensure fair and equitable treatment of employees of Sydney Airports Corporation Limited,[81] including the preservation of accrued entitlements.

---

[80] The sale of the Sydney airports was deferred to resolve noise issues and complete an environment impact study for a proposed second Sydney Airport.

- Ensure the airport lessees demonstrate a commitment to the effective development of airport services, consistent with Australia's international obligations.

A number of stakeholders were interviewed to obtain their views on the Government's objectives in relation to the sale. Generally, their views reinforce the objectives listed above. Optimizing sale proceeds, minimizing ongoing liabilities, and securing future investment in the airport were mentioned as objectives by most stakeholders we interviewed. However, it is clear that a number of other factors played a role. Several stakeholders mentioned efficient operation of the airport as a key objective:

"If anything the strongest driver was a belief that the airport would be more efficient and commercial outside the public ownership." ***(Former member of airport management privatization team)***

Stakeholders also pointed to some of the Government's requirements for potential buyers as indicative of the Government's concerns and objectives. For example, the Government imposed a foreign ownership limit of 49%, meaning that a majority interest of Sydney Airport had to remain Australian-owned. Stakeholders speculate as to the Government's objectives in this regard:

"The Government was keen to ensure that the majority of the ownership of strategic assets remained in Australian hands so that at least part of the benefits from privatization and resulting improvements in efficiency were kept within Australia." ***(Investor in Sydney Airport)***

Many stakeholders felt that, although the foreign ownership limit helped the Australian Government achieve certain objectives, this restriction had had a negative impact on the transaction proceeds raised by the Government.

"Although imposing this restriction probably had a negative impact on the transaction proceeds, it enabled the Government to meet one of its key objectives." ***(Investor in Sydney Airport)***

It is interesting to note in this regard the point made by a representative of the largest investor in Sydney Airport, MAp Airports.

"The foreign ownership restriction, combined with the financial climate at the time [the sale took place several months after September 11, 2001] restricted the amount of equity that was available to fund the acquisition." ***(MAp Airports representative)***

MAp Airports' strategy of creating a listed entity to fund the acquisition allowed it, effectively, to sweep up most of the available equity, in a limited Australian market, meaning that other bidders found it difficult to locate enough equity to compete.

Another restriction imposed by the Australian Government was a cross-ownership restriction of 15%, which meant that, for example, the owner of Melbourne Airport would not be allowed to own more than 15% of Sydney Airport. An airline ownership limit was also introduced.

[81] Sydney Airports Corporation Limited (SACL) was formed in July 1998 as a Government Business Enterprise.

"Maintaining a degree of competition had been a concern and there had, for example been a number of safeguards on the cross-ownership of airports and a limit on airline ownership of 5%." (**ACCC, Australian regulator**)

The main objective of these restrictions was to secure effective competition between Australian airports where possible. However, in contrast to this restriction, the Australian Government did offer the successful bidder for Sydney Airport a 30-year right of first refusal over the development and operation of the second Sydney once it was decided this was needed, as long as the second airport is within a 100km of the current airport. This removed an uncertainty overhanging the deal as well as provided a potential pragmatic solution to the problem of developing a second airport in the face of a determined competitive response from an entrenched and well-sited main airport.

H.8.3 Transaction Process

The decision to sell Sydney Airport on March 2001 via a three stage tender process designed to maximize financial returns with a view for financial close by late 2001, however, the process was put on hold after the events of September 2011 and the collapse of Ansett. Throughout the period the process was put on hold contact was maintained with the three shortlisted bidders. In March 2002 the tender process recommenced at the binding bid stage and all three shortlisted bidders were invited to submit bids.

Table H.19. Sydney Airport Privatization Timeline

December 2000	Australian Government announces its intention to privatize the Sydney basin airports with Sydney Airport being sold separately from Bankstown, Camden and Hoxton Park
29, March 2001	Australian Government announces its intention to dispose of its 100% interest in Sydney Airport by means of a trade sale process
23 April 2001	Invitations for Expressions of Interest was advertized
14 May 2001	Expression of Interest deadline. 13 responses were received. Two were declared bidding consortia, four were in the process of forming another bidding consortium and a further seven parties. The Minister advised parties that three or four competitive consortia were sort for the indicative bid stage. All 13 parties were admitted to the next stage but three chose not to participate further.
4 June 2001	Indicative bids are requested
17 July 2001	Deadline for indicative bids. Three bids were received.
1 August 2001	All three indicative bids are accepted and requested to submit binding bids due on 17 September 2001.
13, September 2001	The terrorist attacks of 11 September shake the aviation industry and the deadline for binding bids is postponed to 26 September 2001
24 September 2001	The sale is deferred to early 2002 because of the disruption to the aviation and airline industry by the events of 11 September and the collapse of Ansett.
March 2002	Tender process is resumed at binding bid stage. All three bidders are notified that they will be requested to submit bids
26 April 2002	The Request for Binding Bids is reissued
12 June 2002	Deadline for binding bids, three binding bids were received.
25 June 2002	Southern Cross Airports Cooperation was announced as the preferred bidder
28 June 2002	Financial close, Sydney Airport is sold to the Southern Cross Airports Corporation for A$5.6 billion (approx US$3.2bn)

The process of privatizing all of Australia's airports appears to have been seen as a relatively smooth one, and investors in Sydney Airport in particular were complimentary about the well-run process and its clear timetable. This was despite the fact that the sellers had to overcome the difficulties of coping with the September 11 crisis and the loss of Ansett.

The success of the privatization program is attributed by one stakeholder to the extensive scoping studies conducted in the years preceding privatization:

"The privatization process for Australian airports has generally gone smoothly and successfully. This was partly because a lot of work had been done in comprehensive scoping studies in advance of the sales. This meant that issues such as IPO or trade sale, foreign ownership, leasehold or free hold, and selling the Australian airport system as a single entity or broken up had been thoroughly dealt, and most of the associated uncertainties resolved, well before the process started." (**Former member of airport management privatization team)**

The issues mentioned in the quote above do indeed appear to have been considered carefully by the Australian Government prior to privatization. The stakeholders interviewed were generally supportive of the decision to pursue a trade sale strategy rather than an IPO. The following points were made:

*"The Sydney Airport privatization is a good example of some of the advantages of privatization via trade sale rather than IPO. In a trade sale, transaction proceeds are typically higher, and the privatized airport is often run more efficiently as a result of having an interested, educated investor who provides constructive challenge to the management team. Also, by running a trade sale process, the Government creates the opportunity for itself to negotiate a contract with the buyer, to ensure some of its wide transaction objectives are safeguarded. An IPO does not have these advantages, and in addition carries the risk of an embarrassing loss of value for the Government, as following an IPO shares are often acquired as part of a takeover offer at a much higher price." (***Investor in Sydney Airport)**

In addition to the reasons listed above, one stakeholder pointed out that the decision to sell Australia's airports individually rather than as a group made a trade sale a more attractive option. An IPO would have been difficult to realize for all but the largest of Australia's airports.

It appears that the Government's decision to privatize the airports individually was driven by two main reasons. First, as already noted, there was a desire to promote a degree of competition among Australian airports where possible. Second, it is speculated that management of the FAC at the time was not considered to be particularly strong, and selling the airports individually via trade sales was deemed to be a good opportunity to attract strong technical expertise.

Another issue that was examined in advance of the privatization of Sydney and other Australian airports was the freehold versus leasehold debate. Stakeholders suggested that a leasehold was selected principally because the Government did not want to relinquish control of its assets entirely, especially in symbolic terms, where perceived loss of power over a major asset of national importance can be exploited by political opponents. However, despite the formal retention of ownership by the Government, bidders were able to use the land of the airport as security when borrowing, which helped improve the financial attractiveness of the airport.

The lease has a term of 49 years with an option to extend by another 50 years, making it effectively 99 years long. One of the stakeholders pointed out the importance of the length of the lease:

"We have experience with leases of different length, and would suggest that anything under 40 years is problematic as it means that property development at the airport is generally not viable, unless the Government becomes involved in agreements to cover the period after the concession ends." (***Investor in Sydney Airport)***

The collapse of Ansett (which, as noted earlier, together with the events of September 11 caused a 6 month delay to the sale) had an unexpected benefit - it provided the opportunity for airport management to purchase the old Ansett terminal and transform it into an open access facility for other airlines.

One of the stakeholders interviewed commented that the decision to pursue a trade sale strategy rather than an IPO helped overcome the difficulties associated with these disruptive events:

"The fact that the process took place at all was partly because it was a trade sale rather than an IPO: some parties had been prepared to bid even if the postponement had not taken place (though the price would have been significantly lower)." (***Former member of airport management privatization team)***

H.8.4 Economic Regulation

Almost all stakeholders, when asked to describe the transaction process, place great emphasis on the economic regulation of charges at Sydney Airport for the privatization. Very significant changes were made in the lead-up to the privatization, as outlined below.

In the period from 1996 to 2002, all major Australian airports with the exception of Sydney Airport (which was Government-owned at the time and subject to significant re-development in advance of the 2000 Olympics) had been subject to price cap regulation.

In 2001, the charges at Sydney were subject to a separate review by the Australian Competition and Consumer Commission ("ACCC"), which led to a full dual till cost-based system being introduced. The combination of the cost-based approach with the major investments at Sydney to prepare the airport for the Olympics, and an asset revaluation, led to an increase in charges of close to 100%. It was intended that prices would remain at this level for 5 years. In 2002, however, following a review by the Productivity Commission ("PC"), the Government announced that it would remove price caps for the airports for a 5-year period, and instead introduced a **light-handed approach** under which prices and service levels would be negotiated between airport and airlines with the results being monitored by the ACCC, and with a review of the arrangements to be conducted by the PC at the end of this period. This approach was applied to Sydney Airport, which was privatized in that year alongside the other major airports which had been privatized previously. This form of regulation was seen as promoting a commercial relationship between airport and individual airline customers with an opportunity to negotiate agreements covering service, capital expenditure and operational issues as well as simply price. .

Under this system the airports have in practice adopted a form of shadow regulation, in which prices agreed with airlines are based on a dual till costs approach in a similar manner to that previously applied by the ACCC to Sydney. An issue which led to continuing debate during the initial period was the revaluation of assets, which airlines believed had led to unjustified opportunities for price hikes.

In 2007, after a second review of the operation of the privatized airports, the Government announced its intention to continue the monitoring approach of charges at Sydney and other major Australian airports for a further 6 years when another PC review would take place. It also resolved the revaluation issue by setting a retrospective 'line in the sand' after which no further revaluations would be accepted for monitoring purposes.

In 2010, as a results of the price and service monitoring undertaken by ACCC, the Government announced that there were concerns over the service provided at Sydney Airport and that it intended to bring forward this review for Sydney to 2011.

The regulatory framework was discussed with a number of the airport's stakeholders. The regulatory process was described by a regulator from the ACCC:

"Under the Australian airport regulatory system, there are no direct price controls on aeronautical charges (other than for regional services). Instead the airport is left to negotiate charges with airlines as part of commercial agreements. The regulator plays no part in these negotiations and (unlike the position under some other jurisdictions) does not play a role in resolving negotiation log jams, under normal circumstances. This is intended to promote the two parties reaching commercial agreement rather than resorting too readily to third parties to sort out their problems." (***ACCC, Australian regulator***)

This approach is regarded as sensible by airport investors:

"The regulation that was chosen was based on the underlying belief that economic partners (airports and airlines) should be given the freedom to negotiate their own commercial agreements. In this way, the Government wanted to ensure that any capital expenditure met the needs of airline users. The regulator, the ACCC, would only become involved if agreement could not be reached. Generally, this approach to economic regulation has been very successful." (***Investor in Sydney Airport)***

One of the airline representatives interviewed was somewhat more guarded in his views, explaining that it took a number of years for the relationships between airlines and the airport to mature, as each party gradually developed a greater degree of understanding (and to some extent acceptance) of the other party's business model. Another airline representative believed the relationship remained problematic:

"Although a good working relationship now exists between Sydney Airport and its airlines, there are still frequent discussions and arguments." (***Airline representative body director***)

In order to protect against a potential abuse of market power, the ACCC monitors both prices and service quality on an annual basis. Service quality monitoring is an important tool in measuring potential abuse of market power because under-investment or inappropriate cost cuts are as powerful as increased charges in terms of enhancing the profitability of an organization with market power.

The ACCC provided an interesting example of the system in operation:

"A recent ACCC monitoring report had indicated significant areas of concern over service at Sydney in particular (albeit hedged with careful qualification based on the limitations of the evidence available). This had led the

Australian (Commonwealth) Government to bring forward the next Productivity Commission review." (***ACCC, Australian regulator***)

Although generally, the regulatory regime put in place as part of the privatization appears to be working reasonably well, one stakeholder pointed out that legacy airlines in particular may not have been ready for the opportunities provided by direct negotiation with the airport.

"Large legacy airlines in particular could have a significant degree of inertia and lack of clarity on decision-making responsibility." (***Former member of airport management privatization team)***

Investors indicate that the regulatory regime helped the Government maximize sale proceeds. This is consistent with the perception in some quarters that the regulatory regime is more favorable to the owners of the airport than some others.

"The privatization could have been much more beneficial to airlines if the regulatory regime had been better designed. The current regulatory regime in Australia is very favorable for airport operators." (***Airline representative body director)***

The service level concerns outlined by the ACCC illustrate a possible downside to airlines of an investor-friendly approach. Regarding this issue, investors in the airport outlined what they believed was principally a public relations rather than a genuine concern:

"It is true that following the privatization, there has on occasion been negative press about profit levels and service standards at the airport. This is probably not linked to the privatization itself, but is the result of the fact that one of the airport's large shareholders, Macquarie, an investment bank with a high local profile, is sometimes portrayed in a negative light by some of the media." (***Investor in Sydney Airport)***

A former member of the airport management privatization team agreed:

*"Despite the tendency for negative press, the service actually provided to passengers had held up, both as a result of agreements with airlines and in order to sustain retail revenues (which are a major component of income). Although they might not say so publicly, relationships with airlines as customers were substantially improved." (**Former member of airport management privatization team)***

A senior member of the airport's current management team made the following statements regarding service level concerns:

"The airport cannot 'sweat the asset', as it must submit a 20-year capital plan to the Government that is refreshed and approved every 5 years by the Government.

*The airport participates in the ACI passenger survey program and conducts its own monthly surveys of passengers. It will not accept standards below 75%." (**Current senior management team member)***

However, airlines are concerned that the regulatory regime does not provide sufficient incentive for investment in aeronautical infrastructure:

"[The dual till approach] creates an incentive for the airport to invest in non-aeronautical infrastructure. This is currently causing a number of problems at Australian airports, including Sydney. While significant amounts of money

are being spent on improving retail facilities, there is a shortage of aeronautical infrastructure such as aircraft parking facilities.” ***(Airline representative body director)***

A final point of interest in relation to economic regulation in Australia is that the regime currently applicable to Sydney Airport as well as other large Australian airports was put in place after those other airports had already been privatized. One of the stakeholders suggested that Government proceeds for the other airports would have been higher had they made the regulatory changes in advance of those privatizations.

H.8.5 Consequences

Stakeholders were generally positive about the consequences of the privatization, and listed a number of benefits. Key benefits mentioned by almost all stakeholders are increased efficiency and better commercial relationships with airlines, particularly in the area of investment.

“Costs are significantly lower; investment is better handled, more cost effective and better targeted, pricing is more flexible, there are better commercial relationships with airlines and management is much more responsive.” (***Former member of airport management privatization team)***

“There have been a number of positive consequences as a result of the privatization, particularly in the area of investment. The concept of negotiating each item of ‘necessary new investment’ as it arose has helped to align the interests of airlines and the airport.” ***(MAp Airports representative)***

“Perhaps most importantly, privatization has ensured efficient use of the airport infrastructure. Estimated capacity of the airport has doubled since the airport was privatized, while significant capital expenditure has been avoided. ***(Investor in Sydney Airport)***

Some less obvious benefits were also raised by stakeholders. Two stakeholders mentioned the fact that, as the Government no longer owns the airport, it may now be perceived as approaching panning and regulatory issues in a more independent manner.

“The Australian Government now faces fewer conflicts of interests as it no longer owns the airport. Although it is possible for Government entities with no involvement in airport ownership, to deal independently with, for example, regulation and environmental matters on an arms length basis, in the eyes of the public this is often confusing.” ***(MAp Airports representative)***

In addition, it was felt that the privatization of Sydney Airport has had a positive impact on the airport itself and the risks to which it is exposed as a business:

“Privatization has helped Sydney Airport in enabling it to broaden the traffic base and lessen its dependence on Qantas.” ***(MAp Airports representative)***

This statement was supported to some extent by the former Qantas representative:

“Since the privatization, Qantas has seen limited growth in its operations at Sydney Airport, and the majority of growth has come from other carriers. This is not, however, a direct result of the privatization, but rather a deliberate strategy on the part of Qantas to focus its operations on those routes which are most profitable.” (***Former Qantas representative)***

However, not all stakeholders were exclusively positive about the privatization. The ACCC was more guarded about the benefits of privatization:

"Broadly, the reforms under National Competition Policy had worked well, especially where had been competition effective. The performance elsewhere has been less clear and Sydney in particular has recently given cause for concern on service and on its relationships with airlines." ***(ACCC, Australian regulator***)

A former member of the airport management privatization team also presented a mixed view, listed in a number of negative consequences of the privatization:

"The negatives include:

- *A community and industry concern that the airport is using monopoly power. This was partly at least a PR issue;*
- *Partly in response to this, creeping intervention by the Government which had extended price monitoring to car parking and other areas and had started effectively providing guidelines for pricing discussions (leading effectively to 'shadow regulation' rather than fully commercial pricing); and*
- *Poor management of planning issues by central Government – (particularly in areas such as airport retail developments and hotels) which may partly reflect the lack of a Government 'interest' in the airport and its prosperity. Effectively the planning limits were less sympathetic to airport commercial initiatives after privatization than before.*

Despite the negatives privatization has undoubtedly been a good thing – largely because the airport is so much better run and able to respond flexibly to new opportunities and/or problems." (***Former member of airport management privatization team)***

H.8.6 Lessons Learned

On balance, it appears that the process of privatizing Sydney Airport was a smooth one, and that it has been regarded as a positive development for the airport and the majority of its stakeholders. Stakeholders provided comments on lessons learned as part of the process, and whether there was anything they would have done differently in hindsight.

- A point raised by a number of stakeholders is the importance of establishing a long-term regulatory regime in advance of the privatization. The clarity that was provided to potential buyers as part of the Sydney Airport privatization is believed to have had a positive impact both on the transaction process and on the proceeds raised by the Government. Airline representatives agreed that a clear regulatory regime was important:

  "A clear regulatory framework is not only more attractive to the parties involved in the privatization, but is also helpful for airlines as it reduces uncertainty and enables them to plan their business in spite of the ongoing privatization." (***Former Qantas representative)***

- Many stakeholders also felt that the nature of the regulatory regime put in place for Sydney Airport had had a positive impact. One stakeholder stated the following:

  "A second lesson has been that leaving airlines and the airport to settle prices between them has worked successfully in the absence of an imposed regulatory arbiter to deal with log jams. My view is that the presence

of an arbitration option would make it significantly harder to reach a commercial resolution." (***Former member of airport management privatization team)***

The regulator itself, the ACCC, is not as positive about the regulatory regime:

"The evidence available suggests that at some airports, price negotiations have gone relatively smoothly and that the airport and airlines have entered into positive commercial relationships. This can not be said for Sydney.

"ACCC staff's view is that the progress of negotiations under price monitoring would have been more effective if a clearer framework on key issues had been established at the outset of regulation. This might have covered issues such as: charging approach, cost of capital, cost allocation and the valuation of assets (which had had to be dealt with by the Productivity Commission in their second review)." (***ACCC, Australian regulator***)

An airline representative made the following comment:

"..Although airlines are probably better off now than they would be had the airport remained publicly owned, significant improvements remain possible, particularly with regard to the level of charges at Sydney Airport and the investment in aeronautical infrastructure." (***Airline representative body director)***

- Another lesson learned mentioned by several stakeholders is the need for careful management of public relations at the time of a privatization and afterwards. A number of stakeholders' felt that some of the negative press received by Sydney Airport in relation to, for example, service standards, is not necessarily justified but is instead the result of poor public relations management.

  "Privatization has meant that the airport no longer has the 'benefit of the doubt', particularly since its majority owners were funds managed by Macquarie – perceived as an aggressive, short-term profit focused, investment bank. The airport would have gained substantially from a more sensitive approach to decisions and their presentation in the wake of privatization which might have avoided the generally negative press coverage that the airport now receives." ***(Former member of airport management privatization team)***

- Finally, thinking specifically about the US debate on privatization, one stakeholder stated that the role of airlines in airport privatization needs to be carefully considered.

  "As airport customers, their views and concerns need to be taken into account, for example through appropriate regulation. However, they should not be given undue control within the privatization process itself and after the takeover by the private owners." (***Investor in Sydney Airport)***

H.8.7 References

Annual reports.

Airport monitoring report- Price, financial performance and quality of service monitoring, 2009-10, Australian Competition & Consumer Commission

International Civil Aviation Organization, *Case Studies on Commercialization, Privatization and Economic Oversight of Airports and Air Navigation Services Providers (ANSPS): Case Study: Australia*, December 5, 2008.

Stakeholder interview with former Sydney Airport management team member.

Stakeholder interview with former Qantas representative.

Stakeholder interview with BARA representative.

Stakeholder interview with Sydney Airport investor representative.

Stakeholder interview with MAp Airports representative.

Case Study: Australia, ICAO case study of Australian airport privatization.

Paul Hooper, Robert Cain, Sandy White, *The privatisation of Australia's airports*, Transportation Research Part E 36 (2000) 181±204.

Government to proceed with the sale of Sydney Airport, Government media statement, March 11, 2002.

Peter Forsyth, *Privatisation and regulation of Australian and New Zealand airports*, Journal of Air Transport Management 8 (2002) 19–28.

Australian Competition and Consumer Commission, *Airport monitoring report 2008–09: price, financial performance and quality of service monitoring*, March 2010

H.9 London Gatwick Airport

Gatwick is the second busiest airport in the UK in terms of passengers and also is the leading airport for point-point flights in Europe. Gatwick has only one runway, which operates near full capacity, and two terminals. Gatwick is serviced by several major airlines such as British Airways, Delta, US Airways and Virgin Atlantic and is also popular with charter and low cost airlines such as EasyJet, Flybe, Monarch and Thomas Cook Airlines. In the UK it is unique to have a range of business models (full service 51%, low cost 25% and charter 24%) serving the same airport and terminals. In 2009, Gatwick served 32 million passengers making it the 9th busiest airport in Europe in terms of passengers.

Trans-Atlantic routes are very prominent at Gatwick this stems from the Bermuda II agreement that was in place until 2008 which limited the use of Heathrow for Trans-Atlantic flights.

Table H.20. Key Financial Information, 2008 (restated in U.S. dollars)[82]

Aeronautical income	$97.3
Concessions income	83.9
Property income	14.3
Specified charges, utilities and other income	26.7
TOTAL INCOME	222.3
Operating costs	142.0
EBITDA before exceptionals	80.3
Reported EBITDA (including exceptionals)	70.9

H.9.1 Transaction Background

The Airports Act of 1986 made the UK the first country to privatize its airports by forming the British Airport Authority (BAA) by means of an initial public offering (“IPO”). BAA owned Heathrow, Gatwick (until 2009), Stansted, Glasgow, Edinburgh, Aberdeen, and Prestwick airports in the UK. In 2006, BAA was acquired by Ferrovial.

Following the acquisition, in March 2007, the UK Competition Commission (“CC”) commenced a market investigation to determine whether the supply of airport services by BAA restricted or distorted competition in the UK. The investigation came in response to concerns raised by the Office of Fair Trading over BAA’s perceived monopoly of airport services in the UK and in particular in the South East of England and Lowland Scotland. In 2008, BAA handled 62% of passengers traveling in the UK and faced criticism that its effective monopoly resulted in lack of investment and compromised service levels.

In an interim ruling by the CC in August 2008, BAA was told it may have to sell 3 of its 7 UK airports, including 2 in the South East. As a result, Ferrovial chose to pre-empt the CC’s final ruling and announced its intention to sell Gatwick on September 17, 2008. It was speculated that Ferrovial opted to bring forward the sales process in order to raise funds to help repay £1billion in debt facilities held by BAA, due for repayment in March 2010.

[82] Vendor Due Diligence report, January 2009. British pounds were converted to U.S. dollars based on the average conversion rate for calendar year 2008 using monthly conversion rates from x-rate.com.

The CC published its final report in March 2009. It required, among other things, the divestiture by BAA of two London airports, Gatwick and Stansted. Since then, the CC's ruling has been subject to two appeals. First, BAA appealed successfully to the Competition Appeal Tribunal on the grounds of apparent bias. However, in October 2010, this ruling was overturned and the requirement to sell Gatwick and Stansted reinstated. BAA has indicated its intention to appeal the latest ruling in the Supreme Court. In the meantime, however, Gatwick Airport has already been sold to Global Infrastructure Partnership, as discussed below.

It should be noted that following the completion of the sale process, the Competition Tribunal upheld BAA's complaint that the CC's recommendations on the break up of BAA were invalid as a result of the inclusion on the Panel of an advisor who had links with one of the potential bidders.

The Gatwick Airport transaction occurred in a period of great economic uncertainty. The airport's traffic figures had been steadily declining since the beginning of the 2008 summer season, with several airlines ceasing operations entirely. This was the result of challenging global market conditions due to high oil prices and global recession and the shift of transatlantic traffic to Heathrow airport following the Open Skies agreement. Bidders had to make difficult assumptions on how quickly they expected traffic levels to recover. The table below identifies the effects certain changes had on passenger levels between 2008 and 2009.

Table H.21. Effects on Number of Passengers83

	Passengers (millions)
2008	**35.6**
Open Skies	-1.6
Charter airlines	-0.9
Other (Oasis, Zoom administrations etc)	-1.1
Growth of Low Cost Carriers (easyJet, Flybe, Aer Lingus etc.)	1.2
2009	**33.2**

Source: LeighFisher.

One of the key issues during the transaction was what assumptions to make on the construction of a new runway within the London airport system, with airfield capacity currently acting as one of the primary constraints on future growth. Furthermore, it was suggested that Gatwick Airport could be removed from price controls (de-designated) following its separation from BAA – a process which would be enhanced by the scope for competition following the construction of further runway capacity in the South East system (initially at Heathrow and Stansted). In practice, however, the new British Government elected to in May 2010 announced that it will not allow the building of a new runway in the London system leaving questions over how capacity issues will be addressed, and the opportunities for competition unanswered.

H.9.2 Objectives

There were a number of different organizations involved in the sale of Gatwick Airport, with different sets of objectives. Stakeholders generally believed that the objectives of the seller, Ferrovial, were closely linked to the CC's investigation.

[83] Jacobs Consultancy London Gatwick Airport Sale Report, April 2009.

"The ongoing Competition Commission investigation meant that there was a risk of a forced sale of Gatwick Airport in the near future. A voluntary disposal had the advantage of avoiding a fire-sale under adverse conditions." **(Gatwick Airport acquirer representative)**

"The objectives of Ferrovial as part of this process were both political and financial. Selling Gatwick addressed some of the competition concerns which culminated in the Competition Commission investigation." (**Former member of BAA management and adviser to Gatwick Airport bidder)**

As suggested by the quote above, it is likely that the seller in this transaction was driven by financial objectives as well as a desire to pre-empt the outcome of the CC's investigation. Several stakeholders mentioned the fact that some of the debt which Ferrovial used to fund the takeover of BAA needed to be refinanced, and that the proceeds from the sale of Gatwick would help improve Ferrovial's financial positions in what were difficult financial times.

It was felt, however, that in the absence of the CC's investigation, Ferrovial might not have chosen to sell Gatwick in 2009.

"The timing of the sale was particularly unfortunate as it was launched pre-financial crisis but suffered the credit crunch in the middle of the process which led to a number of bidders dropping out of the sale process due to limited credit availability. If the sale had been purely driven by financial concerns Ferrovial might have chosen to delay the sale of Gatwick to a time when economic conditions were less adverse." (**Former member of BAA management and adviser to Gatwick Airport bidder)**

"However, even though the sale was not forced, it is unlikely that Ferrovial would have chosen this time to sell in the absence of the Competition Commission investigation. The financial downturn had implications for passenger numbers at the airport, and there was uncertainty about the location of new runways in the South-East of England." **(Gatwick Airport acquirer representative)**

The fact that the sale took place at a less than optimal time was reflected in the fact that all three final bids for the airport were reported to be at significant discounts to the Regulatory Asset Base ("RAB"). The RAB effectively represents the amount which future income streams are designed to remunerate and would normally be regarded as a minimum value (value less than the RAB would indicate causes for belief that past investment will not be fully paid for). On October 21, 2009, Global Infrastructure Partnership was announced as the successful party with a winning bid of £1.51bn, roughly equating to a 6% discount to the RAB. In its 2009 annual results, BAA reported a £277.3 million loss from the sale.

Although it is clear that receipt of the sale proceeds would have strengthened the seller's immediate financial position, a former representative of the UK's airport regulator, the Civil Aviation Authority ("CAA"), raised an interesting issue about the long-term financial impact on BAA of the decision to sell Gatwick Airport:

"The proceeds of the sale of Gatwick Airport would help the company meet its financial obligations, though of course the long-term revenue entitlement from Gatwick's asset base was lost at the same time as the debt was shed" **(Former senior CAA employee)**

Price cap regulation in the UK is applied only to Gatwick, Heathrow, and Stansted airports. It is a single till approach in which the prices over 5 years are set at a level designed to recover:

- Operating costs
- Return of capital (depreciation); and
- Return on assets (RAB X cost of capital or Weighted Average Cost Of Capital);

Less commercial income.

The two capital streams, return on capital and return of capital, represent streams of income which will cover investment costs.

Selling Gatwick meant that BAA no longer received those income streams in relation to Gatwick's assets.

In addition to the objectives of the seller, the presence of the CC as a triggering factor meant that its own objectives and intentions became relevant. Several stakeholders mentioned the involvement of the CC itself in the process.

"The process was complicated by the involvement of the Competition Commission. The Competition Commission had to approve the final buyer and ensure, for example, that the buyer was operationally capable and financially viable." ***(Former member of BAA management and adviser to Gatwick Airport bidder)***

The CC's position in relation to Gatwick was somewhat unusual as the investigation into BAA had not yet been completed. In the case of a forced sale, the CC would normally appoint a trustee to oversee the sale, to ensure the intended development of competition is not in any way impeded by the seller. As this situation was different (the sale was not forced), the role of the CC was less clear. In the CC's final report in relation to BAA, the CC's role is described as follows:[84]

"…the CC requires evidence to satisfy itself that prospective purchasers satisfy several criteria before they may be approved by the CC as 'suitable purchasers'. In summary, the CC considers that a suitable purchaser should be independent of BAA, should have appropriate expertise and financial resources to operate and develop Gatwick Airport as an effective competitor to other London airports and should not create further competitive concerns as a result of divestiture."

It is interesting to contrast the CC's approach with the views of a former CAA employee who was interviewed. This representative explained that the CAA believes it should not generally concern itself with issues such as the identity or financing of owners (whether new or existing) of the airports it regulates.

"In particular, the CAA should not take into account the financial viability of airport owners or their financing structures. Such risks should be borne by the investors with users being entirely isolated from them. As a result, instead of regulation taking into account acquisition financing, financing should take into account the existing regulatory framework." ***(Former senior CAA employee)***

It should be noted, of course, that the different approach these regulators took to involvement in the sale of Gatwick Airport is likely to be to some extent driven by the different issues which they were facing. In this particular case, the CC was clearly focused on ensuring effective competition in a

[84] See Appendix 10.5 in Competition Commission, *BAA Airports Market Investigation - A report on the supply of airport services by BAA in the UK*, March 19, 2009.

sale which effectively pre-empted a forced sale, and felt a degree of operational and financial due diligence on potential buyers was appropriate from that perspective. The CC was concerned to ensure that the outcome did not act against the interests of users, or compromise the intended improvement in competition.

H.9.3 Transaction Process

The transaction process took place at a time of significant uncertainty. It commenced before the financial downturn. However, as the economy worsened there were delays to the process as advisers sought to ensure a competitive number of bidders remained interested. The financial downturn had a negative impact on traffic, making it more difficult to value the airport as views had to be taken on the likely length of the downturn and the speed of the recovery. In addition, there was uncertainty about the location of new runways within the South-East of England. This presented an opportunity for the future acquirer of Gatwick Airport (a possible second runway at Gatwick) as well as a risk (a possible additional runway at a competing airport).

The transaction process was also complicated by two additional issues. First, as outlined above, the CC's involvement created an extra hurdle which bidders needed to clear, and stakeholders suggest there was some uncertainty about how and when the CC's involvement would impact bidders.

"It was never clear exactly how and when the Competition Commission would utilize its 'veto' right" (***Former member of BAA management and adviser to Gatwick Airport bidder)***

Second, Gatwick Airport had formed a part of BAA since BAA's inception, and there were a number of services which were either shared between Gatwick and BAA's other airports, or provided by a BAA-related entity to Gatwick.

"More linkages than expected existed in areas such as IT and finance, and a number of technical service agreements needed to be agreed upon." ***(Gatwick Airport acquirer representative)***

However, a representative of Gatwick Airport's management team explained that the separation of Gatwick from BAA did not present as many difficulties as may initially have been anticipated:

"In practice the transitional arrangements appeared to have worked reasonably well with goodwill and cooperation by both sides. In part this may reflect the fact that the parties involved on the ground were former colleagues who knew each other well, though it also remained in BAA's interests for Gatwick to succeed as an independent entity [given that there were other airports which might ultimately need to be sold] ." (***Gatwick Airport management team representative)***

The process was helped by good preparation -- even before the start of the sales process a number of steps had been taken towards the creation of a standalone entity.

"A number of steps had already been taken to facilitate an eventual split both by the Competition Commission and BAA itself. The Competition Commission had been concerned to ensure that BAA did not take steps to weaken a potential competitor (by for example transferring out all of the staff with key skills). More positively, BAA had deliberately given Gatwick more latitude to expressly adopt its own public position on issues affecting it – for example on consultations with the Government. It had also taken steps to deal with potential separation problems, by considering transition arrangements in the form of short-term contracts between Gatwick and BAA departments which

*currently provided services such as financial reporting and IT." **(Gatwick Airport management team representative)***

Stakeholders also pointed out that, as this was a secondary sale, classic privatization issues such as pensions and job security received less focus and were generally easier to manage. In general terms, employees' rights were protected under Transfer of Public Undertakings ("TUPE") arrangements. Inevitably, there was some uncertainty for staff during the time of the sale process, but this was dealt with effectively by the new owner.

*"It had also been made clear to staff from the outset that their terms and conditions, including their very favorable pension scheme, would be continued." **(Gatwick Airport management team representative)***

Timeline. A summary of the transaction timeline is as follows:

Table H.22. Timeline for Gatwick Transaction Process

September 17, 2008	BAA announces the sale of Gatwick
January 19, 2009	Non-binding bids due. Six non-binding bids are received from: • A consortium of Ontario Teachers' Pension Plan, Canadian Pension Plan and 3i Infrastructure • Global Infrastructure Partners, owner of London City Airport • Gatwick Future Partnership, led by Babcock & Brown and Deutsche Bank • Lysander Gatwick Investment, comprising Citigroup Infrastructure, Vancouver Airport Services and John Hancock Life Insurance • Hochtief AirPort, owner or part-owner of Hamburg, Dusseldorf, Sydney, Athens, Tirana and Budapest airports • The Manchester Airports Group, owner of Manchester, East Midlands, Humberside and Bournemouth airports, with Canadian infrastructure fund Borealis
January 28, 2009	Hochtief pull out of the bidding process
February 2009	Two of the remaining five bidders pull out of the bid (The Gatwick Futures Partnership and 3i Consortium)
March 19, 2009	CC orders the sale of three airports within two years, forcing BAA to sell Gatwick, Stansted and Edinburgh or Glasgow
March 30, 2009	Original deadline for binding bids, but deadline is extended
April 27, 2009	New deadline for binding bids
Early May 2009	Lysander Gatwick Investment Group ejected from the bidding process
Mid May 2009	BAA rejects bid from GIP leaving only the Manchester Airports Group
Mid July 2009	The Manchester Airports Group walk away from bid over price disagreement
July 29, 2009	BAA says it does not need to sell Gatwick
August 2009	BAA re-enters sale discussions with GIP
October 21, 2009	BAA agree to sell Gatwick to GIP for £1.51 billion

H.9.4 Economic Regulation

At the time of the transaction, Gatwick was subject to price regulation by the Civil Aviation Authority (CAA). Price caps are determined for regulatory periods of five years based on single till regulation.

The fact that the transaction was completed successfully at a value close to the airport's regulatory asset base may be partially due to the well-established regulatory framework in place at the time of the sale.

"This [the successful sale] could be regarded as an indication that the purchasers were able to gain significant comfort from the regulatory framework in place, which provides protection against a number of the risks to which Gatwick Airport was exposed – which at the time included gloomy traffic figures, the forthcoming likelihood of competition from main BAA and uncertainty on future Government airport policy." (***Former senior CAA employee)***

In late 2010, the regulatory framework was reviewed and it is planned that a license system, similar to that used for utilities in the UK, will be introduced, with greater flexibility for the regulator to set terms covering issues such as service, capital expenditure and financing, and an ability for the regulator to relax controls where they prove no longer to be necessary. It is possible that Gatwick, as a separate company competing for traffic, could be removed from regulation in due course. At the very least, there is scope for lessening the level of controls and moving towards some more light-handed form of regulation.

Nevertheless, at the time of the sale there was some speculation about future full or partial deregulation of Gatwick Airport. The CC's main reason for requiring the sale of Gatwick Airport was to increase competition, and therefore deregulation seemed to a number of stakeholders a logical next step. Competition was unlikely to be fully effective if a third party controlled prices, and, to some extent, service and capital expenditure as well. Bidders indicated that they would have regarded deregulation as an upside scenario, as the benefits of deregulation are considered to be greater than the increased risks to which the airport would have been exposed. One stakeholder assessed the situation as follows:

"In time, the separation of Gatwick from BAA may also have consequences for regulation. While complete deregulation is unlikely to occur in the short term, separate ownership may result in increased regulatory flexibility, especially when a constructive relationship with airlines exists." (***Gatwick Airport acquirer representative)***

And another stakeholder stated the following:

"One of the longer-term consequences of the transaction over time may be full or partial deregulation. This would make sense as a key objective of this transaction was to create competition in the market. No doubt all bidders would have factored some upside associated with deregulation into their valuations." (***Former member of BAA management and adviser to Gatwick Airport bidder)***

The future of regulation of Gatwick Airport is not yet clear. As stakeholders explained, the removal of common ownership does not necessarily mean that there is sufficient competition to enable the removal of price cap regulation. The key limitation on competition among airports in the London system is lack of capacity, and until this issue was resolved there would be a continuing need for price regulation. However, the stakeholder added that this does not mean that the removal of common ownership has not had the intended benefit of increasing competition. Removing common ownership has introduced a new comparator for the regulator to take into account, enabling yardstick regulation and competition among regulated entities. This is regarded as particularly valuable from a service standards perspective.

H.9.5 Consequences

Strong feedback was received from stakeholders in relation to impact of the transaction on Gatwick Airport and its users. Although almost all stakeholders felt it was too early to comment definitively on the impact of the transaction, the feedback received about changes to date was overwhelmingly

positive. However, rather than linking this specifically to the change in ownership, many linked this improved performance to the separation of Gatwick from BAA.

"There have been a number of positive consequences resulting from this transaction, largely due to the fact that Gatwick Airport is now a standalone airport with a management team that gives the airport its full attention. Within BAA, Gatwick had to compete with Heathrow for management attention." (***Gatwick Airport acquirer representative)***

"The acquisition by GIP has generally had a positive impact on Gatwick in comparison with its previous ownership by Ferrovial. Ferrovial's focus was on Heathrow, and Gatwick did not receive much management attention. For this reason, it was possible for GIP to make a number of improvements almost overnight. The new management is clearly more focused on service quality and the customer experience." ***(Former member of BAA management and adviser to Gatwick Airport bidder)***

Specific examples provided of improvements made include consolidation of security checkpoints in one location in the South Terminal. This project is expected to result in a much improved passenger experience at the airport, while overall capital expenditure savings are being made. An airline representative reported:

"Feedback on passenger experience at Gatwick since the transaction has generally been positive. This appears to be an area of focus for the new owners." (***Gatwick Airport airline representative)***

Gatwick Airport management confirmed that enhancing service standards was one of the new owners' key priorities:

"On arriving at Gatwick they [the new owners] made clear that their priorities included establishing a distinct separate identity for the airport; improving efficiency; enhancing service; reviewing the capital expenditure plans to meet the needs of users more closely; and meeting the requirements of stakeholders." ***(Gatwick Airport management team representative)***

Although this was not explicitly stated, the new owners are likely to see these priorities as giving gains in terms of positive future dealings with planning and regulatory bodies, as well as assisting in the marketing of the airport, and potentially (in terms of service in particular) improving retail performance.

In addition, airport management is focused on working with airlines to make sure that the capital expenditure plans that have been agreed upon can be delivered at lower costs, to the long-term benefit of airport users. More energy than previously is being invested into building a constructive relationship with Gatwick airlines, and this approach appears to be recognized by airlines:

"Where previously decisions on matters such as capital expenditure were driven exclusively by BAA corporate goals, airlines are now consulted. Discussions can be confrontational, but it is better to have a confrontational relationship than to have no relationship at all. There is evidence that airline feedback is taken into account by the new owners, and there is now more correlation between capital expenditure plans and stakeholder preferences." (***Gatwick Airport airline representative)***

Such an approach is consistent with the treatment of capital expenditure which is embedded in UK regulation. The CAA's role is to encourage economic investment, but it has no powers to determine

capital expenditure or impose investment programs on airport owners. This arrangement is regarded as beneficial, as it generally allows airports and airlines to work together to design an optimal capital program on commercial grounds.

The separation of Gatwick has other merits in regulatory terms:

"There are likely to be new ideas and different approaches to doing things from an airport liberated from mainstream BAA. This is an advantage in its own right, and might be used by regulators as a means of challenging some of BAA's long held approaches." ***(Former senior CAA employee)***

This corresponds to the views we reported in the previous section about the benefits of having an additional comparator to enable yardstick regulation.

The above seems to suggest that significant benefits can be achieved simply by separating airport groups into standalone airports. The increased management focus has delivered a number of benefits for Gatwick Airport and its users. However, one stakeholder was keen to warn against drawing the conclusion that separation is always preferable:

"This is not the same as saying that the sale of Gatwick was correct from a public policy standpoint. A different ownership structure to the Ferrovial-led consortium might have avoided the adverse impacts on Gatwick." ***(Former member of BAA management and adviser to Gatwick Airport bidder)***

H.9.6 Lessons Learned

The Gatwick Airport secondary sale took place in challenging circumstances. There were uncertainties associated with the decision on the location of the next runway in the London area, and economic conditions were challenging. For these reasons, it is generally seen as a significant achievement to achieve a sale in the face of these uncertainties. The lessons learned from this transaction include:

- The completion of the sale demonstrates that where investors can be convinced of the overall quality of an asset and the strength of its regulatory institutions, transactions can be achieved even in uncertain circumstances. However, the valuation achieved in such circumstances is likely to be lower.

- The transaction highlights the importance of a strong management team:

  "An airport's ownership structure (private v. government ownership) does not have a significant impact on an airport's business or an airport's attractiveness to airlines. The key determinant is the strength of an airport's management team, and its relationship with the airport owners. In the case of Gatwick, the key change in relationship is due to the airport's move out of BAA and a new, dedicated, management being put in place." (***Gatwick Airport airline representative)***

- In addition, the successful separation of Gatwick from BAA reveals that the complexities associated with such a separation can be overcome.

  "Complex separation issues in a highly integrated company did not form an insoluble obstacle to a successful independent business." ***(Gatwick Airport management team representative)***

- Several parties also provided opinions about the involvement of the CC. One stakeholder felt that it might have been helpful for the role of the CC to have been more clearly defined,

and in particular for the CC to have developed measures through which the impact of its involvement could have been evaluated:

"From a public policy perspective, an interesting alternative approach may have been for the CC to have stated what consumer benefits it expected the Gatwick sale to generate then measure these after the event. For some service quality measures it could have implemented a performance bond, which would measure whether certain CC targets were met, and reward the winning bidder if this was the case (or penalize the winning bidder if this was not the case). The CAA's work in this area could have been used as a starting point to define service quality measures." ***(Former member of BAA management and adviser to Gatwick Airport bidder)***

The former CAA employee suggested that given similar responsibilities, the CAA might have approached the situation differently: The CAA would have been less inclined than the CC was to seek comfort on the financial viability of the new owner.

"The CAA believes it is the responsibility of the new owner to ensure financial viability within the existing regulatory framework. In addition, regulators should not be unduly concerned about the operational credentials of a new owner. It is considered to be unlikely that people choosing to invest in an airport such as Gatwick would not either bring or hire the operational capability to run the airport." (***Former senior CAA employee)***

H.9.7 References

Annual reports.

Competition Commission, *BAA Airports Market Investigation - A report on the supply of airport services by BAA in the UK*, March 19, 2009.

International Civil Aviation Organization, *Case Studies on Commercialization, Privatization and Economic Oversight of Airports and Air Navigation Services Providers (ANSPS), Case Study: United Kingdom*, December 5, 2008.

Stakeholder interview with Competition Commission representative.

Stakeholder interview with for member of BAA airport management and adviser to Gatwick bidder.

Stakeholder interview with former regulator of Gatwick Airport.

Stakeholder interview with Gatwick Airport acquirer representative.

Stakeholder interview with Gatwick Airport airline representative.

Stakeholder interview with Gatwick Airport management team member.