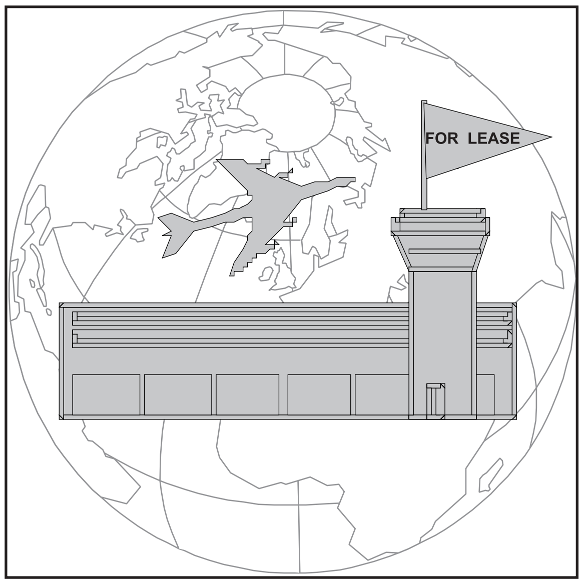
Should Milwaukee's Airport Be Privatized?

Robert W. Poole, Jr.

In May 2006, the Illinois legislature passed a measure requested by Chicago Mayor Richard Daley to clear the way for leasing Midway Airport to a private operator. Earlier, in January 2005, Daley had made national news by leasing the Chicago Skyway to a private consortium for 99 years, receiving the entire lease payment of $1.8 billion up front.



Chicago's new strategy of long-term leasing of public infrastructure has caught the attention of Milwaukee County supervisors. In June 2006, the County Board authorized a study of leasing General Mitchell International Airport (known by its airport code of MKE). In parallel, Representative Jeff Stone asked the Legislative Council to create a study committee on the airport's future. With the county's finances in less than excellent shape, the idea of generating cash from an asset that currently provides no direct fiscal benefits has obvious appeal.

But while leasing MKE might well help the county budget, would it be a good deal for the airport's customers, notably the airlines who use the airport and the 3 million passengers who use the airport each year?

This is not a new question. Back in 1994, the Wisconsin Policy Research Institute commissioned me to assess the feasibility of a long-term lease of MKE. That study, published in July 1994, reviewed the initial experience of other countries with privatizing airports and found that, in general, privatization led to a sharper business focus. Specifically, for-profit management tended to reduce operating costs and increase revenues, thereby generating increased economic value from the airport. That study estimated that MKE's market value might be between $96 million and $132 million, which was equated to an annual lease payment of $8-10 million.

Consequently, the study suggested that leasing the airport could be in the public interest, benefiting airlines, passengers, and Milwaukee County and its taxpayers.

What Has Changed Since 1994?

First, that 1994 study took place when airport privatization was relatively new. Since that time, airport privatization has become a

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major, worldwide phenomenon, so we know a lot more about what airports are worth and how they perform under private ownership and operation. Second, a global airport industry has emerged, in which a number of airports have changed hands since their initial privatization, so there are now more potential, well-qualified bidders. Third, Congress has created a legal framework for U.S. airport privatization, removing some of the legal uncertainty associated with this issue prior to that legislation. Indeed, it is that federal Airport Privatization Pilot Program that Mayor Daley seeks to use to lease Midway, and that is presumably also the route Milwaukee County would use should the decision be made to privatize MKE. Let's take a closer look at these three major changes.

Global Airport Privatization

Only three major airport privatizations had taken place by 1994, all via the sale of shares of stock to the public. The British government sold 100% of the shares of the British Airports Authority (Heathrow, Gatwick, and Stansted) in 1987 for $1.9 billion. Austria sold 27% of Vienna International Airport in 1992 for $180 million, and Denmark sold 25% of Copenhagen Kastrup airport in 1994 for $106 million.

Since then, airport privatization has reached every continent and many of the world's major airports. Western Europe has mostly followed the initial pattern of governments selling part or all of the ownership of an airport via an initial public offering (IPO) of stock. Today, nearly every airport of consequence in the United Kingdom (except Manchester) has been privatized. Frankfurt and Hamburg in Germany have likewise been privatized, as have Rome and Naples in Italy. The Greek government entered into a long-term lease deal to develop its new Athens airport in time for the Olympics, and is now in the process of selling its remaining ownership stake. The Brussels airport was sold in 2004, and the French government sold a minority stake in Aeroports de Paris (owner of DeGaulle and Orly airports) in June 2006, raising 1.2 billion euros.

Australia offered 99-year leases for most of its airports in 1997, and a similar lease of Sydney International went for $3 billion in 2002. Next-door New Zealand privatized Auckland and Wellington airports via public stock offerings. In Asia, China has begun offering minority stakes in airports to overseas investors, and Thailand sold 30% of Airports of Thailand via an IPO in 2004. Both Japan and Hong Kong have begun a several-year process of privatizing their principal airports. And India in 2006, after several false starts, succeeded in selling 30-year leasehold interests in its two leading airports, Mumbai and New Delhi, to consortia of domestic and overseas firms.

In the Western hemisphere, Mexico grouped its several dozen leading airports (except for Mexico City) into three regional groupings, and sold a 15% stake in each to an international consortium in the late 1990s. After several years of private management, it then sold the remaining 85% of each group to investors via the stock market. Many other countries in Latin America and the Caribbean (Argentina, Bolivia, Chile, Colombia, Ecuador, Peru, Jamaica, etc.) have entered into long-term (typically 30-year) concession contracts under which the winning bidder agrees to finance, build, and operate major new airport facilities (usually new terminals in exchange) for most or all the airport's revenue, often paying an up-front fee for the privilege.

Global Airports Industry

Americans encountering airport privatization for the first time often wonder who would be interested in buying or leasing an airport. Now that airport privatization has become common practice around the world, an industry of airport owner/operators has developed. *Airline Business* publishes an annual table of the leading companies, and the December 2005 edition listed 22 such firms. Some are former government airport authorities like BAA that, since being privatized, have gone on to acquire ownership stakes in other airports (as BAA recently did, winning a 75-year concession for Budapest Airport). Others are "corporatized" government airport authorities that operate as businesses, even to the point of paying corporate taxes; examples are AENA of Spain and Schiphol Group in The Netherlands, both of which will probably be privatized before the end of this decade. Still others are divisions of major global infrastructure construction firms, such as Germany's Hochtief and Spain's Ferrovial. And we are also seeing the emergence of global airport investment funds, created by financial institutions, such as Macquarie Airports.

The past 12 months have seen several major acquisitions of one airport firm by another. The largest such transaction was Ferrovial's purchase of BAA; their combined annual airport revenues exceed $4.6 billion. Spain's Abertis bought the British airport firm TBI (which had previously acquired U.S.-based Airport Group International). And Macquarie purchased the Danish government's remaining 38% stake in Copenhagen airport (a global player in its own right).

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What this means for a city like Chicago or a county like Milwaukee is that there is no shortage of experienced, world-class airport firms available to provide professional management of an airport put up for privatization. And these firms clearly have access to the global capital markets for airport deals that make economic sense, i.e., where the company can improve the economics of the airport to make a competitive return on investment.

Airport Privatization Pilot Program

By the mid-1990s there was considerable interest in airport privatization, among city and county governments that owned airports and among airport management companies. But when cities such as Los Angeles proposed actually going forward with privatization, airlines and other interests raised a number of legal objections. Although opposing legal briefs argued that existing federal law did not preclude the sale or lease of airports, there was sufficient legal uncertainty (and worries about litigation) that those favoring airport privatization petitioned Congress for legal clarification.

The result was the 1996 compromise legislation creating the Airport Privatization Pilot Program. In broad terms, it allows for up to five U.S. airports to be privatized, via sale or long-term lease, via a process of seeking waivers from various legal restrictions otherwise imposed by the terms of grant agreements between the airport and the Federal Aviation Administration (FAA). Under this program, of the five airports allowed, only one can be a large hub airport and one must be a general aviation airport. For air-carrier airports (like MKE), only the long-term lease form of privatization is permitted; for general aviation airports, either lease or sale is allowed.

What would otherwise be a requirement to repay a portion of previous federal grants is waived for airports in the Pilot Program. And participating airports remain eligible to receive federal Airport Improvement Program (AIP) grants, as long as they agree to continue to comply with all the standard grant agreements imposed on airports receiving such grants. The new owner/operator must honor any existing labor agreements. Increases in rates and charges to airlines and other aircraft operators are limited to the annual rate of inflation, unless a higher rate is approved by a super-majority.

The most difficult requirement of the Pilot Program law concerns the financial proceeds from the transaction—the lease payments or sale proceeds. The normal practice, as required by grant agreements, is that no "airport revenue" may be taken off the airport or used for non-airport purposes. Although legal opinions differ, the FAA maintains that lease payments or sales proceeds fall within this definition. Changing this was one of the main aims of proponents of the legislation, because unless a city or county could realize a return on its investment in the airport, there would be little motivation for it to proceed with privatization. Likewise, why would an airport company buy or lease an airport unless it could earn a profit and distribute that profit ("off the airport") to its shareholders?

The legislation makes clear that the acquiring firm is allowed to earn a profit from operating the airport. But in order for a city or county government to receive lease or sales proceeds and use them for non-airport purposes (as Chicago and Milwaukee would want to do), the legislation requires super-majority approval from the airlines serving the airport. Specifically, 65% of the carriers serving the airport must agree to the privatization, as well as airlines representing 65% of the total landed weight during the previous calendar year. This provision was added to the legislation after serious airline lobbying.

U.S. Airport Privatization Today

Apparently due to the perceived difficulty of gaining airline approval, most city and county governments have not pursued privatization under the provisions of the Pilot Program. Although applications were filed for all five slots in the program, only one airport has completed the process. Other forms of airport privatization continued or expanded outside the provisions of the program.

Privatization via the Pilot Program

New York Governor George Pataki had been one of the proponents of the Pilot Program, so his state was the first to apply, seeking to lease Stewart International Airport. It selected UK firm National Express as the winning bidder, for a 99-year lease, and this transaction was finalized in April 2000, when National Express took over the airport. Attempts to obtain the 65% airline approvals did not succeed; hence, New York State must reinvest its lease revenues in Stewart and its other state-owned airports.

No other air-carrier airport of any consequence has applied to the program. Applications came in from Niagara Falls (no scheduled service), Puerto Rico's Aguadilla (sporadic scheduled service), and two general aviation airports with plans for expansion, San Diego's Brown Field and New Orleans' Lakefront Airport. The Niagara Falls application was withdrawn following the airline recession that began after the 9/11 events, and the Puerto Rico and San Diego applications were withdrawn due to changed local politics. The New Orleans Lakefront application is still pending, despite the airport's having been flooded during Hurricane Katrina, but it's not clear if the proponents are still serious.

Thus, until Mayor Daley raised the prospect of leasing Midway Airport, most observers considered the Pilot Program as inherently flawed by the airline super-majority requirement.

Other U.S. Airport Privatization

Two other forms of privatization have proceeded independently of the Pilot Program: contract management and new-facility development.

A number of air-carrier and general aviation airports have been operated and managed by private companies since long before the enactment of the Pilot Program. Air-carrier airports operated this way include Albany, Atlantic City, Burbank, Indianapolis, New Haven, and White Plains/Westchester. Under this type of arrangement, the government remains responsible for capital investments, while the company operates and maintains the airport and receives a management fee for doing so. These contracts comply with all the federal grant agreements, and do not involve airport revenue going off the airport. The Indianapolis contract (with BAA) stands out only because it is (a) the largest, (b) one of the longest-term (15 years), and (c) the newest, having been entered into around the same time as enactment of the Pilot Program.

More interesting are several arrangements in which the private sector finances, builds, and operates new airport capacity. The largest such arrangement is a 25-year build-operate-transfer agreement between the Port Authority of New York and New Jersey and a consortium of Schiphol, LCOR, and Lehman Brothers that has developed and is operating the new $1.4 billion Terminal 4 at JFK International Airport. On a somewhat smaller scale, UK firm TBI has built and now operates the terminals at Orlando Sanford airport in Florida, an up-and-coming alternative to Orlando International. Most recently, LCOR has signed a contract to develop what is expected to be the third Chicago airport, 40 miles south of the Loop at Peotone, IL. The Illinois Department of Transportation is acquiring the land and will build the initial runway, while the LCOR consortium will finance, build, and operate the terminal and parking facilities.

Can the Pilot Program Be Used for Midway and Milwaukee?

The crucial question regarding Midway (MDW) and MKE is whether the relevant airlines can be persuaded that a long-term lease would be a good deal for them. In the case of MDW, it might appear that this decision depends heavily on one airline. Southwest provides nearly three-quarters of the traffic at that airport, easily meeting the 65% of landed weight requirement. However, the second part of the two-part test requires that 65% of all scheduled airlines agree. Midway carriers include AirTran, American, ATA, Continental, Frontier, and Northwest plus the regional/commuter affiliates of American, Continental, Delta, Northwest, and United. That's 12 airlines, of which at least eight must agree to the deal.

It seems clear that for both MDW and MKE, any lease proposal must be judged by a super-majority of the airlines to be in their interest.

The situation is more complex at MKE, where there are six major carriers (AirTran, Delta, Frontier, Midwest, Northwest, and USAirways) plus 15 regional/commuters. All six majors together only constitute 59% of the 2005 landed weight (with the biggest, Midwest, alone accounting for just 33% of the total). And with 21 scheduled airlines serving MKE, it takes 14 to reach the 65% threshold.

It seems clear that for both MDW and MKE, any lease proposal must be judged by a super-majority of the airlines to be in their interest. In principle, what might the airlines want that would reconcile them to accepting the privatization of the airport, something the U.S. airline industry has always strongly opposed? To answer this, we need to understand what it is that airlines have feared about privatization.

There are two such fears: increased costs to use the airport and loss of control over capital-investment decisions. The first concerns the charges airlines pay—primarily landing fees and space rentals. The second concerns the contractual right of "signatory" airlines (those which sign long-term lease and use agreements) to say yes or no to airport expansion projects. Historically, this right has given incumbent airlines (which typically have exclusive-use gate agreements) a powerful tool for reducing the extent to which new competitors can establish a significant presence at the airport: the incumbents control most of the existing gates, and they can vote against adding new gates.

MKE is in a fortuitous position to negotiate with its current airlines, because the existing long-term lease and use agreements (which define who the "signatory" carriers are) expire Sept. 30, 2010. These agreements are of the older kind, called "residual cost agreements," under which the signatory carriers agree to cover the difference between airport costs and all other airport revenues (the residual cost). This annual calculation determines the rates they pay each year for landings and for space rentals. Residual cost agreements can be a good deal for airlines when times are good, but they also expose carriers to potentially high (and unknown) costs if airport revenues are reduced during recessions. There has been a trend since airline deregulation for airports to shift from residual cost agreements to more straightforward "compensatory" agreements, under which airlines pay landing fees and space rentals on a commercial, negotiated basis (which exposes the airport to the possibility of both profits and losses). Privatized and commercialized airports overseas always operate with compensatory agreements, and do not grant to airlines the ability to veto expansion projects.

None of the three largest MKE carriers—Midwest, Northwest, and Delta—is in robust financial health, nor is the industry as a whole. Consequently, the airlines may be more amenable than was true historically to giving up veto power over airport expansion in exchange for low and predictable charges to operate at MKE. Southwest Director of Properties Pete Houghton told *Public Works Financing* newsletter (July/August 2006) that with respect to the proposed lease of Midway, "We think there's some room . . . for fixing or even reducing our costs, and at the same time providing a good rate of return for investors." This is a far more positive response to an airport privatization proposal than was seen during previous attempts in the 1990s.

One possible approach would be to charge each airline a variable amount, either per landing or per passenger. This would allow the airline to reduce its expenditures at MKE if its passenger numbers or scheduled flight activity went down, due either to a declining air travel market or to strategic decisions to shift services elsewhere. Under the current residual cost arrangement, the savings to the airline during such a cutback would be much less than proportional to the cutback, since the airline would still be contractually obligated to cover its share of the overall airport budget. This is an example of the willingness of the private airport operator to assume the risks involved in operating the airport, rather than sharing them with the carriers, as occurs under residual-cost agreements.

Should Milwaukee County decide to proceed with MKE privatization, it would be wise to make clear to the carriers that under no circumstances will it renew or extend the current residual-cost agreements, whether privatization goes forward or not. Then the county could challenge potential lessees to develop a rates-and-charges regime that would be attractive enough to gain assent via the two forms of 65% airline approval.

Is there enough potential value-added from privatization to make it feasible for an airport company to agree to modest and predictable airline rates and charges? That remains to be seen, but since very few airports that have been put on the market have failed to attract bidders, it seems plausible that there could be.

Airport companies create additional value by reducing costs and increasing revenues. My 1994 study suggested, based on a wide-ranging review of privatization experiences in many fields, that a 10% reduction in operating costs would be quite possible were MKE to be privatized. On the revenue side, two opportunities for increased revenues would be obvious to any potential bidder. First, although airports are allowed by the FAA to levy passenger facility fees (PFCs) of up to $4.50 per person, MKE's current PFC is only $3.00. With more than 3 million annual enplaned passengers, a change to $4.50 could add $4.5 million in annual revenue, to help pay for capital projects that would otherwise have to be financed with revenue bonds.

Second, MKE's retail concession revenue (food, gifts, etc.) is very low. In recent years it has been running in the vicinity of 90 cents to $1.10 per enplaned passenger. Airports privatized overseas generate far more concession revenue per passenger. But these comparisons can be misleading, since so many of the more prominent examples of privatized airports (Copenhagen, Heathrow, Rome, Sydney) have a high percentage of international travelers, who spend substantially more than domestic passengers. MKE's enplanements are 97.6% domestic. But an example of an airport with similar domestic percentage that has done a very commercially successful job with retail concessions is Portland, OR (PDX). With 97.9% domestic passengers, PDX generates close to $9 per passenger in retail concessions, according to a recent article Aviation Week's *Airports* newsletter (July 11, 2006). If MKE were able to increase its concession revenue to even half PDX's level, that would generate an additional $13 million per year.

MKE's total airport revenues in 2004 were nearly $54 million. Thus, the potential of just the additional PFC and concessions revenue is nearly 32% more revenue. This clearly suggests that a private lessee could add value that would give it flexibility in negotiating affordable rates and charges for the airlines serving the airport.

Possible Airport Value

The final, bottom-line question is: How much might MKE be worth today, under a long-term lease? The best way to address this question is to look at the market for airport acquisitions in recent years. The following table summarizes airport privatizations from 2000 through 2005. Because our data source listed the market value of the airport in the currency of the transaction, and in then-year values, those values themselves are not that helpful. More directly useful for valuation purposes is the ratio of the market value to a fairly standard measure used in the acquisition of companies: EBITDA. This stands for earnings before interest, taxation, depreciation, and amortization. It is a basic measure of the ability of the enterprise to generate cash flow.

MARKET VALUE OF RECENTLY PRIVATIZED AIRPORTS

Airport Company	Acquirer	Year	Stake Purchased	Currency	Value (M)	Value/EBITDA
Budapest	BAA	2005	75.0%	Euro	1,957.0	31.9
Copenhagen	Macquarie	2005	37.7%	DKK	15,075.0	10.2
Airport Co. of S. Africa	Public Investment Corp.	2005	20.0%	Rand	8,607.8	7.5
Hochtief European airports	Hochtief Airport Capital	2005	100.0%	Euro	432.3	9.7
TBI	ACDL (Abertis/ AENA)	2004	100.0%	GBP	685.0	14.8
Brussels	Macquarie	2004	70.0%	Euro	1,635.0	12.3
London Luton	TBI	2004	28.6%	GBP	351.3	15.9
Firenze	Acquisizione Prima	2003	29.0%	Euro	99.3	14.3
Belfast City Airport	Ferrovial	2003	100.0%	GBP	35.0	14.5
Hainan Mellan	Copenhagen Airports	2002	20%	HK$	1,907.2	11.3

MARKET VALUE OF RECENTLY PRIVATIZED AIRPORTS (CONTINUED)

Airport Company	Acquirer	Year	Stake Purchased	Currency	Value (M)	Value/EBITDA
Aeroporti di Roma	Macquarie	2002	44.7%	Euro	2,680.8	14.3
Sydney	So. Cross (Macquarie)	2002	100.0%	A$	5,588.0	17.7
Auckland	Institutionals	2001	7.1%	NZ$	1,828.3	13.1
Birmingham	Macquarie	2001	24.1%	GBP	417.5	10.1
Newcastle	Copenhagen Airports	2001	49.0%	GBP	293.8	17.5
London Luton	TBI	2001	46.4%	GBP	195.0	26.8
East Midlands	Manchester Airport	2001	100.0%	GBP	241.0	13.8
Bournemouth & Glasgow	Infratil	2001	100%	GBP	40.4	28.4
Bristol	Macquarie	2000	100.0%	GBP	234.0	16.4
Hamburg	Hochtief & Air Rianta	2000	36.0%	Euro	804.5	8.6
Aeroporti di Roma	Leonardo	2000	51.2%	Euro	2,591.6	17.4
Centro Norte (Mexico)	ADP consortium	2000	15.0%	US$	606.7	11.2
Beijing Capital	ADP Management	2000	10.0%	HK$	12,688.0	17.4
High						**31.9**
Low						**7.5**
Average						**15.6**
Median						**14.5**

Source: Macquarie

As can be seen, there has been considerable airport privatization activity in the past five years. And in general, these recent valuations are considerably higher than those seen in the early days of airport privatization in the late 1980s and early 1990s.

To apply the valuation multiple to MKE, we need to know its EBITDA value. Financial statements for the Milwaukee airport system (which includes MKE and a small general aviation airport) give total revenue for 2004 as $53.9 million and for 2005 as $57.2 million. Total expenses were, respectively, $52.6 million and $56.2 million. The budget shows a total for “Debt and Depreciation” each year of $15.3 million and $15.1 million. Since the airport does not pay taxes, we take this sum as the value for ITDA. Thus, for 2004 and 2005, we estimate EBITDA at $16.5 million and $16.1 million, respectively.

If we use the average Value/EBITDA figure from the above table, it says that acquirers have been willing to pay an average of 15.6 times EBITDA to acquire ownership of an airport in recent years. If a lease of MKE were offered for a term long enough to be the functional equivalent of ownership (say 50 years or longer), this same multiple might apply. To be a bit more conservative, we could use the median ratio of 14.5. This range of multiples provides an estimated market value of MKE in the $234-$240 million range. Obviously, given the large range in multiples shown in the table, from 7.5 to 31.9, airport investors assess each airport on its own merits. Thus, the potential range of values for MKE could be as low as $122 million and as high as $520 million. Realistically, MKE's value is more likely to be in the mid-range than at either of these extremes.

As a point of comparison, the 1994 WPRI study of leasing MKE estimated its market value at that time to be between $96 million and $132 million. As noted, airports were being privatized at lower valuations during the early 1990s. And MKE's gross revenue in 1994 was about $30 million, about half its current revenue. So it is not surprising that it may be worth about twice as much today as it was estimated to be worth in 1994.

Closer examination of the MKE income statement reveals that it only includes a portion of the airport's likely gross revenue from the $3.00 charge per passenger (PFC) levied by the airport. After making several minor adjustments to the data, I estimate that in 2004 MKE generated $9.241 million in PFC revenue (net of payment to the airlines for collection costs). But the financial statements show only $1,064,955 in PFC revenue for that year. Adding the $8.176 million of additional revenue to the previously computed EBITDA figure for 2004 gives a revised number of $24.698 million. Applying the 14.5X-15.6X multiple to this figure yields a revised estimate of airport value of $358-$385 million.

As a check on the reasonableness of these estimates, airport finance people find that acquisition values tend to be 1.5 to 2.0 times the total amount of airport debt. MKE has $176.7 million in general-obligation and revenue bonds outstanding. Thus, its market value, by this rule of thumb, should be in the $265-$353 million range. That fits in between the upper end of our first calculation ($240 million) and the lower end of our alternative calculation ($358 million).

Conclusion

Although the idea of privatizing Milwaukee's airport sounded strange in 1994, the world has changed a lot over the past decade. Airport privatization has become a worldwide phenomenon, with active investors and global airport management companies now turning their attention to the previously neglected U.S. market. And although U.S. airlines have historically opposed airport privatization, in their current financial condition they might welcome a privatization deal that reduced their future risk of unpredictable increases in airport rates and charges. With Chicago moving ahead with its process to lease Midway Airport, Milwaukee County should look seriously at doing likewise with General Mitchell International Airport.