Airport privatisation the challenges way forward economics essay

Environment, Air

Traditionally all the airports were owned by the public sector. The European airports in major cities such as Paris, London, Dublin, Stockholm, Copenhagen, Madrid, and Geneva were all owned by national governments. The airports outside Europe like Tokyo, Singapore, Bangkok, Sydney, and Johannesburg were similarly owned by their country's government bodies. Elsewhere, the major airports like in the U. S. were controlled by local or regional governments. Regional airports in Europe too followed this rule. For example, Manchester airport was owned by Manchester City Council and a combination of 8 local authorities of nearby towns with 45% ownership resting with the latter and 55% with the former authority. In Germany, Dusseldorf airport was owned by the governments of North Rhine, Westphalia state and the city of Dusseldorf together, whereas, the Hanover airport was owned jointly by the governments of Lower Saxony and the city of Hanover.

In the 1990's, private or partially privately owned airports became significant. Before this, the privately owned airports were limited only to the general aviation or to the aeroclub airports. The norm during that period was that the public ownership, i. e. the government handled the airport operations at least at a local or majorly at national level. This had a major impact on the operations of the airport and its degree of independence. The strictest form of control existed when the government had direct control over the airport, for example the Civil Aviation Authority (CAA), Ministry of Transport or, in few cases, the military. This was commonly practiced in Asia, the Middle East, Africa and South America. In Canada, 150 commercial Canadian airports were directly controlled by The State Department of

Transport. Within Europe, Greece was a good example where CAA controlled all the airports effectively.

In some cases, semi-autonomous bodies and companies, those were still under the public ownership owned the airports. Some organizations managed more than one airport, British Airports Authority (BAA) and Aer Rianta Irish Airports were good examples in Europe. Other airport authorities and companies also existed that operated just one major airport. This was the case at Amsterdam airport and many German airports. In the U. S., airport authorities also existed for some of the airports, such as the Minneapolis-Saint Paul Metropolitan Airports Commission. In some cases, multipurpose transport authorities which operated other modes of transport also operated airports, such as the Port Authority of New York and New Jersey or Massport in Boston.

There were also examples of airports where companies which were publicly owned managed the airports at concession for the central government. For example, the major Italian airports like Venice and Milan were controlled by public shareholdings and perhaps some private shareholdings at concession for long terms, such as 60 years. The concession could cover management of the total airport operations and handling services like Milan and Turin or just some of the operations like terminal management and handling services like Palermo. At French regional airports, the concessions were given to the local chambers of commerce, but national government holding some control over the airfield facilities. For example, at the Zurich airport, the planning and the overall operation of the airport and the airfield infrastructure is controlled by

the Zurich Airport Authority, which is owned by the Canton of Zurich, while a mixed public private company, named FIG, managed and constructed the terminal infrastructure.

Commercialization

The publicly owned and strictly controlled airports were historically considered as a public utility for the public service obligations. As a result, the airport industry was not considered as a business dominant industry but a general public service transport system. However, in the 1970s and 1980s the perspective towards airport management changed as the industry grew towards airline privatization and deregulation. Many airports then were considered more of a commercial industry and businesslike management philosophy was adopted. Thus the airport industry around the world took steps towards commercialization with Europe as its leader. However, airports in areas like Africa and South America mostly stuck on to the traditional way and experienced less changes.

The coming of commercialization was seen in many different steps. For instance, many independent airport authorities and airport companies with public shareholders were established resulting in less government control over airports. This gave airports more of operational and commercial freedom and also gave private sector investment and partnership more chances. In 1972, the International Airports Authority of India was established to manage India’s four international airports. In 1986, National Airports Authority took control of the domestic airports in the country. These two merged in 1995. In Canada, where the Transport Canada was in direct

control of the country’s major airports, passed its airport management completely to individual non-profit-making authorities in a long-term lease in the 1990s. its main reason was to improve its efficiency and integrate it to the local economy.

During the commercialization process, airport management was focused upon operational aspects like financial management, non-aeronautical revenue generation and airport marketing. Many airport directors and senior managers were operational specialists. This realization of commercialization resulted in expansion of staff members and operational resources. Also the typical departments for finance, administrations, operations, and so on was replaced with new department or ‘ business units’ like customer needs, passenger and airline services.

One of the most significant changes during commercialization was an increased focus on the non-aeronautical revenues and commercial revenues. Aeronautical revenues such as landing and passenger fee from the airlines had been the most important source. In most of the airports, mainly European airports, non-aeronautical revenues overtook aeronautical revenues as the most important source. For example, Amsterdam airport first reported of its higher non-aeronautical revenue when compared to its aeronautical revenue. This was due to large space allocation to commercial retail shops and other non-aeronautical facilities.

In the past, it was very difficult to obtain a true indication of an airport’s financial and economic performance. Often the government would undertake

normal public accounting practices specific to its country and would use public sector rather than more standard commercial procedure. This resulted in difficulty in comparing it with the other organizations. In some cases, airport’s cost and revenues were considered as one item only within the government department’s financial accounts. Therefore no specific profits from the airports could be determined. In the 1970s and 1980s, more commercial accounting practices were adopted in most of the airports. This was mainly due to less control in the hands of the government. For example, in 1987, all major airports in the U. K. became public limited companies (plc). This meant that these airports adopted commercial private sector accounting procedures. One example of this was when Geneva airport became an independent authority in 1994, it began to show balance sheets and asset values in its annual accounts, which previously was ignored.

Privatization

During the 1970s and the 1980s, commercialization took great strides in the growth of airports around the globe. But it was during 1990s when privatization became a reality. But what is actually meant by privatization? In its broadest sense, it usually means the transfer of airport management, and sometimes ownership as well, to the private sector.

Privatization of publicly owned airports had many arguments both supporting and against it. Privatization reduces the need of public sector investment and provides access to commercial sectors. It reduces government control and interference enabling the organization to diversify. It may also increase the operational efficiency of the airport, induces competition and payment of

incentives for management and employee staff to perform well. There were some developments that took place in the 1970s and 1980s which strengthened the reasons for airport privatization to occur in some countries. For example in North America and Europe, deregulation resulted in the growth of the airports which meant the existing airport capacity could not cope with this growth. Privatization of airports was considered as a means of injecting additional finance into the airport systems to pay for the future investments. In addition to this, public sector funding became very scarce in the modern-day global economic climate as government thought of reducing their spending and turned to non-revenue-earning activities like education and health.

Privatization also has some adverse effects like it may create a private monopoly which charges extra for same or lesser standards of services, invests inadequately and gives less consideration to externalities like controlling environmental impacts and maintaining social justice. Less favorable employment condition may occur and redundancies may occur. From a point of view, airport privatization can be considered as just an evolutionary development of the aviation industry. Airports evolved from public sector utility to commercial enterprises and privatization can be considered as commercialization taken to its limits. Increased commercialization has brought about good profits and market oriented management.

The increase in number of airport privatization around the world has shown us that this method has successfully achieved ways to tackle some problems

that could be faced by the airports in the 21st century. However, this in some countries where publicly owned organizations are considered as national or regional assets being transferred to private companies could be a sensitive political issue. It brings fear that the focus would be then shifted to private shareholders and the customer needs will be neglected. Privatization of airports may have different views among different groups and even between the local and national government. As a result, it should not be thought that commercialization always leads to privatization. A good example for this is the Manchester airport, which runs on a very commercial basis, but has no desire to undergo privatization.

Types of Privatization

Airports are one of the most attractive organizations for investors, for many reasons. Firstly, the aviation industry has a unique growth rate. Many airports, mainly the major airports have less or no competition, from the airports and also from other modes of transports. It is difficult to enter into the airport industry as it requires heavy capital investment and also difficult to find an appropriate and convenient locations where airport development is allowed. However, there are risks also available such as the political interference in the form of airport regulation and control over airport development as there is deregulation and greater collaborations through alliances.

According to the document prepared by Carney and Mew in 2003, the types of privatization can be broadly classified into 5 types:

Share floatation

Trade sale

Concession

Project finance privatization

Management contract

The selection of the most appropriate type of privatization for the airports is done by a series of complex decision-making process in which the reasons for privatizing is checked by fulfilling certain conditions.

Share Floatation

The first type, i. e., the share flotation or Initial Public Offering (IPO), where the airport share capital is issued, and traded on the stock market. The Management or the public owners are given options to acquire shares.

In this type, the government or the public owners give up the total or partial ownership according to the shares open, transferring economic control and risks to the new shareholders. Generally this type of privatization has shown positive results with promising economic growth rate and limited competition as the capital investments are too high for the risk to be taken. Even when total privatization occurs, the government has a certain degree of influence by issuing a golden share so that the national interests can be secured in extreme cases.

Trade Sale

In this type of privatization, some parts of the airport or the total airport is sold to a trade partner or a consortium of investors, through a public tender. The trade sales which took place in the 1990s had strategic partners involved rather than just passive investors. As a result, the managerial and technological expertise was considered while agreeing on a sale.

Concession

With this type of arrangement, an airport management company or consortium will purchase a concession or lease to operate the ‘ privatized’ airport for a defined period of time, commonly between 20 and 30 years, again usually through a tendering process. Financial terms and the types of lease will vary but typically this option will involve an initial payment and a guaranteed level of investment and/or payment of an annual fee. Hence this tends to be a more complex approach, which has high transactions costs and needs to carefully designed and implemented to ensure that the private contracts achieve the government policy objectives.

Project Finance Privatization

With this option, a company will usually build or redevelop and then operate an airport or specific facility, such as a terminal, for a certain length of time, typically 20-30 years. This company may be totally private or may be a private-public partnership. At the end of this period, ownership will revert to the government owners. Thus this approach can be viewed as a particular type of concession agreement. Generally such an arrangement will not usually require a large upfront payment but the operating company will bear

all the costs of building or re-developing the facility. When it is built, the company will have to cover the operating costs but will also retain most revenues (often after paying an annual fee to the government) until the facility is handed back. Thus, the airport company will take full economic risk for investment and operations. There are a number of project finance privatization methods with the most popular being build-operate-transfer (BOT) when, as the name suggests, the company will build the facility, operate it for a certain length of time and then transfer ownership back to the government. Other similar models include build-transfer (BT), build-rent-transfer (BRT) or design-construct-manage-finance (DCMF). Other options may actually involve the ownership of the facility such as build-own-operate-transfer (BOOT) or rehabilitate-own-transfer (ROT) projects. All these methods, however, are often referred to by the generic term BOT.

Management Contract

The least radical privatization option is a management contract when ownership remains with the government and the contractors take responsibility for the day-to-day operation of the airport, usually for a period of 5-10 years. The government either pays an annual management fee to the contractor, usually related to the performance of the airport, or the contractor will pay the government a share of its revenues. Normally investment will remain the responsibility of the government owner and so the overall economic risk is shared between the owner and the management company. For the government owner this may be politically more acceptable, whereas for the contractor such an arrangement may be

attractive in countries where greater financial exposure, through a trade sale, for example, may be seen as too great a risk.

Overview

The overall reason for this report is to analyze the effects of ownership change on the economic growth of the industry. The main success of privatization is not by attaining maximum airport profits but by providing quality service with continuously improvising efficiency and maintaining cost of charges.

There are a number of lessons that can be learnt from this experience:

The cost of capital is found to be too high in the ‘ plc’ privatization model.

Efficiency is optimized when the business is outsourced.

Performance can be improvised even without ownership change.

It is difficult to reach objectives to provide quality, cheap, and safe service simultaneously.

Privatization is not a successful option unless customer needs are not kept in priority for the growth and development.

Customers have gained some from privatization, in terms of lower prices relative to the public ownership organizations, but not by a lot.

Identifying Challenges

Vienna International Airport (VIA), Austria

Privatization resulted in inadequate investment and high charges for customers.

Before privatization, VIE had high costs. The weak economic regulation did not help much to change this providing no incentive to improve efficiency, provide adequate investment, or hold back monopoly profits. This is due to the direct regulation of charges from the government.

Due to the classic monopolist behavior, profit margins are restricted. As a result, insufficient incentives are being produced which cannot further pay for the cost-efficient investments for the future of the airport.

Zurich Airport (ZRH), Switzerland

The independent TRL Charges Index of the top-50 airports worldwide ranks Zurich Airport as the 10th costliest airport in the world.

Due to the collapse of Swissair, capacity constraints have emerged at the Zurich Airport. As a result it is the least profitable airport among the top 50 airports.

Absence of an independent economic regulation resulted in low incentives for higher efficiency.

The airport has switched from single-till to dual-till which resulted in the aeronautical revenue to bear all the cost of aircraft and passenger service.

Auckland International Airport (AIA), New Zealand

Absence of an effective economic regulation, due to which they charge excessively on their customers for higher incentives.

Asset base and operational cost valuation of the AIA is remarkably high due to its dominant market position. Moreover the cost of capital used by AIA also appears to be extremely high. These appear to be the reasons for high base for charges.

Sydney International Airport (SYD), Australia

Although the service quality is complimented by passengers, airlines are less satisfied and charges are high.

The prices rose high in 2001, giving reasons that it would help SYD earn a commercial rate of return.

SYD also switched to Dual-till; therefore the aeronautical revenue is only confined to cover the aircraft and passenger service charges.

The ACCC, similar to the Competition Commission in the U. K., is not influential enough to encourage SYD to increase their efficiency as there is no incentive-based price cap.

Perth Airport (PER), Australia

Huge price rise in service charges with no improvement in services or any significant capital investment.

Absence of economic regulation, asset evaluation and the use of dual-till; all this result in increase in charges for the customers.

Ezeiza International Airport (EZE), Argentina

Privatization meant very bad for the customers. High charges for the structure, under-investment and poor quality of service to the customers.

Absence of an independent economic regulator has led to very high service charges. It also resulted to a very confrontational relationship between the government, airport operator and the customers.

Capacity constraints have been dealt very poorly. Under-investments due to payment of high royalties.

No competition between service providers led to high customer charges with low standards of service.

Athens International Airport (AIA), Greece

Service quality is good to the customers but comes at a very high price. It ranks the 3rd highest charges in the world.

No consultation with the airline customers on building of the new airport, therefore high cost and inefficient investment.

The rate-of-return economic regulation creates no incentives for improving efficiency and permits monopoly profits. If the profits are not met within one year, then the regulator allows charges to be raised in order to recoup.

The AIA also uses the dual-till. This means the aeronautical revenue is confined only to the aircraft charges and passenger charges which should have been also used for the commercial charges.

There has been over 20 years since privatization of infrastructure providers started in different industries. Although, considerable rise of amounts had been achieved by privatizing many publicly owned companies fully or partially, general public and customer interest had not been one of the major concerns. From the identified challenges brought into light due to privatization of airports all around the globe, some prominent issues like cost inefficiency, high charges due to no independent economic regulation in existence. The cost of capital is too high under the ‘ plc’ privatization model. There is no improvisation in the efficiency and quality of customer services to cope with low or minimal incentives.

The privatization of airports has also brought the issue of capacity, financial and environmental constraints into light. This resulted in potential discrimination between incumbent and new airline companies. Expanding capacity at new major airports require huge amounts of capital, where public sector funding might not be sufficient, therefore private sector investment has to be considered. But for future investments, incentives and service charges have to be rightly considered and revised.

Compacting Strategies

An efficient economic regulation is necessary to regulate the cost of capital, the asset and resource valuation and to control the service charges

according to the quality of service provided. It is also needed to improvise the quality of service provided to airlines and customers according to the incentives. It has to optimize the use of given space capacity, both for aircrafts and passengers.

An efficient economic regulation system is appropriate for bringing a balance between the service provided and service charges by setting up a fair and efficient charging system for airports infrastructure. It may encourage private investors to invest and take control of commercial management.

It is noticed through history that airports when operated with commercial outlook, the performance, efficiency and financial situation is improved, whether it may be publicly owned or privately owned. Airports governed by national or local governments should be allowed some degree of freedom to run more like a commercial type and unnecessary regulations should be lifted.

British Airports Authority (BAA), U. K.

Excellent example of how to privatize an airport successfully, by implementing effective economic regulation of assets.

Since privatization, the company has diversified. It started managing airports overseas with equal stakes and concentrating on particularly the non-aeronautical revenue generation at the airports.

Effective economic regulation has been critical for the success of privatization, which regulated the aeronautical revenue considerably low and maintaining good quality of services.

The existence of a Competition Commission has resulted in effective regulation of charges by keeping the customer’s interest in mind.

The price-caps are given a regular check in order to prevent the increase in airport profits in excess of the cost of capital. This avoids inefficient investment which would lead to excessive charging of customer services.

Revision of incentives for better services keeps the quality of service good and also in improvisation. If neglected, it would lead to poor quality of service in order to increase airport profits.

Single-till is the mode of airport accounts management. In this method, both the aeronautical and non-aeronautical revenues are taken into account during setting the airport charges.

Copenhagen Airport (CPH), Denmark

Relatively successful privatization with quality service and relatively low airport charges.

Effective economic regulation has been critical for the success of this privatization. This controlled the aeronautical revenue relatively low and quality of service high.

Improvisation in the efficiency of services was the key to its success since shareholders are also benefitting.

The regulation put price-caps by negotiation with the airline customers, if this failed, then incentive based charges are assigned to improve efficiency of the services.

Brussels Airport (BRU), Belgium

The economic regulation brought customers into reassurance by setting appropriate charges.

With respect to the rate-of-return policy, little incentives are produced for cost efficiency improvements to reduce airport charges.

Conclusion

Privatization brought drastic changes as the ownership changed from public owners like national or local government to private sector ownership. But commercialization is of greater asset than privatization. Increasing the airport profits, expansion of airport capacity and economic growth happens by undertaking commercial type of management. The public owners can increase the revenue generation by liberalization and allowing the airports more degree of freedom.

Effective economic regulation is critical for successful privatization as capital investment is high therefore there is less competition for private sector investment. The economic regulation is highly necessary for creating incentives, which would help in improvisation of quality of service and

increasing efficiency and would restrain monopolies created by privatization and allow sharing of airport profits with the customers by reducing customer service charges. A regulatory committee in association with the economic regulation could be considered highly beneficial as they would complement each other’s price-capping by keeping the customers and the airport’s cost of capital into consideration.

For successful privatization, customers should be considered as key stakeholders in the development and expansion. The pricing infrastructure should be set by keeping the customer’s interest as one of the most important criteria in making capital investments for growth and future development.