

**PROFITS, PLANES AND POLICY**  
AN ANALYSIS OF THE MIDWAY AIRPORT PRIVATIZATION AND ITS  
IMPLICATIONS FOR FUTURE AIRPORT PRIVATIZATIONS IN THE  
UNITED STATES

Master of Arts in Law and Diplomacy Thesis

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## ABSTRACT

Midway International Airport in Chicago is poised to become the first large hub U.S. airport to be privatized through a 99-year lease and concession to the private sector. This precedent-setting airport privatization presents America's air transportation and infrastructure investment communities with a rich opportunity for discerning the immediate impact and broader implications of a domestic airport privatization.

The Midway Airport privatization crests a confluence of forces that have made airport privatization an attractive and viable option for meeting the current and future needs of airports, and those of their public owners. America's aviation infrastructure requires far-reaching and expensive upgrades at a time when traditional airport financing modes are falling short. Further compounding this development are the mounting pressures on public budgets that serve to relegate infrastructure spending to a second-tier priority. At the same time, global infrastructure investors have amassed the money and trained their sights on transportation assets that provide steady cash flows. Both demand and supply line up to create an investment climate conducive to airport privatization.

However, the theoretical arguments supporting and opposing airport privatization reveal a host of unresolved issues that serve to render airport privatization no panacea to the challenges facing the system. Instead, the theory and previous airport privatization experiences – both domestic and international – highlight the difficulty of undertaking a privatization and the inherent trade-offs involved. Most importantly, limited competition among airports makes efficiency gains under private ownership a questionable outcome.

Against this backdrop, the Midway Airport privatization was structured and pursued to maximize upfront financial gain to the City of Chicago. This approach is problematic for several reasons: It reduced future revenue streams from the airport to the city; forced the city to incur ongoing financial obligations at Midway Airport that whittle down the amount netted from the transaction; and increased the risk of an overvaluation that will make it difficult for MIDCo to earn reasonable returns, thus ensuring precipitous price increases for airport users. While predicting the future financial and operational performance of a privatized Midway is difficult, the unresolved issues outlined above should give pause to other public airport owners considering airport privatization.

The Midway International Airport privatization demonstrates that future airport privatizations in the United States should evolve beyond the narrow motive of immediate revenue generation to assume a structure that secures the diversion of long-term sustainable cash flows from the privatized airport and that provides for more competition and efficiency gains.

**Addendum:** On April 20, 2009, the City of Chicago announced that the 99-year lease and concession of Midway Airport to MIDCo had collapsed. According to the city, MIDCo was unable to secure the financing necessary to make its \$2.521 billion upfront payment to the city. Current city Chief Financial Officer Gene Saffold said the deal's collapse was attributable to the global economic crisis and liquidity crunch, which had severely impacted the availability of financing. Saffold also stated the city's intention to re-bid Midway Airport when market conditions improve.

## INTRODUCTION

At the beginning of the 20<sup>th</sup> century, the French actress Sarah Bernhardt remarked: “I adore Chicago. It is the pulse of America.”<sup>1</sup> If Chicago is the pulse of America, then in the ensuing 100 years, the city’s two airports have evolved into the pulse of Chicago. Swallowing and disgorging more than 95 million passengers and 1.7 million tons of mail, freight and express cargo in 2006,<sup>2</sup> Chicago’s O’Hare Airport and Midway Airport are indispensable to the economic vitality of the city, region and country. In the globalized economy, an air transportation system acts as both an access, facilitator and receptacle point for the world’s flow of people, goods, services and capital – and it is therefore essential to reap its rewards.

Determining the exact rewards from an air transportation system and to whom they do or should accrue is a complex undertaking, and one on which the City of Chicago is embarking with the impending privatization of Midway International Airport in 2009. If completed under the Federal Aviation Administration’s (FAA) privatization demonstration program, Midway Airport, the nation’s 25<sup>th</sup> busiest airport,<sup>3</sup> will be the first large hub airport in the United States operated, managed and developed under a long-term lease to the private sector.

With America’s air transportation community and global infrastructure investors closely monitoring the execution and outcome of the precedent-setting Midway deal, it is important to delve into the deal and its details to ascertain the process, prospects and implications of this privatization. It is the contention of this paper that the Midway Airport privatization is problematic for its stakeholders owing to the manner and form in which it was pursued and structured. Nonetheless, airport privatization will remain an attractive and viable option for

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<sup>1</sup> *Chicago Quotes*. (accessed November 2008); available from <http://thinkexist.com/quotes/with/keyword/chicago/2.html>.

<sup>2</sup> *Chicago Airport System: 2006 Annual Report*. Chicago: Chicago Airport System, 2007

<sup>3</sup> U.S. Department of Transportation, Bureau of Transportation Statistics, National Transportation Statistics, *Tbl. 1-41 2007*

public airport owners in the United States, but it is no panacea to the challenges facing the aviation system. Within that context, the Midway International Airport case reveals important and instructive insights into how airport privatization can and should evolve in the United States.

Part I of this paper examines the confluence of forces – on both the demand- and supply-side – that have brought consideration of airport privatization to the fore in the United States. It discusses the scope and scale of America’s aviation infrastructure needs, the shortfall in current modes of airport financing, the mounting demands on public sector budgets, and the emergence of infrastructure as a new asset class. Part II dissects the commonly marshaled theoretical arguments advocating or opposing airport privatization. Part III discusses the evolution of airport privatization in the United States and the development of an enabling legislative and regulatory framework, before presenting specific examples of international airport privatization experiences to inform the subsequent appraisal of international comparative studies on whether private ownership enhances airport efficiency. In Part IV, the paper presents the Midway Airport privatization in detail, profiling the airport, the City of Chicago’s privatization objectives, the financial structure of the deal and the public reception to the privatization process. Part V melds the broader contextual and theoretical background with the details of the Midway Airport deal to determine the privatization’s potential impact on each stakeholder and to draw conclusions as to the deal’s ability to deliver the benefits sought. Lastly, the paper offers some final remarks on airport privatization in the United States in the wake of the pilot case of Midway International Airport.

**I. AN “UNHOLY TRINITY”: ESSENTIAL AVIATION INFRASTRUCTURE UPGRADES, SHORTFALLS IN AIRPORT FINANCING, AND STRAINED PUBLIC BUDGETS.**

With America’s air transportation community and global infrastructure investors closely monitoring the execution and outcome of the precedent-setting Midway Airport privatization, it is important to examine the confluence of forces that have made airport privatization an attractive option for addressing the current and future needs of U.S. airports, and those of their public owners.

*THE NEED FOR AVIATION INFRASTRUCTURE UPGRADES*

President Barack Obama has made revitalizing America’s transportation infrastructure a central tenet of his economic recovery plan – and not a moment too soon. The American Society of Civil Engineers estimates that the United States needs to invest at least \$2.2 trillion over the next five years to maintain and expand its infrastructure.<sup>4</sup> The nation’s infrastructure – from bridges to drinking water systems to airports – earned a D average from the ASCE, which warned that continued neglect and rising inflation are adding billions to the price tag for improvements.<sup>5</sup> According to Robert Puentes of the Brookings Institution, the United States has lacked a comprehensive transportation development plan for more than two decades with states, municipalities and metropolitan planning organizations shouldering the bulk of responsibilities: “Look at the physical neglect – crumbling bridges, the issue of energy security, environmental concerns. It’s more relevant than ever and we have no vision.”<sup>6</sup> And as New York City Mayor Michael Bloomberg told Congress at the start of 2008: “We are facing an infrastructure crisis in

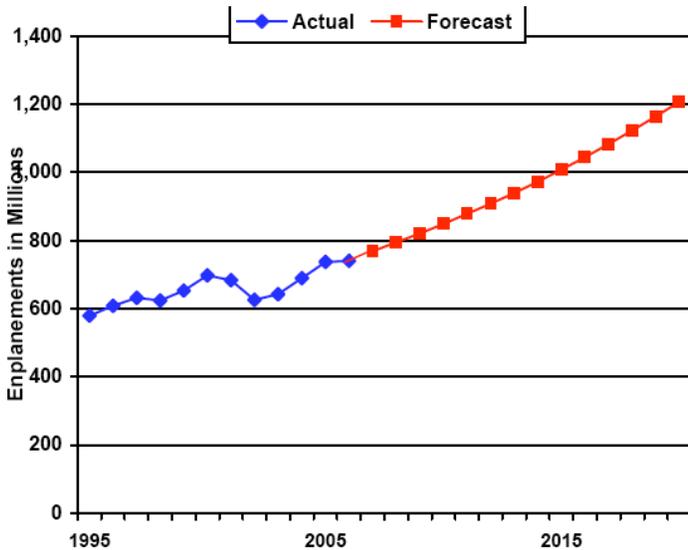
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<sup>4</sup> American Society of Civil Engineers, *Report Card for America’s Infrastructure*, (accessed March 2009), accessible from <http://www.asce.org/reportcard/2009/>

<sup>5</sup> Ibid.

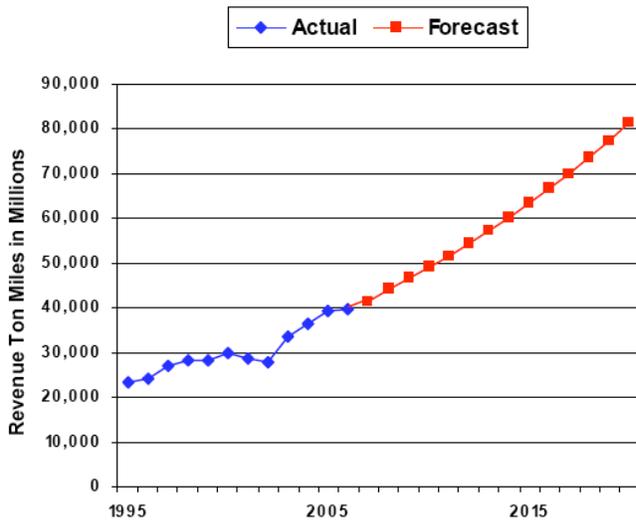
<sup>6</sup> Anderson, Jenny. “Cities debate privatizing public infrastructure.” *The New York Times*, August 27, 2008.

Figure 1: FAA Passenger Growth projections



Source: FAA.

Figure 2: FAA projected air cargo growth



Source: FAA.

this country that threatens our status as an economic superpower, and threatens the health and safety of the people we serve.”<sup>7</sup>

Along with highways, bridges and mass transit, the U.S. air transportation infrastructure needs an infusion of capital and cutting-edge technology in order to meet the growing demands on the system. The FAA estimates that by 2025 U.S. air traffic will almost double to 1.3 trillion enplaned passengers.<sup>8</sup> The demand for air cargo will also grow consistently through 2025. The FAA projections are shown in **Figures 1 and 2.**<sup>9</sup>

The existing system is unable to absorb such an increase, and the FAA warns that if capacity and efficiency gains are not achieved, the result will be

<sup>7</sup> Ibid.

<sup>8</sup> FAA, *Next Gen Implementation Plan*, (accessed December 2008), available from

[http://www.faa.gov/about/office\\_org/headquarters\\_offices/ato/publications/nextgenplan/](http://www.faa.gov/about/office_org/headquarters_offices/ato/publications/nextgenplan/)

<sup>9</sup> Airports Council International – North America, *Airport Capital Development Costs 2007-2011*, (accessed December 2008), available from [http://www.aci-na.org/stats/stats\\_studies](http://www.aci-na.org/stats/stats_studies)

“gridlock in the sky and in the airports.”<sup>10</sup> By 2022, the FAA estimates that a failure to upgrade the aviation infrastructure will cost the U.S. economy \$22 billion annually in lost economic activity. The cost from 2022 onward is exponential: The figure almost doubles within a decade to \$40 billion in 2033.<sup>11</sup>

#### *AIRPORT FINANCING SHORTFALLS*

Increased demand for passenger and cargo service necessitates a corresponding increase in airports’ capital development projects -- and these sport a hefty price tag. According to the Airports Council International-North America (ACI-NA), an estimated \$87.4 billion or \$17.5 billion annualized in airport capital development costs is projected for 2007-2011. This 22.2 percent increase over the 2005 estimate of \$71.5 billion or \$14.3 billion annualized for 2005-2009 is attributable to additional capital development projects needed for accommodating ongoing and forecast air traffic growth, rising construction costs that outpace inflation, and inflation. The development projects at the nation’s 3,400 airports – from large hub commercial airports to small general aviation airports –fall into five main categories:

- Expanding airport capacity beyond its current design to meet demand;
- bringing an airport up to FAA-recommended design standards to achieve full productivity of aircraft;
- reconstructing aging airport infrastructure;
- upgrading infrastructure to accommodate the introduction of newer, modern aircraft; and
- addressing safety, security and environmental concerns.<sup>12</sup>

The projected demands on the system, their broader economic implications and the price tag of capital development projects lay bare the need for serious and sustained efforts to equip the U.S. air transportation system to accommodate twenty-first century flows of goods and people.

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<sup>10</sup> FAA, *Next Gen Implementation Plan (FAQ)*, (accessed December 2008), available from [http://www.faa.gov/about/office\\_org/headquarters\\_offices/ato/publications/nextgenplan/faq/](http://www.faa.gov/about/office_org/headquarters_offices/ato/publications/nextgenplan/faq/)

<sup>11</sup> Ibid.

<sup>12</sup> *Airport Capital Development Costs 2007-2011*

In order to do so, airports will need to tap into global flows of capital. Traditionally, external finance for airport development has come from three main sources: bonds, federal grants (AIPs), and passenger facility charges (PFCs). Until recently these financing flows, combined with the internal revenues generated through increased reliance on landside – shops, restaurants and parking -- services, had largely insulated U.S. airports from the pressures to privatize faced in other countries.

The US' \$383 billion municipal bond market “has been an efficient source of capital for governments over the years”<sup>13</sup> – with airport operators availing themselves of it. For example, in 2005, the Port of Seattle, operator of the Seattle-Tacoma International Airport, issued \$454 million in revenue bonds to finance new construction at the airport and to refinance outstanding debt. Port Commission President Bob Edwards said investors’ enthusiasm for the bonds was the product of “[our] excellent credit ratings by the major rating agencies...[and it] reflects the growth we've seen in our core business activities as well as strong operational and financial performance.”<sup>14</sup>

Airports maintain investment-grade ratings from credit rating agencies, and airport operators can issue numerous types of bonds. Airport operators have used, among others, general obligation bonds, general airport revenue bonds, bonds backed by PFCs, bonds to be paid with future AIP or state grants, and special facility bonds to finance capital projects.<sup>15</sup> Given the airports’ public ownership, these bonds are exempt from federal income tax on interest

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<sup>13</sup> Thornton, Emily. “Roads to Riches.” *BusinessWeek*, May 7, 2007.

<sup>14</sup> Port of Seattle. *Port of Seattle Bonds See Strong Demand Among Investors* (accessed March 2009), accessible from [http://www.portseattle.org/news/press/2005/06\\_24\\_2005\\_63.shtml](http://www.portseattle.org/news/press/2005/06_24_2005_63.shtml)

<sup>15</sup> Nichol, Cindy. “Innovative Finance and Alternative Sources of Revenue for Airports,” *Airport Cooperative Research Program, ACRP synthesis 1*. Transportation Research Board, Washington, DC: 2007.

paid to bondholders.<sup>16</sup> While the municipal bond market will continue to act as a safe haven for investors in a roiled financial system and provide much-needed airport development funds, it increasingly functions as the primary source of substantial amounts of financing – much to the consternation of smaller and medium-sized airports.

The FAA disburses Airport Improvement Program (AIP) grants, which are financed through user taxes on various aspects of the aviation system and are disbursed to airports on the basis of national priorities.<sup>17</sup> AIP grants help finance projects that enhance airports' capacity, safety, security and noise mitigation. However, "over the years, less money has been given out [under AIP] for aviation projects than is obtained from the taxes, because of the need to balance the federal budget."<sup>18</sup> In 2007, more than 2,000 AIP grants totaling \$3.4 billion were distributed to US airports.<sup>19</sup> Yet, the ACI-NA projections indicate that airport capital needs for 2007 averaged around \$17.5 billion. This leaves a shortfall of approximately \$14.1 billion to be funded with local sources.

Moreover, AIP grants come with the caveat that "all revenues generated at a publicly owned airport receiving federal AIP grants must be used to cover capital or operating costs of that airport or local airport system."<sup>20</sup> This "revenue retention" requirement underwent several incarnations before the FAA issued its Final Policy on Airport Revenue Diversion in 1999. The policy explicitly lists the permitted and prohibited uses of airport revenues, and is designed to negate the incentive for "local governments...to charge excessive fees at airports in order to

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<sup>16</sup> Graham, Anne, "The Regulation of US Airports, 64, in Forsyth, Peter, ed. et al., *The Economic Regulation of Airports: Recent Developments in Australasia, North America and Europe* (Hants: Ashgate Publishing Limited, 2004).

<sup>17</sup> Morrison, Steven and Clifford Winston. "Delayed! U.S. Aviation Infrastructure Policy at a Crossroads." *Aviation Infrastructure Performance: A Study in Comparative Political Economy*. Ed. Clifford Winston, Gines de Rus. (Washington, DC: The Brookings Institution, 2008), 7.

<sup>18</sup> Graham, 64.

<sup>19</sup> FAA, *Grant Histories*, (accessed December 2008), available from [http://www.faa.gov/airports\\_airtraffic/airports/aip/grant\\_histories/](http://www.faa.gov/airports_airtraffic/airports/aip/grant_histories/)

<sup>20</sup> Graham, 65.

support other obligations of government.”<sup>21</sup> At the same time, however, it has acted as a significant barrier to private ownership and lease proposals, because any recovery by the private sector of its original investment would be considered illegal “revenue diversion.”<sup>22</sup> Under the FAA’s privatization demonstration program, the “revenue retention” requirement is waived for the original public owner and subsequent private owner if certain conditions are met.

One source of local external funding is Passenger Facility Charges (PFCs). Congress created the PFC program in 1990, which allows airports to impose a charge of up to \$4.50 per passenger to fund FAA pre-approved airport projects. For airports imposing a PFC of more than \$3, Congress required the airport to surrender 75% of its AIP funding: “The idea was that small airports would not raise PFCs directly, and this was a way for them to benefit indirectly from PFCs levied by the larger airports.”<sup>23</sup> Almost two decades later, more than 300 airports have been authorized to collect PFCs, which, in recent years, have generated more than \$2.5 billion per year.<sup>24</sup>

The mix of these funding sources differs across airports, reflecting their ability to generate revenue from passenger traffic. For example, in 2000, 40 percent of external funding for large hub airports came from bonds, 33 percent from PFCs and only 12 percent from AIP grants. At small hub airports, however, 39 percent of external funding came from bonds, 16 percent came from PFCs, and 37 percent came from AIP grants.<sup>25</sup>

Discussion of the external financing sources reveals that increases in federal grant money cannot keep pace with the growing demands for further airport upgrades and expansion. The

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<sup>21</sup> Reilly, Jack. “Evaluating the privatizing of a small airport.” In *Privatizing Transportation Systems*, ed. Simon Hakim, et. al, 97-100. (Westport, CT: Prager Publishers, 1996), 100.

<sup>22</sup> Ibid.

<sup>23</sup> Dempsey, Paul Stephen. “Theory and law of airport revenue diversion.” Airport Cooperative Research Program, Transportation Research Board. Washington, DC: May 2008.

<sup>24</sup> Ibid.

<sup>25</sup> Graham, 64.

amount that PFCs can generate is limited, which leaves the municipal bond market as the only viable external source for large amounts of funding. Consequently, airport owners and operators look internally – within airport operations and government budgets – to cover costs.

According to Germa Bel and Xavier Fageda in their study of *Airport Management and Airline Competition in OECD markets*, “U.S. airports show important economic and financial differences with respect to airports [in the] rest of the world.”<sup>26</sup> These differences and their implications for privatization manifest themselves in the characteristics of the predominating commercial airport model.

Airports are multi-product enterprises and their activities fall into two main types: the provision of aeronautical or airside services and the provision of landside services. Aeronautical or airside services include, for example, such activities as air traffic control, runway and terminal maintenance, police and security, and aircraft maintenance. According to The World Bank, these are services “that by their nature are still considered monopolistic within each airport.”<sup>27</sup>

On the other hand, landside services, such as food and beverage concessions, duty-free shops, hotels and parking are commercial services that can accommodate a wider variety of suppliers. Increasingly, landside services drive airport revenue, reducing traditional reliance on airside charges. The emergence of a “commercial airport model,” with operators maximizing the ability of the private sector to realize business opportunities latent in airport infrastructure, has transformed swathes of airports into conference centers, shopping malls, spas and food courts.

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<sup>26</sup> Bel, Germa and Xavier Fageda. “Airport management and airline competition in OECD Markets.” In *Essays on Transport Economics*, ed. Pablo Coto Millan, 159-179. (Heidelberg: Physica-Verlag, 2007), 166.

<sup>27</sup> Juan, Ellis J. Privatizing Airports – Options and Case Studies, Public Policy for the Private Sector. Vol. Note No. 82. Washington, DC: The World Bank, June 1996

Further, an airport's revenue distribution appears linked to its ownership structure. A study of more than 40 airports worldwide revealed that airports owned by a government department generate, on average, 70% of their revenues from airside services and only 30% from landside. In contrast, 57% of a privately owned airport's revenues come from landside services and only 43% from airside. Strikingly, U.S. airports, although publicly

**Figure 3: Distribution of airport operating revenues**

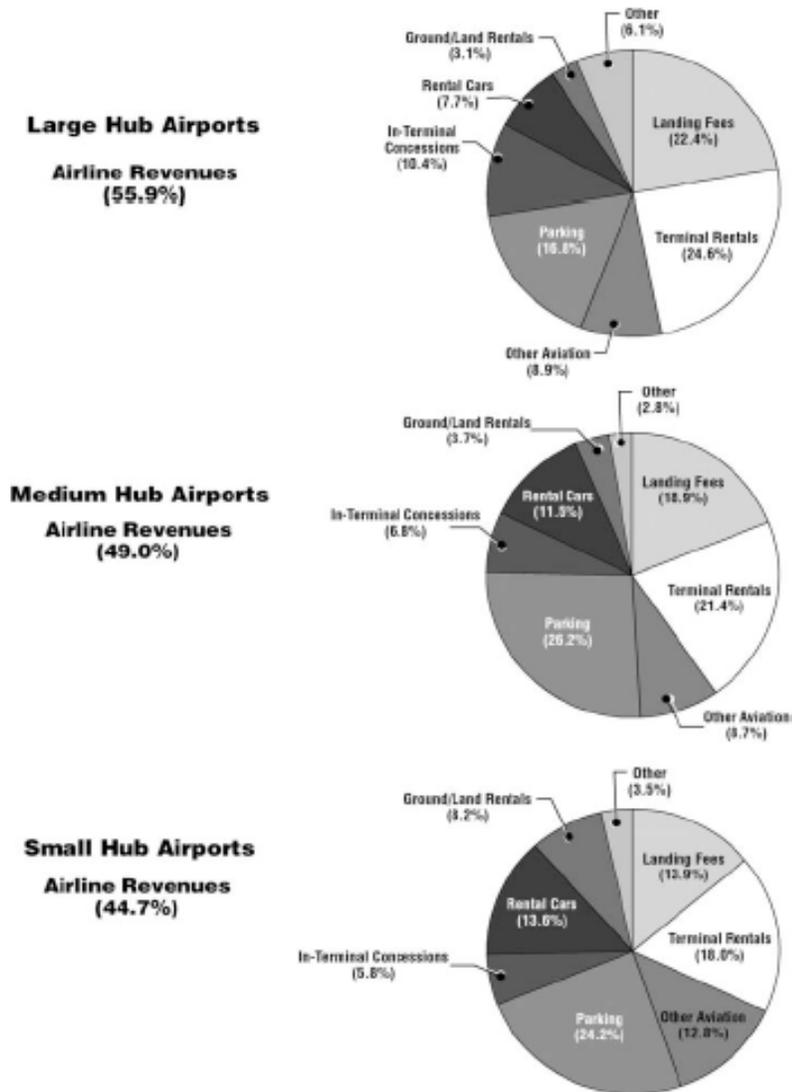


FIGURE 20 Distribution of airport operating revenues. Source: FAA, AAS-400, CATS Report 127, 2005.

owned by local governmental authorities, generate, on average, 64% of their revenues from landside services and only 36% from airside.<sup>28</sup> **Figure 3** provides a closer look at the breakdown in airport operating revenues.<sup>29</sup>

The airport-airline relationship is also central to the development and profitability of the commercial airport model. While the setting of aeronautical charges varies across countries, there are two basic approaches to establishing fee levels: residual and compensatory.<sup>30</sup> Under the residual approach, the airlines assume the financial risk of running the airport by paying fees that generate revenues equal to the remaining costs of airport operation after all commercial and non-airline sources of revenue have been considered. This is also known as the “single-till”<sup>31</sup> practice and encourages airlines to exert influence on the airport operator to increase profitability. With a compensatory approach, airlines typically pay only for the facilities and services that they occupy or use. The airport operator thus assumes the financial risk of running the airport. This approach is known as the “dual till,” where only the aeronautical aspects of the airport are considered in the setting of airside charges. In practice, airports often adopt a hybrid agreement, incorporating both a residual and compensatory approach to meet their particular needs.

In the United States, the financial obligations of airlines are specified in use and lease agreements with the airports. Typically included within these contracts is a Majority-In-Interest (MII) clause, which requires “the airport operator to consult with and seek approval of a prescribed percentage of signatory airlines, which together carry the majority of the airport’s

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<sup>28</sup>Betancor, Ofelia, and Robert Rendeiro. Regulating Privatized Infrastructures and Airport Services: A Background Paper for a Course on Transport Privatization and Regulation. Organized by the World Bank Institute. Vol. Policy Research Working Paper 2180. The World Bank, World Bank Institute, September 1999, 5.

<sup>29</sup>Nichol, 25.

<sup>30</sup>Graham, 67.

<sup>31</sup>Ibid.

traffic, for a proposed capital project to be developed.”<sup>32</sup> The airport dominance of certain airlines also depends on contractual agreements for exclusive-, preferential- or shared-use of the airports’ facilities in the terminal building (leasing and renting of gates, check-in counters, etc.). Most large airports in the US support long-term, exclusive-use lease arrangements, since they often rely on a specific airline to finance the construction of new or improved facilities.<sup>33</sup>

The U.S. public airport owner is essentially “minimally involved”<sup>34</sup> in all but the basic provision of airside facilities and services. Private sector influence is substantial given the structure of the airport-airline relationship and the revenue stream from commercially outsourced landside services.

The commercial airport model has made many airports in the United States self-sustaining, thus mitigating the financial impact of airport operation on a government’s balance sheet. But the financing amounts needed for future airport development are exceedingly large and onerous for the public airport owners that must shoulder them. In the United States, local or regional governments own all commercial service airports and operate them through commissions, special government departments, advisory boards, single-purpose authorities or multi-jurisdictional regional authorities. As such, “airports represent one of the largest capital investments from which local governments do not earn any direct return,”<sup>35</sup> and the potential for them to strain already strapped public budgets and resources is high.

#### *THE STRAINED BUDGETARY POSITION OF PUBLIC AIRPORT OWNERS*

Local and state governments face mounting pressures on their budgets as they contend with rising health care costs and retiree liabilities, high debt-service levels and large operating

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<sup>32</sup> Bel and Fageda, 169

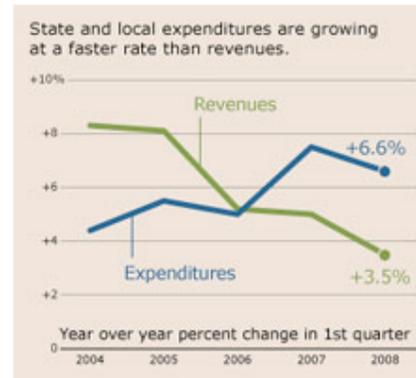
<sup>33</sup> Ibid.

<sup>34</sup> Graham, 64.

<sup>35</sup> Truitt, Lawrence J., and Michael Esler. Airport Privatization: Full Divestiture and its Alternatives. Policy Studies Journal, Vol. 24., 1996, 2.

deficits. For instance, in 2006, state spending on Medicaid increased by an estimated 7.7% to \$132 billion.<sup>36</sup> Credit Suisse, an international bank, estimates that governments could foot the bill for up to \$1.5 trillion in retiree liabilities.<sup>37</sup> The state of Illinois ranks fifth among states for largest fraction of expenditures going toward interest on debt, with almost 5 cents of every dollar spent going toward that purpose,<sup>38</sup> and the City of Chicago reported a \$469 million operating budget deficit in 2007.<sup>39</sup> Moreover, the average size of states' general funds – the repository for discretionary revenue – has shrunk from 48 percent of total funds in 2000 to 44.7 percent in 2007.<sup>40</sup> **Figure 4** captures a snapshot of states' fiscal difficulties.<sup>41</sup>

Figure 4: State and local expenditures & revenues



Since public officials tend to equate tax increases with career suicide, they are in the market for ideas on how to generate additional revenue and scale back government obligations. The idea has gained traction at the highest political levels: President Obama's nominee for Transportation secretary, Ray LaHood, told the Senate Commerce Committee during his confirmation hearing in January 2009 that "there's not going to be enough money...I think we do have to think outside the box."<sup>42</sup> And as Chicago's former chief financial officer, Dana

<sup>36</sup> Thornton.

<sup>37</sup> Ibid.

<sup>38</sup> *Debt Service Expenditures 2006*, Data Visualization at the Pew Center for the States, (accessed March 25, 2009); available from

[http://www.pewcenteronthestates.org/ttw/trends\\_map\\_data\\_table.aspx?trendID=11&assessmentID=26&year=2006](http://www.pewcenteronthestates.org/ttw/trends_map_data_table.aspx?trendID=11&assessmentID=26&year=2006)

<sup>39</sup> City of Chicago, *Mayor Daley Proposes 2009 Balanced Budget*, (accessed December 2008), available from [http://egov.cityofchicago.org/city/webportal/portalContentItemAction.do?contentOID=537015416&contentTypeName=COC\\_EDITORIAL&topChannelName=HomePage&blockName=I+Want+To](http://egov.cityofchicago.org/city/webportal/portalContentItemAction.do?contentOID=537015416&contentTypeName=COC_EDITORIAL&topChannelName=HomePage&blockName=I+Want+To)

<sup>40</sup> *Bills Coming Due*, The Pew Center on the States, (accessed March 25, 2009); available from [http://www.pewcenteronthestates.org/trends\\_detail.aspx?id=31678](http://www.pewcenteronthestates.org/trends_detail.aspx?id=31678)

<sup>41</sup> Ibid.

<sup>42</sup> Conkey, Christopher, "Nominee for Transportation Dept. urges role for private sector," *Wall Street Journal*, January 21, 2009.

Levenson, told BusinessWeek, privatization of infrastructure assets could be a useful tool:

“There is money to be had, and cities need money.”<sup>43</sup>

Funding shortfalls and governments’ fiscal problems have created the potential supply-side for airport privatization. The demand-side has also evolved in recent years. *The New York Times* reports that investors have “amassed an estimated \$250 billion war chest – much of it raised in the last two years – to finance a tidal wave of infrastructure projects in the United States and overseas.”<sup>44</sup> Morgan Stanley estimates that total equity capital committed to infrastructure increased by over 100 percent from 2006 to 2008 to approximately \$180 billion.<sup>45</sup> Large infrastructure investors like Goldman Sachs, the Carlyle Group, and Morgan Stanley, among others, are trolling the globe looking for a respite from the volatility of other investments. According to Sadek Wahba, Chief Investment Officer and Global Head of Morgan Stanley Infrastructure, “the current challenging market conditions are creating unique opportunities in the infrastructure sector, and [the bank] is generating a strong investment pipeline across the Americas, Europe and Asia.”<sup>46</sup>

Steady cash flows from public infrastructure, like airports, are a virtual guarantee given limited competition and the resultant captive customer base. When questioned by the Chicago City Council as to whether the city had netted the highest amount possible for the lease of Midway Airport, Chicago’s then Chief Financial Officer Paul Volpe told aldermen the airport “attracted greater value today than it would have in a healthy economy when the Dow was rolling.”<sup>47</sup> While some analysts question the accuracy of Volpe’s statement, it is nonetheless

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<sup>43</sup> Thornton.

<sup>44</sup> Anderson.

<sup>45</sup> *Benefits of Private Investment*, Kearsarge Global Advisors, (accessed March 25, 2009); accessible from [http://www.kga-dc.com/index.php?option=com\\_content&view=article&id=167&Itemid=184](http://www.kga-dc.com/index.php?option=com_content&view=article&id=167&Itemid=184)

<sup>46</sup> Morgan Stanley. “Morgan Stanley Closes \$4.0 Billion Global Infrastructure Fund.” Press Release, May 12, 2008. (accessed March 25, 2009), available from: <http://www.morganstanley.com/infrastructure/PressRelease.html>

<sup>47</sup> Spielman, Fran. “Aldermen Delay Midway Vote on Worries about Deal.” *Chicago Sun-Times*, October 7, 2008

clear that infrastructure has evolved into a new and attractive asset class, and the attention from global investors does not look likely to dissipate.

Ostensibly, if international investors are looking to invest in airports, thereby reducing the burden on the public sector and filling a financing shortfall that threatens the vitality of the U.S. economy, then airport privatization appears a ready-made solution to a problem whose scale and implications are growing. Yet precisely because airports are such a vital access, facilitator and receptacle point for the world's flow of people, goods, and services, it is essential to determine what the exact benefits from a privatization are and to whom they do or should accrue. In order to assess the rationale, prospects, and implications of the Midway International Airport privatization, it is necessary to first examine airport privatization in its broader theoretical context.

## **II. THE THEORETICAL ARGUMENTS SUPPORTING AND OPPOSING AIRPORT PRIVATIZATION**

Different interpretations of what exactly is meant by the term privatization abound. Broadly defined, privatization is the deliberate sale or transfer by a government of state-owned enterprises or assets to private investors. Agency theory and strategic management literature suggest that ownership influences firm performance because of the different goals and incentives driving different owners.<sup>48</sup> The simple view of privatization as a transfer of ownership from the public to the private sector “implies that ownership defines control, so that when ownership changes so does control over all important management and strategic issues.”<sup>49</sup> However, the privatization options available to airports, given their diverse activities, allow for either a transfer of ownership or a transfer of control. Rather than focusing solely on ownership, it is useful to

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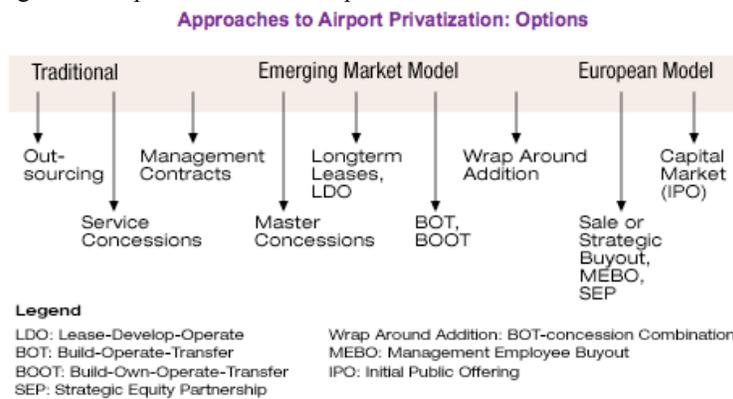
<sup>48</sup> Oum, Tae H., Jia Yan, and Chunyan Yu. "Ownership Forms Matter for Airport Efficiency: A Stochastic Frontier Investigation of Worldwide Airports." *Journal of Urban Economics*, 64.2 (2008): 423.

<sup>49</sup> de Neufville, Richard. *Airport Privatization: Issues for the United States*. Technology and Policy Program, Massachusetts Institute of Technology, Cambridge, MA., 1999.

think about the degree of government participation in strategic direction and management of an activity – and the desirability of such government involvement.

Airports are not subject to competition unless another airport competes for traffic in close geographic proximity, and even then, it must compete for a similar kind of traffic, whether business or leisure travelers, prestige or low-cost carriers. But given the complex, multi-product nature of the modern airport, “are airport infrastructures genuine natural monopolies, ...or should

Figure 5: Airport Privatization Options



Source: Robert J. Aaronson, Strategies for Airports Inc.

we distinguish those activities where the exertion of monopoly power is very likely from others where the forces of competition are feasible and desirable?”<sup>50</sup>

Potential unbundling of airport activities informs the

privatization models available and pursued thus far. A spectrum of airport privation options is presented in **Figure 5**,<sup>51</sup> but should not be regarded as all encompassing.

Given the historically small number of true state-owned enterprises, privatization assumes different forms and meanings in the United States than in other countries. According to research by Lopez-de-Silanes, Schleifer and Vishny, privatization in the United States refers to contracting out the provision of services currently provided by the public to the private sector. In their study, they examine empirically why different governments contract out certain activities,

<sup>50</sup> Betancor, 13.

<sup>51</sup> Sander, Charles. *Airport Privatization: Trends and Opportunities*, Unisys Global Transportation (accessed November 2008); available from [http://www.unisys.com/transportation/insights/insights\\_compendium/airport\\_privatization\\_c0\\_part\\_ii.htm](http://www.unisys.com/transportation/insights/insights_compendium/airport_privatization_c0_part_ii.htm)

and find that the more rigid state fiscal constraints and the less powerful public-sector unions are, the greater the likelihood of contracting out public services.<sup>52</sup> This finding is consistent with the argument that the United States could see a wave of airport privatizations – legislative and regulatory framework permitting – since public budgets are strained and the percentage of public sector workers at airports is low, between 10 to 20 percent.<sup>53</sup>

Under the existing regulatory framework, a public airport operator in the United States can pursue three main forms of airport privatization. These have typically assumed the form of service concessions or management contracts. While the FAA did not prohibit long-term leases, its removal of the “revenue retention” requirement under the privatization demonstration program made this a viable third option. Full or partial divestiture of a commercial airport, whereby the public owner of the airport facility sells a majority or minority of its ownership to the private sector through a public offering, a trade sale or combination, is not permitted by the FAA.

Closer examination of the US regulatory landscape, the FAA privatization demonstration program, and domestic experiences with airport privatization follow in a subsequent section, but it is useful to first examine how airport privatization in general engenders support and opposition among various stakeholders in the air transport system. Based on privatization experiences in other industries, interested parties have marshaled some generally accepted theoretical arguments supporting and opposing airport privatization. Proponents of airport privatization advocate moving toward a model where the airport is a vehicle that will simultaneously acquire profits, achieve enhanced efficiency, and relieve government of an unduly necessary financial burden.

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<sup>52</sup> Lopez-de-Silanes, Florencio, Andrei Shleifer, and Robert W. Vishny. 1997. “Privatization in the United States.” *RAND Journal of Economics* 28, pp. 447-471, as discussed in Megginson, William, *The Financial Economics of Privatization* (New York, NY: Oxford University Press, 2005), 398-399.

<sup>53</sup> de Neufville, 9.

Opponents of airport privatization, on the other hand, believe airports are public use facilities inclined to act as a monopoly, and their operation is better left to the government in the service of the public interest.

#### *THE CASE FOR AIRPORT PRIVATIZATION*

Airport privatization proponents view airport operation as a non-core government function and one that correlates more to the private sector's key competencies. The main theoretical arguments in support of airport privatization are threefold: Privatization will generate additional private capital necessary for further airport development; increase cost and operational efficiencies and inject competition; and augment government budgets.

With the FAA forecasting more than 1 billion passenger enplanements by 2016,<sup>54</sup> and warning that delays and their associated costs will worsen unless the United States' aviation infrastructure improves, advocates view privatization as essential to generating the capital needed for further airport development. Declines in funding from AIP grants at a time of increasing needs is compounded by the post 9/11 security focus that overwhelmingly funnels airport development money into increasing and upgrading security measures. Privatization supporters claim that privately operated airports would be better positioned to "potentially tap new sources of private capital – including private equity – that airports will need to meet the growing demand for capacity and facilities."<sup>55</sup> Access to non-debt financing via the stock market is viewed as critical to the future success of airports, especially since the financing amounts needed are large.

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<sup>54</sup> FAA, Aerospace Forecast Fiscal Years 2008–2025 (accessed December 2008); available from [http://www.faa.gov/data\\_statistics/aviation/aerospace\\_forecasts/2008-2025/](http://www.faa.gov/data_statistics/aviation/aerospace_forecasts/2008-2025/)

<sup>55</sup> Burton, Casey Andrew. "An Analysis of the Proposed Privatization of Chicago's Midway Airport." *The Journal of Air Law and Commerce* 72.3 (2007): 613.

Proponents argue that not only will private operators be able to access more capital to invest in future airport development projects, they will also be inclined to make investments in new capacity and to achieve greater operating and cost efficiencies with existing airport infrastructure. Privatization would give airports the freedom and incentive to compete for passengers and carriers, and to efficiently price and produce a level of service that its customers value. Given the private sector's different incentive structure, private operators will seek innovations that lead to fewer delays, less congestion, greater capacity and greater value-added services. In short, proponents argue that the profit-maximizing behavior of the private sector will drive it "to allocate resources to the points of greatest demand."<sup>56</sup>

Mounting demands on public budgets make removing an airport from a government's balance sheet an attractive and practical option. Proceeds from an airport lease or sale provide a "financial windfall"<sup>57</sup> for a government, and free up financial resources for other government obligations. Moreover, since government property and revenues are tax-exempt, once an airport is privatized, the private operator will have to pay income tax on profits made, and may potentially have to pay an additional property tax on airport land. This steady stream of revenues "could make a potentially enormous contribution to budget shortfalls."<sup>58</sup>

#### *THE CASE AGAINST AIRPORT PRIVATIZATION*

The main theoretical arguments against airport privatization seek to negate those marshaled by its supporters, while also raising important additional issues. Opponents of airport privatization view airports as natural monopolies whose functions provide important public services and whose insulation from market forces is desirable. Moreover, they believe that

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<sup>56</sup> Haririan, Mehdi, and Bijan Vasigh. "Airport Privatization: Procedures and Methods." *Transportation Quarterly* 48.4 (1994): 396.

<sup>57</sup> Craig, Eleanor. "The Benefits and Costs of Airport Privatization." In *Privatizing Transportation Systems*, ed. Simon Hakim, et. al, 87-97. (Westport, CT: Prager Publishers, 1996), 87.

<sup>58</sup> Burton, 617.

private sector ownership is not a prerequisite for accessing large amounts of capital and achieving efficiency gains.

The crux of the opposition to airport privatization centers on the argument that airports are monopolies. Most cities are served by only one airport, creating a natural monopoly bottleneck. However, some economists argue that airports do not share the characteristics of most other natural monopolies in terms of declining costs over a long range of output. David Starkie writes:

“...if we double the potential output of a sizable airport by doubling the capacity available for use, total costs will more than double....The source of the airport monopoly, therefore, is not the usual economies of scale in the long-run production function, but the fixity of “locational” inputs (i.e. good sites) and economies of scope associated with established air service networks.”<sup>59</sup>

An airport’s market power thus stems from the fact that it takes decades to plan, environmentally review, and construct a new airport – especially in densely populated metropolitan areas. An airport’s market power is further reflected in the level of captivity of airlines and passengers. For example, if an airport is the home base of a carrier, it will have sunk costs in operational facilities, buildings, maintenance, etc.<sup>60</sup> The predominance of long-term exclusive use lease agreements also constitutes a significant barrier to entry and exit by airlines. In short, “for airlines to have countervailing power vis-à-vis an airport they need to have a viable alternative airport to use – and in most instances, this is not the case.”<sup>61</sup> The same is true for passengers: “the captivity of passengers will increase with decreasing distance between the place origin in the catchment area and the airport.”<sup>62</sup>

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<sup>59</sup> Starkie, David, *A New Deal for Airports* (Institute of Economic Affairs, Nov. 1, 1999) as quoted in Dempsey, 10.

<sup>60</sup> De Wit, Japp. “Privatisation and Regulation of Amsterdam Airport,” in Forsyth, Peter., ed. *The Economic Regulation of Airports*. Aldershot: Ashgate Publishing Limited, 2004: 87.

<sup>61</sup> Forsyth, Peter, ed. *The Economic Regulation of Airports*. Aldershot: Ashgate Publishing Limited, 2004: xix.

<sup>62</sup> De Wit, 91.

Moreover, in many cities or regions supporting two or more commercial airports, market segmentation has occurred, further reducing the potential for competition. In Chicago, for instance, O'Hare Airport serves large network carriers with long-haul international as well as domestic routes, while Midway Airport is home to lower-cost carriers servicing almost exclusively domestic routes. Given that commercial airports serving the same area neither provide the same services nor necessarily compete for the same customers, the substitution effects between these airports, such as in the case of Heathrow and Luton airports in the greater London area,<sup>63</sup> are weak.

Moreover, research into the choice process of air travelers finds some evidence of airport "loyalty." In his 2001 study of airport choice in the San Francisco Bay area's multiple airport market, Pels et. al found that both business and leisure travelers choose the departure airport and airline sequentially (first airport, then airline), with the implication that travelers are more willing to switch between airlines than airports. Moreover, in their 1995 study, Windle and Dresner found a significant inertia term: The more often a traveler uses a certain airport in a year, the more likely he is to choose the same airport again.<sup>64</sup> Thus, privatization opponents believe that given airports' market power, a change in ownership and shift in incentives will lead to monopolistic abuses.

Moreover, opponents view the link between ownership and enhanced efficiency as tenuous at best. A review of the economics literature reveals that neither empirical nor theoretical evidence is conclusive with respect to the relative efficiency of public versus private firms. De Fraja (1993) uses a principal-agent model to show that government ownership "is not

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<sup>63</sup> Oum, Tae and Xiaowen Fu. "Impacts of Airports on Airline Competition: Focus on Airport Performance and Airport-Airline Vertical Relations." Discussion Paper No. 2008-17, OECD and International Transport Forum Joint Research Centre: September 2008, 12.

<sup>64</sup> Kouwenhoven, Marco. "The Role of Accessibility in Passengers' Choice of Airports." Discussion Paper No. 2008-14, OECD and International Transport Forum Joint Research Centre: August 2008, 14-15.

only not necessarily less productively efficient, but in some circumstances more productively efficient.”<sup>65</sup> Research by Vickers and Yarrow (1991) suggests that competition is the key to efficiency rather than ownership per se.<sup>66</sup> But if airports suffer from a lack of competition, then efficiency arguments in favor of privatization are nullified. Further, the discussion of cost savings and efficiency gains often fails to differentiate between net gains to society and those that amount to simple transfers from one group to another. For example, critics of Canada’s 1994 airport privatizations point to the fact that its eight largest airports pay \$250 million a year to the federal government in rent, which, they say, is generated through a hidden tax on airlines and their passengers.<sup>67</sup>

In further countering the enhanced efficiency argument and its presumption that this translates into increased consumer satisfaction, opponents of airport privatization believe the private sector is ill equipped to account for an airport’s negative externalities. Driven as it is to maximize profits, the private sector will be unwilling or unable to adequately address noise or environmental complaints of surrounding airport communities. Private sector performance goals are believed to work at cross-purposes with the broader public interest. Moreover, public owners have traditionally used airports as mechanisms for pursuing other important public interest objectives – such as regional development.<sup>68</sup> The private operator is perceived to possess limited ability or incentive to correlate the two.

Lastly, opponents argue that while a privatized airport may be able to tap alternative and diverse sources of funds, the benefits are largely exaggerated. Privatization may attract equity investors with a greater willingness to accept higher risks than the average municipal bond

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<sup>65</sup> Oum and Yu, 423.

<sup>66</sup> Ibid.

<sup>67</sup> Dempsey, 10.

<sup>68</sup> Forsyth, xv.

investor, however large public enterprises enjoy access to lucrative financial arrangements. Thus, an airport's size (whether measured through passenger boardings, volume of cargo, or general aviation activity) correlates to its ability to secure investment capital through the municipal bond market. Since these bonds are secured by the stream of revenues flowing from the airport, "historically, larger airports have received adequate financing, and as a result have been financially the most sound airports in the United States system and already have ready access to capital."<sup>69</sup> In fact, the better access to capital argument raises another problem insofar that only a small minority of commercial airports are attractive candidates for privatization: "United States airports represent a highly integrated system that might be jeopardized seriously if the 'crown jewels were to be sold.'"<sup>70</sup>

### **III. AIRPORT PRIVATIZATION EXPERIENCES**

International and US public airport operators approach privatization from very different starting points. Some of the most far-reaching privatization experiences have occurred in countries where airport planning, design, finance and day-to-day management were wholly under governmental control.<sup>71</sup> This centralized national control over airports translated into greater opportunities for movement away from "governmental processes toward a competitive commercial environment."<sup>72</sup> In the United States, however, the private sector's influence on airport management and operation has been much more extensive. It is therefore not clear to some observers "how or to what extent the US ought to follow the apparent lead of other

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<sup>69</sup> Truitt, 5.

<sup>70</sup> Ibid.

<sup>71</sup> Neufville, 4.

<sup>72</sup> Ibid.

countries in airport privatization.”<sup>73</sup> The airport privatization spectrum for an existing airport facility includes four main options:

- *Service concessions*: This is the most limited form of privatization. The public owner retains the right to set policy and manage the airport, but contracts with private vendors for the delivery of a range of selected, usually commercial, services. These typically include food and beverage sales, retail establishments, and parking, but can also include cargo and baggage handling, and fueling services. The public owner collects rent from the vendors, and airlines reduce their costs under the residual fee-setting system as commercial revenues cover a greater proportion of airport costs.
- *Management contracts*: Under a management contract, more control is ceded to the private sector than through service concessions. The management of all or part of the airport is contracted out to a specialized operator for a certain period of time and under certain conditions for performance, maintenance and investment.<sup>74</sup> A management contract is typically five to ten years in length. The public owner retains responsibility for operating and capital expenses, but the management firm draws up the operating budget for approval by the public owner. The private firm is responsible for the hiring and firing of airport employees.
- *Long-term leases*: Under this model, the government negotiates with a private firm to manage, operate, and upgrade or expand the airport facility within guidelines established by the lessor. Airport ownership remains with the government. In a typical long-term lease arrangement (30 years or more), the private lessee receives most of the profits and bears most of the losses of the facility. However, lease payments usually are structured so that the government receives a percentage of the airport’s gross revenue. Therefore, “lessees are motivated to keep costs at a minimum, to maximize the difference between gross receipts and costs.”<sup>75</sup> A long-term lease is attractive to the private sector if the following criteria are met: sufficient commercial passenger traffic, cargo or general aviation activity, land and facilities that can be developed profitably, and location in a region of economic growth.<sup>76</sup>
- *Full or partial divestiture*: The public owner of the airport facility sells a majority or minority of its ownership to the private sector through a public offering, a trade sale or a combination.<sup>77</sup> Divestiture necessitates a new regulatory framework, which can be costly and difficult to implement.<sup>78</sup>

The pursuit of these options across countries depends on the development of an enabling legislative and regulatory framework. In order to analyze the Midway privatization, it is

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<sup>73</sup> Ibid, 5.

<sup>74</sup> Betancor, 17.

<sup>75</sup> Ibid.

<sup>76</sup> Ibid, 8.

<sup>77</sup> Juan, 4.

<sup>78</sup> Betancor,19.

necessary to first examine the evolution of airport privatization in the United States and internationally, before discussing the implications of comparative international studies of airport efficiency and ownership.

*THE EVOLUTION OF AIRPORT PRIVATIZATION IN THE UNITED STATES*

Due to the predominance of the commercial airport model, the importance of landside revenues in overall profits and the clout wielded by airlines in the United States, private sector influence in decisions concerning key airport activities and capital investment decisions is high. While the airport's public owner proposes major airport development projects and garners funds from the FAA, the Majority-in-Interest clauses of airline leases and the carriers' financial stake in the airport's profitability under the single-till system ultimately shape the project's realization. For example, the City of Denver pushed for the development of the new Denver International Airport and received about \$800 million in public funding, however private sector financing provided about three times as much, and both United and Commercial airlines exercised significant influence over the design concept and final execution.<sup>79</sup>

Moreover, the government entity that owns US airports typically employs only about 10 to 20 percent of the workers in the airport since airlines typically control their own check-in counters and baggage systems, while third parties routinely carry out cleaning, parking, and other housekeeping operations.<sup>80</sup> The private sector's extensive cooperation and influence in day-to-day operations and large-scale development projects renders "private control of airports in the United States about the same as in the most privatized airport systems in the world."<sup>81</sup>

Nonetheless, public and political reception to airport privatizations in the United States has differed significantly depending upon the privatization form pursued. Virtually all major and

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<sup>79</sup> Neufville,9.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid.

many smaller airports in the United States have contracted out a variety of services to private vendors. Traditionally narrowly construed, service concessions have evolved in recent years to assume new and more comprehensive forms. For example, at the time that Pittsburgh International Airport was constructing its new terminal, officials negotiated with several private airport management firms for the right to manage all the retail activities in the terminal. BAA PLC won a long-term “master concession contract,” under which it was responsible for finishing the construction inside the terminal to suit the needs of its tenants.<sup>82</sup> In 1992, BAA opened its “Airmall” and by 1995, per passenger retail spending at the airport had increased 250 percent.<sup>83</sup>

Moreover, several public airport owners in the U.S. have made use of management contracts. A widely cited example of a successful management contract is Indianapolis Airport Authority’s (IAA) 10-year management contract with BAA. In 1994, IAA’s board noticed that stagnating non-airline revenues were increasing the cost to airlines of serving the airport under the single-till system. Worried about remaining integrated in carrier networks and noting that the terminal “had all the appeal of an East German bus station,” the authority sought management contract bids.<sup>84</sup> Awarded in October 1995 to BAA, the management contract stipulated that IAA pay BAA \$1.75 million a year, and BAA would raise non-airline revenues by \$32 million and back that guarantee with a \$50 million letter of credit.<sup>85</sup> Airport profits were to be split between the contractor and the airport authority, the latter passing on its share of the profits to tenant airlines in the form of reduced rates and charges.<sup>86</sup> By bringing in brand name restaurants and stores, revamping parking and cutting employees, BAA grew terminal revenue from \$17 million

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<sup>82</sup> Truitt, 5.

<sup>83</sup> Government Accountability Office. Report to the Subcommittee on Aviation, Committee on Transportation and Infrastructure, House of Representatives. *Airport Privatization: Issues related to the sale or lease of U.S. commercial airports*. Washington, DC: November 1996, 25.

<sup>84</sup> O’Malley, Chris. “Airport prepared to fly solo: Departed private manager left innovative lesson plan for authority to follow,” *Indianapolis Business Journal*, July 21, 2007.

<sup>85</sup> Ibid.

<sup>86</sup> GAO.

to \$28 million and parking revenue from \$17 million to \$26 million between 1995 and 2005. The contract was renegotiated in 1998 and extended until 2008, although in 2007 BAA announced its intention to end the contract one year early because of an ownership change and a decision to refocus on its U.K. airports.<sup>87</sup>

Other airports operated under management contracts include Orlando's Sanford Airport; Burbank Airport, which is owned jointly by the cities of Burbank, Glendale, and Pasadena, California; Atlanta's Hartsfield Airport; and Miami International Airport, among others. Management contract compensation structures vary widely and can assume the form of performance incentive payments, management fees, maximum profit or loss restrictions, or even capital investment commitments.<sup>88</sup>

Long-term leases, however, have proved inherently more problematic to pursue due to the federal grant restrictions regarding airport revenue diversion. In 1989, Albany County, New York, attempted to sell or lease its airport to the private sector, but a special panel convened by the FAA deadlocked over the legality and public interest of the proposed transaction: "Basically, the FAA objected to both proposals because the purchase or lease payments would constitute an impermissible transfer of airport revenues to off-airport purposes."<sup>89</sup> Following the Albany failure, President George Bush signed an executive order in April 1992 encouraging the privatization of state and local government infrastructure by enabling the public owners to free themselves of previous federal grant restrictions, like the airport revenue retention requirement, by repaying past federal grants. Although the order instructed agencies to use the historic value of the grants and deduct reasonable depreciation in calculating the repayment due, the initiative

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<sup>87</sup> O'Malley.

<sup>88</sup> GAO.

<sup>89</sup> Gomez-Ibanez, Jose and John R. Meyer. *Going Private: The International Experience with Transport Privatization* (Washington, DC: The Brookings Institution, 1993).

did little to spur increased interest in privatization. In short, the revenue retention requirement and the prospect of grant repayment combined to make a sale or long-term lease of an airport economically unattractive and legally murky.

In light of these ongoing economic and legal impediments to increased private sector participation, Congress decided to establish a privatization demonstration program under the 1996 Aviation Reauthorization Act to determine if “airport privatization in the United States could generate alternative sources of capital for airport development and provide benefits such as improvements in customer service.”<sup>90</sup> The Act authorizes the FAA to permit up to five public airport owners to sell or lease an airport. However, only one large hub air carrier airport can participate in the scheme and it can only be leased. In order to make privatization feasible and attractive, the Act exempts the airport sponsor from several federal requirements:

- The revenue retention requirement is lifted for the public airport sponsor so that it can use the revenues from the lease or sale for non-airport purposes – provided it can garner the approval of 65 percent of the air carriers (by number of carriers and by landed weight) at the airport for the privatization.
- The revenue retention requirement is also removed for the new private operator so that it can earn a return on investment from the operation of the airport. The private operator must gain approval of 65 percent of the air carriers (by number of carriers and by landed weight) at the airport if it seeks to increase airside charges at a rate that exceeds the consumer price index.
- The public sponsor is not obliged to repay federal grants and return property acquired with federal assistance once the airport is leased or sold.<sup>91</sup>

The FAA grants these exemptions contingent upon a number of assurances that the private and public operators will fulfill specific duties. These include the private operator’s obligation to ensure continued access to the airport on “reasonable terms,” while the public sponsor must provide a plan for the continued operation of the airport should the private operator

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<sup>90</sup> Burton, 605

<sup>91</sup> FAA News. Fact Sheet: Chicago Midway Airport Privatization Program. Washington, DC: Federal Aviation Administration, April 2008.

default or enter bankruptcy. Moreover, the private operator must provide assurance that it will operate the airport safely, mitigate noise and environmental impacts, abide by any collective bargaining agreements already in place, and continue maintenance and improvement of the airport.<sup>92</sup>

Removing the revenue retention requirements and specifying the respective obligations of the partners introduced the legal certainty and economic incentive necessary to encourage the transfer of an airport between the public and private sectors. The pilot program has a two-step application process: The public owner submits a preliminary application to the FAA, and upon approval, solicits bids, selects a private sponsor, negotiates the terms and submits a final application to the FAA. However, there has been only limited interest in this scheme due to the complex approval procedures and the majority airline consensus rule.<sup>93</sup> As of March 2009, only six applications had ever been filed with the FAA, with three withdrawn in 2001 and one terminated in 2008.<sup>94</sup>

To date, the only airport privatized under the demonstration program was Stewart International Airport in Newburgh, N.Y. Stewart International Airport is the nation's 194th busiest airport,<sup>95</sup> and was leased for 99 years to the National Express Group, a United Kingdom-based private operator in 2000. The New York State Department of Transportation netted \$35 million upfront from the transaction and NEG was obligated to pay 5% of gross income on the earlier of the lease's 10<sup>th</sup> anniversary or when traffic exceeded 1.38 million passengers.<sup>96</sup>

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<sup>92</sup> Ibid.

<sup>93</sup> Graham, 69.

<sup>94</sup> FAA, *Airport Privatization Pilot Program* (accessed April 15, 2009); available from [http://www.faa.gov/airports\\_airtraffic/airports/airport\\_obligations/privatization/](http://www.faa.gov/airports_airtraffic/airports/airport_obligations/privatization/)

<sup>95</sup> FAA, *Calendar Year 2006 Passenger Activity Commercial Service Airports in US*, October 18, 2007 (accessed March 2009); available from [http://www.faa.gov/airports\\_airtraffic/airports/planning\\_capacity/passenger\\_allcargo\\_stats/passenger/media/cy06\\_primary\\_mp\\_comm.pdf](http://www.faa.gov/airports_airtraffic/airports/planning_capacity/passenger_allcargo_stats/passenger/media/cy06_primary_mp_comm.pdf)

<sup>96</sup> Nichol.

However, the lease came to an abrupt end in 2007 when NEG announced its intention to exit the airport operating business. The Port Authority of New York and New Jersey expressed interest in developing Stewart as a reliever airport and purchased the remaining 93 years on the lease from NEG for \$78.5 million.<sup>97</sup>

Ten years after the act's authorization, the City of Chicago filed the first application to privatize a large hub airport on September 16, 2006. With the FAA's preliminary approval in hand by October 2006, the City of Chicago was poised to undertake the largest airport privatization in United States history.

#### *INTERNATIONAL AIRPORT PRIVATIZATION EXPERIENCES*

The pioneering example of airport privatization is the 1987 initial public offering of 100 percent of the shares in the British Airport Authority (BAA) that netted the British government £1.225 billion.<sup>98</sup> In 1986, as part of the Conservative Government's policy to reduce the financial burden on the state of government-owned enterprises, the Airports Act was introduced with the following objectives:

- “to encourage enterprise and efficiency in the operation of major airports by providing for the introduction of private capital;
- in general to minimize the subsidizing of air transport facilities by the ratepayer or taxpayer (airports, whoever their owners, should normally operate as commercial undertakings); and
- to ensure that all U.K. airports maintain the highest standards of safety.”<sup>99</sup>

The act decreed that BAA airports should be transferred from government ownership into a private company listed on the stock exchange. Seven airports were transferred: Heathrow, Gatwick and Stansted airports in London; Edinburgh, Glasgow and Aberdeen airports in

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<sup>97</sup> Rife, Judy, “Port Authority Approves Stewart Airport Buyout,” Times Herald-Record, January 26, 2007; available from <http://www.recordonline.com/apps/pbcs.dll/article?AID=/20070126/NEWS/701260321/-1/NEWS>

<sup>98</sup> BAA, *Our History* (accessed December 2008); available from [http://www.baa.com/portal/page/Corporate%5EAbout+BAA%5EOur+history/6f666da45a282010VgnVCM100000147e120a\\_\\_\\_/448c6a4c7f1b0010VgnVCM200000357e120a\\_\\_\\_/](http://www.baa.com/portal/page/Corporate%5EAbout+BAA%5EOur+history/6f666da45a282010VgnVCM100000147e120a___/448c6a4c7f1b0010VgnVCM200000357e120a___/)

<sup>99</sup> Humphreys, Ian, Graham Francis, and Jackie Fry. “Lessons from Airport Privatization, Commercialization, and Regulation in the United Kingdom.” Transportation Research Record 1744, *Paper No. 01-3239*, 2001, 10.

Scotland; and Prestwick airport. Each airport was set up as a subsidiary of BAA plc and was now required to self-finance future development. The decision not to break up BAA and introduce ‘competition’ through divvying up its seven airports, or at least BAA’s three London airports, to different owners was controversial, and ignites regular debate among privatization observers. “Interestingly, the demand for break-up has tended to come from academics, political sources, and potential investors, rather than from airlines. With the exception of Virgin, British airlines have remained conspicuously neutral on the subject of airport ownership.”<sup>100</sup> In December 2008, however, BAA Plc put up Gatwick Airport for sale.<sup>101</sup> Currently, BAA is the largest airport operator in the world, serving 230 million passengers yearly through its ownership of seven airports in the United Kingdom and its management of 11 airports outside the UK.<sup>102</sup>

While the assets of the major British airports are in private hands, BAA operates them in a highly regulated environment. The British Monopolies and Mergers Commission sets rates and charges, and large airport development plans are subjected to extensive public inquires with final decision-making authority resting with the British national government.<sup>103</sup> The net effect: “BAA has been encouraged by the price control on aeronautical charges to seek out [unregulated] revenues elsewhere.”<sup>104</sup>

Several commentators note that beyond providing government and shareholders with financial returns, the principal impact of privatization in the UK appears to be increased commercial activity and revenue at the airports. The change in ownership does not appear to have delivered operational and cost efficiency gains often touted as primary reasons to privatize.

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<sup>100</sup> Toms, Mike. “UK-Regulation from the Perspective of the BAA plc,” in Forsyth, Peter., ed. *The Economic Regulation of Airports*. Aldershot: Ashgate Publishing Limited, 2004.

<sup>101</sup> BBC News, “*BAA boss on challenges ahead*.” December 22, 2008.

<sup>102</sup> Vasigh, Bijan, and Javad Gorjidoz. "Productivity Analysis of Public and Private Airports: A Causal Investigation." *Journal of Air Transportation* 11.3 (2006): 145.

<sup>103</sup> Neufville, 8.

<sup>104</sup> Parker, David. "The Performance of BAA before and After Privatization: A DEA Study." *Journal of Transport Economics and Policy* 33.2 (1998): 135.

This is borne out in David Parker's data envelopment analysis (DEA) of BAA's technical efficiency before and after privatization. Parker conducted a two-stage DEA analysis to discern if performance at BAA's airports improved after privatization and if BAA's airports outperformed other airports in the UK on efficiency ratings after privatization. Calculating technical efficiency within BAA for each year between 1979/80 and 1995/96, Parker found that the average efficiency rating up to 1986/87, the year of privatization, was 97.6. After removing the recession years of 1991/92, the average technical efficiency rating since privatization was 97.3. These virtually identical ratings reveal that while technical efficiency varies closely with the stage of the business cycle, "it is not obvious that [it] was higher in BAA [after privatization] when compared to the years immediately before privatization."<sup>105</sup>

In examining how BAA's airports performed relative to other airports in the UK on technical efficiency ratings, Parker found great variability in the performance of different airports within the BAA group and over time.<sup>106</sup> The results further revealed that several non-BAA airports scored highly on technical efficiency ratings, and that the different ownership forms, including municipal ownership, of these airports underscores "the view that ownership may not be a critical factor in determining performance."<sup>107</sup>

Parker also notes this his analysis revealed economies of scale in airport operations. This finding could prove significant for the ownership and enhanced efficiency argument in favor of privatization, yet at the same time it proves problematic as realizing this potential would necessitate a concentration of airport ownership, thus leading to further concentrations of market power.

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<sup>105</sup> Ibid, 143. For his decision-making units (DMUs) in the DEA, Parker used passenger numbers, cargo and mail handled as outputs; and employment capital stock variable, non-labor and capital costs in real terms as inputs.

<sup>106</sup> Ibid, 141.

<sup>107</sup> Ibid, 142.

In the particular BAA context, however, Parker concludes, “the impact of privatization on BAA may be blunted by continuing state regulation of outputs and inputs.”<sup>108</sup> Thus, economic regulation on airside charges spurred BAA’s aggressive expansion into retailing and hospitality activities, but as Truitt notes “[these] activities might represent an increase in efficiency and profits for the airports, [but] a significant proportion of these gains occur at the expense of restaurants, hotels and retailing establishments in the surrounding vicinity... Thus, from a general societal perspective, airport privatization does not represent enhanced efficiency and profits as much as it does the transfer of profits from one sector to another.”<sup>109</sup>

While BAA remains the most prominent and far-reaching example of airport privatization in the world, more than 50 countries have introduced various forms of private sector participation in the ownership and management of airports.<sup>110</sup> For example, majority stakes in several major European airports have been sold to private and institutional shareholders. In Asia, the Mumbai and New Delhi airports have been privatized, and minority stakes of the Beijing and Shanghai airports have been sold to private investors. Tokyo’s Narita International Airport was corporatized in 2003 and is slated for privatization in the near future. Airports in South Africa, Argentina and Mexico are also in the process of being partially or wholly privatized.<sup>111</sup> The international privatization example most akin to the route chosen for Midway airport is Australia’s 1996/97 \$2.6 billion privatization of its Perth, Melbourne and Brisbane airports in a lease for fifty years with an option for a further forty-nine years.<sup>112</sup> In their

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<sup>108</sup> Ibid, 144.

<sup>109</sup> Truitt, 4.

<sup>110</sup> Humphreys, 9.

<sup>111</sup> Oum and Yu, 423.

<sup>112</sup> Burton, 499.

bid, the private operators projected significant savings in labor, utilities, services and maintenance costs by improving the efficiency of the airports and renegotiating contracts.<sup>113</sup>

*COMPARATIVE INTERNATIONAL STUDIES OF AIRPORT OWNERSHIP AND EFFICIENCY*

Although efficiency gains and a concomitant increase in customer satisfaction form a core argument in favor of airport privatization, the evidence supporting this link, as gleaned from comparative studies of international airports and their varying ownership structures, is mixed. For example, in setting out to quantify the effects of ownership forms on airport efficiency, Oum and Yu applied a stochastic frontier model to a data set of 109 airports around the world “representing different sizes, ownership and institutional arrangements.”<sup>114</sup> Their findings support the classic argument that private ownership translates into higher efficiencies: There is about 80% probability that airports owned/operated by a majority private firm achieve higher efficiency than those owned/operated by the mixed enterprise with government majority ownership. Moreover, Oum and Yu’s study indicates, “airports owned/operated by government controlled agencies (US ports authorities, shared government ownership, US city or state government, mixed enterprises with government majority ownership) have significantly lower efficiency in multiple airport markets than in single airport markets.”<sup>115</sup> The implications from the Oum and Yu study for the US airport market are twofold: Privatization should transfer 100% or majority ownership to the private sector to reap optimal efficiency gains and government ownership of multiple airports leaches efficiency from operations.

As definitive as Oum and Yu regard their findings, however, a study by Vasigh and Goorjidoz concludes the opposite. To investigate ownership’s influence on operational and financial efficiencies, the researchers divided 22 major airports in the US and Europe into three

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<sup>113</sup> Sander.

<sup>114</sup> Oum and Yu, 426.

<sup>115</sup> Ibid, 432.

groups based on private ownership (7 BAA-owned airports), public ownership (8 major US airports) and mixed public-private ownership (7 major EU airports). Vasigh and Goorjidoz employed a total factor productivity (TFP) model to measure airport performance in terms of operational and financial efficiencies, and then a regression model to measure the relationship between TFP and ownership structure. They found that no significant relationship existed between airport TFP and ownership structure, but rather that airport productivity and efficiency is dependent upon the level of competition, choice of market and regulatory control.<sup>116</sup>

Moreover, Vasigh and Goorjidoz found that the US airports group, representing public ownership, posted the highest average annual TFP throughout the five years studied, outperforming the BAA group and the mixed ownership European group. They attribute this finding to how

“US airports, although marked as public ownership owned by government departments or public authorities, [contract the] majority of their operations to private enterprises. Since US airports operate in a competitive environment with significant private contractors of their operations, it is not unexpected to see that their performances are not significantly different as compared to the airports owned by the private enterprises under this study.”<sup>117</sup>

The U.S. context for airport privatization is without peer and the long-term lease of Midway International Airport is precedent setting. Whether or not further regulatory adjustments are made to enable other public operators in the United States to follow suit, and whether or not they will want to, depends in large part upon the Midway deal’s ability to realize its objectives and benefit its varied stakeholders.

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<sup>116</sup> Vasigh and Gorjidoz, 160.

<sup>117</sup> Ibid.

#### IV. THE MIDWAY INTERNATIONAL AIRPORT PRIVATIZATION

On September 30, 2008, Mayor Richard Daley unveiled the winning bid of \$2.521 billion from Midway Investment and Development Company (MIDCo) for a 99-year-lease of Midway Airport, heralding the privatization as a “transaction [that] will provide unprecedented benefits for the traveling public, the airlines and the taxpayers of Chicago.”<sup>118</sup> The following week, the Chicago City Council debated and approved the deal unanimously, and the FAA told the press that approval of the privatization would happen by the end of 2008 or in early 2009.<sup>119</sup> The first privatization of a major American airport was underway.

##### *PRIVATIZATION PIONEERS*

The City of Chicago is no stranger to privatization. In 2005, the city closed on the 99-year lease of the 8-mile long Chicago Skyway toll bridge for \$1.8 billion – the first major transaction of its kind in the United States. Parallel to the Midway privatization process, the City sold control of downtown parking garages to Morgan Stanley for \$563 million in 2006 and netted \$1.2 billion in 2008 from a 75-year concession to Morgan Stanley to operate and collect revenues from the city’s 36,000 parking meters.<sup>120</sup> The city’s previous Chief Financial Officer and architect of the Skyway deal – Dana Levenson– came from Wall Street and has since returned to it as head of the Royal Bank of Scotland’s North America Infrastructure and Advisory business.<sup>121</sup> Levenson and his successor’s championing of the privatization of the city’s transportation and infrastructure assets rests on their assessment that cash-strapped US cities should take advantage of the asset privatization boom: “There are always possibilities [for

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<sup>118</sup> FAA News. Fact Sheet: Chicago Midway Airport Privatization Program. Washington, DC: Federal Aviation Administration, April 2008.

<sup>119</sup> Wisniewski, Mary. "FAA may Rule by Year-End on Midway Deal." *Chicago Sun-Times*, November 9, 2008

<sup>120</sup> Levin, Matt. “Morgan Stanley wins \$1.2 bn Chicago parking deal.” *Infrastructure Investor*, December 2, 2008 (accessed March 2009); available from <http://www.infrastructureinvestor.com/Article.aspx?aID=0&article=32690>

<sup>121</sup> Thornton

further privatizations],” Levenson told *Infrastructure Investor* on the close of the parking meter transaction. “A bigger question is what are the assets that are owned by other states and local governments throughout the rest of the country? Chicago is simply showing the way and exercising leadership.”<sup>122</sup>

But the city’s pioneering privatizations have not escaped scrutiny from those looking beyond the sticker tag to question who really wins and loses, and by how much and when from these transactions. Reactions to the financial details of the Skyway and parking meter deals underscore the lack of consensus as to how the city best improves its long-term fiscal health: Should it remove these assets from its balance sheet for an immediate financial gain or should it retain them for their inherent value and potential future revenue stream? For instance, Levenson claims the city earns as much in annual interest on the \$500 million it netted from the Skyway deal as it used to make from operating the road (\$25 million). But some analysts question whether or not the city could have earned more without privatizing. According to analysis from one financial advisory firm, Chicago could have raised tolls and sold tax-exempt municipal bonds backed by the scheduled hikes. That way, the city would have received the up-front cash it needed while holding on to a portion of the proceeds from the toll hikes. Now, however, the private investors, Macquarie and Cintra, pocket that income.<sup>123</sup>

Under the terms of the deal, parking meter rates will increase across the board in the next five years, and in some high-congestion downtown areas will more than double from the current rate of \$3 to \$6.50 by 2013. After five years, the system value will adjust by inflation, the addition of more meters, expansion of hours, or further rate increases. Morgan Stanley and its

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<sup>122</sup> Levin.

<sup>123</sup> Thornton

operating partner LAZ Parking will maintain the system and collect revenues.<sup>124</sup> The deal structure raised Chicago 5th Ward Alderwoman Leslie Hairston's hackles:

“It's a bad deal for the city. Just because it's cash upfront does not mean we won't need the (parking meter) money 60 years from now,” Hairston said. “This is the third time the city has rushed aldermen on a privatization deal, and I think it is done by design. And every time they do this, I will vote no.”<sup>125</sup>

But the Hairston-esque stands are few and far between. The political willingness to raise parking meter rates or impose toll hikes is naturally small, and privatization offers a convenient way to generate revenues while obfuscating responsibility for future higher prices: “In many ways, privatization can take an activity off the political agenda.”<sup>126</sup>

#### *THE MIDWAY AIRPORT PRIVATIZATION OBJECTIVES*

Ten years after the FAA launched its privatization demonstration program, on Sept. 16, 2006, the City of Chicago filed its preliminary application for Chicago Midway International Airport's (MDW) participation in the program. In her letter to the FAA, Nuria Fernandez, the city's Commissioner of Aviation, expressed her confidence that Midway International Airport was a strong candidate for the program and its successful privatization could serve as a template for further privatizations under the program.<sup>127</sup>

Issued in February 2008, the city's Request for Qualifications, which enabled prospective bidders to formally express their interest in bidding on the concession and lease, listed three primary objectives for pursuing privatization:

- “Protect the Public Interest;
- Risk Adjusted Value Optimization; and

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<sup>124</sup> Levin.

<sup>125</sup> Hutson, Wendell. “Black aldermen defend their vote on parking meters. *The Chicago Defender*, December 10, 2008 (accessed March 2009). Available from <http://www.chicagodefender.com/article-2677-black-aldermen-defend-their-vote-on-parking-meters.html>

<sup>126</sup> Gomez-Ibanez, 4.

<sup>127</sup> FAA, Office of the Associate Administrator for Airports, Preliminary Application under 49 U.S.C. 847134 for privatization of Chicago Midway International Airport. (Accessed November 2008); available from <http://www.regulations.gov>

- Fair and Transparent Process.”<sup>128</sup>

To fulfill its first objective, the city said it would “protect the public interest within the context of seeking value for the City and the airlines.”<sup>129</sup> Its concrete steps for fulfilling this objective included: Establishing a new rate-setting methodology for airlines; increasing operating efficiencies, and improving customer amenities and satisfaction through “incentive provisions” in the private operator’s new use agreement with the airlines; and ensuring that the highest levels of passenger safety and security are maintained through a raft of contractual provisions.

Under its “risk adjusted value optimization” objective, the city declared its intention to “maximize sale proceeds.”<sup>130</sup> The city also stated its requirement that the private operator maintain, improve and modernize Midway Airport in accordance with standards set forth in the future transaction document. Moving forward, the city will monitor the private operator’s compliance with these standards and will obligate the private operator to satisfy minimum capital investment requirements.<sup>131</sup>

Lastly, the city’s objective of a “fair and transparent process” would ensure that the privatization of Midway Airport was implemented such that the airport “continues to be available for public use on reasonable terms and without unjust discrimination; the interests of general aviation users will not be adversely affected; and there will be no unfair or deceptive trade practices or unfair methods of competition.”<sup>132</sup> The city also underscored that the future private owner would be bound to respect any employee collective bargaining agreement in effect on the effective date of the proposed long-term lease.

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<sup>128</sup> Ibid, RFQ, 1.

<sup>129</sup> Ibid.

<sup>130</sup> Ibid.

<sup>131</sup> Ibid, Section 2 – Objectives of the Privatization Initiative

<sup>132</sup> Ibid.

These objectives – however convolutedly titled --, their invocation of the various stakeholders in an airport privatization, and the concrete steps delineated in the application for their attainment illustrate the complexity of this undertaking. Whether or not the city’s pioneering airport privatization can serve as a template for others depends in large part on how its objectives were or are on route to be attained.

*FOR SALE BY OWNER: PROFILE OF MIDWAY INTERNATIONAL AIRPORT*

Located 10 miles southwest of downtown Chicago, Midway Airport is nestled in the nation’s third most populous city and in a metropolitan region with a population of more than 9 million.<sup>133</sup> Ranked as the 25<sup>th</sup> busiest airport in the United States, Midway enplaned close to 9 million passengers in 2006. Moreover, from 1996 to 2006, Midway was the fastest growing airport among the fifty largest airports in the United States, increasing its number of enplaned passengers by approximately 100 percent.<sup>134</sup> Although the airport complex covers little more than one square mile (approx. 750 acres), the city claims it is the world’s busiest square mile in aviation with nearly 285,000 flight operations in 2005.

Midway International Airport was as busy – relatively speaking – in the 1920s as it was in 2005. Built in 1924 as a single airstrip, Midway airport was acquired by the City of Chicago in 1927, and by 1929 had earned the moniker of busiest airport in the world.<sup>135</sup> Renamed in honor of World War II’s Battle of Midway in 1949, Midway was soon too small to serve the needs of a rapidly growing Chicago and the city began to develop O’Hare International Airport. Opened in 1955, O’Hare quickly eclipsed Midway and by 1962 the airlines had shifted all scheduled air traffic from Midway to O’Hare. Midway languished until deregulation of the

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<sup>133</sup> Ibid, RFQ, 3.

<sup>134</sup> U.S. Department of Transportation, Bureau of Transportation Statistics, National Transportation Statistics, tbl. 1-41 (accessed November 2008); available from [http://www.bts.gov/publications/national\\_transportation\\_statistics/html/table\\_01\\_41.html](http://www.bts.gov/publications/national_transportation_statistics/html/table_01_41.html)

<sup>135</sup> FAA preliminary application, RFQ, 8.

airline industry in 1978, which opened up the market for low-cost and smaller carriers. The real boost to Midway came in 1985 when Southwest Airlines commenced operations, with a fleet of similar low-cost carriers following suit.<sup>136</sup> Midway thus carved out a market niche and continues to tout itself as “the premier point-to-point, or O&D [origination and destination] airport in the United States, providing low-cost service to business and leisure travelers throughout the region.”<sup>137</sup>

This niche is an important service differentiation in a multiple airport market. As the second busiest airport in the United States, O’Hare dwarfs Midway in terms of airlines in residence and passengers served. Both American Airlines and United Airlines have significant hubs at O’Hare and the airport is in the midst of a \$15 billion expansion project.<sup>138</sup> Standing in stark contrast to O’Hare is Gary/Chicago International Airport, located about 25 miles from downtown Chicago in Indiana. No commercial carriers currently serve the Gary airport, but it does serve as a base for corporate aircraft. In 1995, the city of Chicago and the city of Gary entered into an interstate airport compact establishing an Interstate Airport Authority that reviews and approves certain actions affecting the three airports. In its RFQ, the city stated it would obtain all approvals required pursuant to the compact to finalize the concession agreement. Both O’Hare and Midway are served by direct rapid rail transit links into downtown Chicago, and all three airports are connected to the regional expressway network.<sup>139</sup>

In its RFQ marketing pitch, the city highlights Midway’s “state-of-the-art facility, modest capital expenditure plans, untapped commercial upside, and international route potential.”<sup>140</sup> In

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<sup>136</sup> Burton, 602

<sup>137</sup> FAA Preliminary Application, RFQ, 5.

<sup>138</sup> Hilkevitch, Jon and Julie Johnsson. “Airlines seek to scale back O’Hare’s expansion.” *Chicago Tribune*, November 20, 2008 (accessed March 19, 2009); available from <http://archives.chicagotribune.com/2008/nov/20/travel/chi-ohare-20-nov20>

<sup>139</sup> FAA preliminary application, RFQ, 10-19.

<sup>140</sup> *Ibid*, 5-6.

2004, Midway opened a new terminal, increasing the number of gates from 29 to 43 and providing 53,000 square feet of concession space. The airport's five runways were resurfaced in the late 1990s, a new parking garage opened in 2005 adding 6,300 spaces to bring the total up to 13,500, and the city opened a Federal Inspections Services facility in 2002 to enable air carriers to expand internationally. The city mentioned that all current concessions have short-term termination provisions, providing the new private owner with increased flexibility to enhance commercial revenues. Moreover, Midway employs a city staff of only 192, of whom 19 are management and 173 are unionized.<sup>141</sup> In short, the city appears to have already executed or embarked on the capital development projects necessary for outfitting the airport to keep pace with airline and passenger demands; moreover, its extensive use of concessions and outsourcing makes the transition to private ownership easier and more attractive for both parties.

Major parties to the privatization effort – thanks to the 65% approval clause of the demonstration program – are the airlines in residence at Midway. At the time the RFQ was issued, seven airlines provided nearly 300 daily flights to more than 55 markets. However, Southwest Airlines accounted for approximately 64% of the passenger traffic at Midway, ATA for 20% and the remaining carriers all had 5% or below of market share.<sup>142</sup> Clearly, progress toward privatization pivoted on Southwest's support for the initiative.

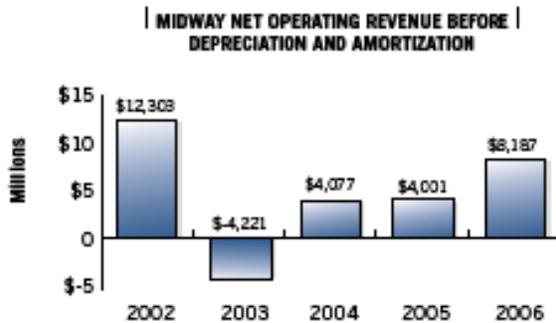
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<sup>141</sup> Ibid.

<sup>142</sup> Ibid, 14.

The final piece to the privatization puzzle that potential bidders would require was the airport’s financials. In its RFQ, the city reported that the airport had total income in 2005 of \$133 million, 69% of which came from operating revenue, 17% from PFCs and 14% from federal grants. The sum total covered Midway operating and capital expenses, fund deposits and net

Figure 6



debt service requirements. The \$92 million in operating revenue was generated from landing fees (\$15.6 million), terminal area use charges (\$17.4 million), rental fees (\$12.8 million), and concession revenues (\$46 million).<sup>143</sup> Closer inspection of the financial statements filed with the preliminary application, however, reveals that net operating revenue before depreciation and amortization hovered at approximately \$4 million in 2004 and 2005.<sup>144</sup> Moreover, data presented in the city’s Department of Aviation 2006 Annual Report reveals wild swings in net operating revenue between 2002 and 2006 as exhibited in **Figure 6**.<sup>145</sup>

Irrespective of the swings in operating revenues, it was made explicit in the RFQ that the private investors would have continued access to federal grant and PFC funding on essentially the same terms as the city. According to the RFQ, Midway was expected to receive \$3 million per year of AIP grants through 2012 and, under the pilot program, the private operator would be considered a “public agency” for the purposes of the PFC program with the corresponding ability

<sup>143</sup> Ibid, 12.

<sup>144</sup> Ibid, section 5, 30-34.

<sup>145</sup> Chicago Airport System: 2006 Annual Report, 38.

to levy and use PFCs.<sup>146</sup> The city also stated that a portion of the privatization's proceeds would go toward paying off Midway's existing financial debts.

According to the city, the long-term concession and lease of Midway would be a landmark transaction offering a "first mover advantage to [a] new asset class for privatization in the U.S."<sup>147</sup> Midway's profile left no reason to doubt that its privatization would garner interest from private investors. Boasting impressive passenger traffic growth, the airport was an anchor in an economically robust region; the city had absorbed much of the recent and even ongoing costs of its capital development and expansion; and the pilot program guaranteed the private owner access to favorable public financing. How – and by how much -- a private operator could increase net operating revenue to earn a return on its investment remained an open question, however. Moreover, enabling the precedent-setting airport privatization to happen would prove substantially different than merely having reasons why it could.

#### *DEAL EXECUTION*

The city went on the offensive even before filing the preliminary application. In an exact replica of the Skyway transaction process, the Illinois General Assembly passed enabling legislation that applied a property tax exemption to the land under Midway, thus further encouraging private investors to bid – and bid high.<sup>148</sup> Mayor Daley also immediately set to work securing the necessary airline support for a privatization deal and negotiating the terms of a new use agreement that would "establish the new rate-setting methodology" articulated as a core objective of the privatization. As Southwest Airlines represents 80% of flights at Midway, Mayor Daley put in calls to the airline's chairman, but was met initially with skepticism. As

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<sup>146</sup> FAA preliminary application, RFQ 12-13.

<sup>147</sup> *Ibid*, 5.

<sup>148</sup> Burton, 626.

Southwest's VP Bob Montgomery told the *Chicago Tribune*: "We wanted to protect Midway's role as a low-cost airport. Our customers like value."<sup>149</sup>

In the end, Daley offered Southwest and the other airlines a sweetheart deal, fulfilling the city's intention to "provide for long-term certainty and favorable levels of rates and charges" for the airlines. Under a new 25-year use agreement – significantly longer than the prevailing 10-year agreements --, the city would freeze airline rates for both landing fees and terminal use rentals for six years at a level below 2008 charges. For the remainder of the agreement's 25 years, total fees can be raised by no more than the core consumer price index, which excludes energy and food.<sup>150</sup> Moreover, the airlines would retain their existing gate rights at Midway. After the use agreement ends, MIDCo must obtain the approval of 65% of the air carriers (by number of carriers and by landed weight) to increase airside rates and charges at a rate that exceeds the consumer price index, as stipulated by the privatization demonstration program. These terms secured Southwest's support, after which the remaining airlines came on board, and the city could begin to solicit bids.

Initial projections by independent transportation experts placed the bid range from \$2 to \$3.5 billion. Observers were split as to what effect the current credit crunch and financial crisis would have on the bids. According to the director of the Chaddick Institute for Metropolitan Development at DePaul University, Joseph Schweiterman, "these deals are a harder bargain than they were a year or two ago. The airline situation is so dire that you cannot ignore the risks of another round of bankruptcies cutting into the revenue stream."<sup>151</sup> At the same time, however, the steady revenue streams of an airport provide a safe haven for investors in a sea of market

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<sup>149</sup> Chandler, Susan. "Midway Leasing Plan Hits Bumps: Tight Credit Market Likely to Keep Bids 20% Lower." *Chicago Tribune*, September 7, 2008.

<sup>150</sup> Mayor's Press Office

<sup>151</sup> Barner, Craig. "Deal to Privatize Midway may pay for Chicago Projects." *Engineering News-Record*, October 6, 2008.

turbulence. As Chicago's Chief Financial Officer Paul Volpe told the city council, "these are long-term, steady investments. It attracted greater value today than it would have in a healthy economy when the Dow was rolling."<sup>152</sup>

By April 2008, the city received six bids, which it reviewed for the bidders' technical capability, financial resources and commitment to submit a competitive price. It winnowed the six to four by June 2008: The MIDCo consortium consisting of Citi Infrastructure Investors and John Hancock Life Insurance bidding with YVR Airport Services; a consortium of Macquarie Group-affiliated funds; German infrastructure developer Hochtief bidding with Goldman Sachs Global Infrastructure Partners; and Morgan Stanley Infrastructure Partners bidding with Aeroports de Paris.<sup>153</sup>

Ultimately, the city awarded the 99-year lease to MIDCo, which bid \$2.52 billion for the airport. While the city declines to release the details of its vetting process or the amounts of the competing bids, it is rumored that MIDCo's bid was at least \$700 million more than the next-highest offer.<sup>154</sup> Citi, John Hancock and YVR, a Canadian airport operator, are approximately 89%, 8% and 3% equity owners, respectively, in MIDCo. Lisa Schrader, deputy CFO, told the press: "That's how these transactions work: You have equity partners and you have an operator."<sup>155</sup> According to George Casey, CEO of YVR, the new operator has a growing to-do list at Midway that includes adding valet parking, doubling the space for shops and services, and encouraging Southwest to use the airport as a base for its international ambitions. "We take a very aggressive approach," he told Toronto's *The Globe and Mail*.<sup>156</sup>

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<sup>152</sup> Spielman, Fran. "Aldermen Delay Midway Vote on Worries about Deal." *Chicago Sun-Times*, October 7, 2008.

<sup>153</sup> Podkul, Czery. "Citi-led consortium wins \$2.5bn Midway Airport privatization." *Infrastructure Investor*, October 1, 2008 (accessed October 2008); available from <http://www.infrastructureinvestor.com/Article.aspx?article=28983>

<sup>154</sup> Infrastructure Investor Magazine, *Buying Cinderella*, April 2009.

<sup>155</sup> Barner

<sup>156</sup> Ebener, David. "On a Wing, and a Deep-Pocketed Partner." *The Globe and Mail*, October 18, 2008.

However, the deal has flown straight into the turbulence of the global economic downturn and credit crunch. Under the agreement signed with the city in October 2008, MIDCo was supposed to reach financial close by April 6, 2009 and make its \$2.5 billion upfront payment.<sup>157</sup> By the last week of March 2009, there were rumblings in the press that the deal might miss the deadline, given MIDCo's inability to pull together adequate financing to make the payment. According to *Infrastructure Investor*, MIDCo was seeking about \$800 million in debt prior to the close.<sup>158</sup> But John Schmidt, a lawyer with Mayer Brown, which advised the city on the transaction, highlighted the depth of MIDCo's difficulties:

“The market was already tough when we did [this deal], but the stock market has fallen about 35 percent since the bidding in late September, so it's even tougher. But it's not just the debt financing. It's also the equity crunch, which is created by the fact that what looked like a good deal in September now doesn't look quite as good compared with the falling prices of other airports.”<sup>159</sup>

Schmidt and the Mayor's office, however, appeared to take the stalemate in stride, owing largely to the transaction team's foresight in negotiating what amounts to an insurance policy for the city. As the deadline neared, Mayor Daley had two options: Grant MIDCo a six-month extension to put the financing together or cancel the deal and keep the group's \$126 million deposit. When MIDCo bid, it initially posted a \$75 million unconditional letter of credit, which, when it was declared the winning bidder, it had to raise to five percent of its bid -- \$126

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<sup>157</sup> U.S. DOT/FAA – Concession and Lease Agreement. (Accessed March 2009); available from <http://www.regulations.gov>.

<sup>158</sup> Podkul, Czery. “Citi-led investor group seeks extension on Midway financing.” *Infrastructure Investor*, March 31, 2009 (accessed March 2009); available from <http://www.infrastructureinvestor.com>.

<sup>159</sup> Baxter, Brian. “Mayer Brown Awaits Outcome of Midway Airport Privatization.” *The AmLaw Daily*, April 6, 2009 (accessed April 2009); available from <http://amlawdaily.typepad.com/amlawdaily/2009/04/midway-airport-privatization-close-postponed.html>.

million.<sup>160</sup> Schmidt calls the arrangement a “penalty provision” and said it grew out of the 2005 Chicago Skyway Toll Bridge deal:

“You really don’t want to be in a position of [supporting privatizations] unless you have a very high level of certainty that you’re going to close. So these amounts of money – like the \$75 million and \$126 million – have always been set at levels so that no one would ever voluntarily fail to close with that much money at stake.”<sup>161</sup>

And it appears that the city is also quite reluctant to walk away from the prospect of a \$2.5 billion payday: On April 8, 2009, the mayor agreed to a two-week extension to negotiate with MIDCo the terms of a six-month extension.<sup>162</sup>

Factoring into the city’s decision is the knowledge that if this deal collapses and it opts again to seek bids, it will most likely have to settle for less money. At 28-times EV/EBITDA (enterprise value/earnings before interest, taxes, depreciation and amortization) in October 2008, the Midway deal led some observers to consider the airport overvalued:

“Chicago Midway had the characteristics of a trophy asset for the acquirer, which resulted in the willingness to pay a considerable premium given listed comparables such as Zurich or Vienna airport were trading at EV/EBITDA multiples in the range of 6.0x.”<sup>163</sup>

Moreover, as Schmidt alluded to, the depth and severity of the economic downturn has led to steeply declining passenger traffic and would necessitate a “revaluation” of any new or renewed airport privatization. For example, passenger volumes at Midway in December 2008 were down 13% over last year and off 11% for the full year.<sup>164</sup> Debt-rating agency Fitch Ratings forecasts

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<sup>160</sup> Ibid.

<sup>161</sup> Ibid.

<sup>162</sup> Associated Press, “Talks continue on closing Midway Airport lease.” *Forbes*, April 8, 2009; available from <http://www.forbes.com/feeds/ap/2009/04/08/ap6269168.html>

<sup>163</sup> Eckermann, Henning and Benita von Lindeiner, “Infrastructure – defensive portfolio diversification.” Partners Group Research Flash, March 27, 2009 (accessed March 27, 2009), 8; available from <http://www.partnersgroup.com/index.php?nav=204,295,296&lang=en>.

<sup>164</sup> The Chicago Airport System, “2008-Airport Statistics, December-Revised Midway,” (accessed March 2009); available from <http://www.flychicago.com/Statistics/home.shtm>

passenger declines of 10% or more to continue into 2010 for many airports.<sup>165</sup> This will make it more difficult to attract bidders with high willingness-to-pay. Nonetheless, Mayor Daley remains undeterred: “This is a huge crisis that’s affecting all markets,” he told the *Chicago Tribune*. “But there’s money out there. We know there’s money out there.”<sup>166</sup>

For now, the Midway deal remains aloft, but it is unclear how much longer it can stay on route. The credit crunch and economic downturn cast doubt on the structure and viability of the deal, throwing into sharp relief the debate over valuation, revenue maximization, the public interest and the long time horizon of such privatizations.

#### *THE FINANCIALS*

At the time of writing it is unclear whether or not the Midway deal will collapse. Nonetheless, it is still important to examine the transaction as it was originally conceived in order to accurately assess the implications of this deal for its stakeholders and for future airport privatizations in the United States.

Although MIDCo would make a one-time cash payment of \$2.52 billion at the closing of the 99-year concession and lease, it is important to look more closely at the deal structure to determine what the city actually nets and how. Of the total amount, \$1.17 billion will go toward retiring outstanding Midway airport revenue bonds. The city agreed to provide Midway with free police and fire service for the duration of the lease, and has reserved \$225 million from the sale to cover that cost for approximately 20 years. The city will also use \$126 million of the proceeds to undertake and complete capital improvement projects. Lawyers and bond merchants

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<sup>165</sup> Sechler, Bob, “Chicago Midway’s Price Vulnerable To Traffic Slide – Fitch.” *Dow Jones Newswire*, April 2, 2009; available from <http://www.easybourse.com/bourse-actualite/marches/chicago-midway-s-price-vulnerable-to-traffic-slide-fitch-645625>

<sup>166</sup> Mihalopoulos, Dan, “Daley gives winning team six more months to cough up Midway cash,” *The Chicago Tribune*, March 31, 2009; available from [http://newsblogs.chicagotribune.com/clout\\_st/2009/03/daley-gives-winning-team-six-more-months-to-cough-up-midway-cash.html](http://newsblogs.chicagotribune.com/clout_st/2009/03/daley-gives-winning-team-six-more-months-to-cough-up-midway-cash.html)

who helped to negotiate the deal net another \$19 million.<sup>167</sup> This leaves approximately \$1.1 billion in net proceeds.

However, Illinois law mandates that 90 percent of the \$1.1 billion be used for infrastructure improvements or to shore up the city's under-funded pension scheme. Only \$100 million of the deal winds up as discretionary income. Moreover, there is no future flow of airport revenues to the city as the leaseholders are exempt from paying taxes on the property.<sup>168</sup>

The lease mandates that MIDCo maintain reserve requirements. At all times, MIDCO must hold reserves equal to the total amount of debt payable with respect to Midway in the current year and 25% of the projected operating expenses for Midway in the current year.<sup>169</sup> MIDCo's capital improvement plan for the first five years hews to the specifications required by the city and is projected to cost approximately \$38.1 million.<sup>170</sup>

#### *CITY COUNCIL AND PUBLIC OPINION*

Fissures in the support for the deal emerged at the same time as the deal's financial structure became apparent. Although the city council unanimously approved the deal, certain aspects – such as the disconnect between a low-cost carrier airport and the private sector's profit motives – came under scrutiny from aldermen. *The Chicago Sun-Times'* coverage of the council meeting noted that Alderman Ray Suarez pointed out the increase in Skyway tolls and parking fees at downtown garages when the city sold those assets, and asked Volpe:

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<sup>167</sup> FAA, Office of the Associate Administrator for Airports, Final Application under 49. U.S.C. §47134 for privatization of Chicago Midway International Airport. (Accessed November 2008), 5; available from <http://www.regulations.gov>.

<sup>168</sup> Mayor's press office

<sup>169</sup> FAA final application, 13.

<sup>170</sup> Ibid, 38.

“Sometimes you force people to pay a price because they have no choice. You force it down peoples’ throats...What safeguards are we taking to make sure we have a fair [pricing] system in place?”<sup>171</sup>

Volpe replied: “Contractually, none.” But he noted that MIDCo was well-aware of Midway’s customer base: “Southwest Airlines is going to have a hard time attracting passengers to an airport that sells \$25 hamburgers...I don’t think anybody believes that the way to make money off of Midway Airport is to...gouge people.”<sup>172</sup>

At the same time, however, Volpe admitted the city’s desire to net the largest lump sum possible. According to *The Chicago Reader*, Volpe “said the city couldn’t exact property taxes, cut back the years of the lease or demand a portion of the airport’s profits without forcing the leaseholders to lower their price.”<sup>173</sup> Moreover, the same paper also noted that the financial breakdown of the deal leaves little discretionary income to dramatically alter the city’s financial straits: “...in the grand scheme of things [\$100 million] is chump change and everyone in City Hall knows it. It would cover only a fraction of the city’s \$469 million operating deficit.”<sup>174</sup> But city officials are quick to counter that the \$1 billion slated for infrastructure improvements “can be used during this difficult economy to... move Chicago forward, as well as protect Chicago taxpayers.”<sup>175</sup>

Calling the privatization a “unique opportunity for Chicago,” city officials and MIDCo now hope the financing lines up so airport and money can change hands. This trade-off will not be the only one, as MIDCo’s pursuit of profit will fundamentally alter the airport’s cost-structure and relationship with its customers.

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<sup>171</sup> Spielman

<sup>172</sup> Ibid

<sup>173</sup> Joravsky, Ben. "Easy Money: Is the Midway Lease really a Good Deal for Taxpayers?" *Chicago Reader*, October 16, 2008

<sup>174</sup> Ibid

<sup>175</sup> Mayor’s Press Office

## V. AIRPORT PRIVATIZATION IN THE US: THE IMPLICATIONS OF THE MIDWAY DEAL FOR AVIATION STAKEHOLDERS

The Midway Airport privatization is the first of its kind in the United States. As such, it carries significance far outside its impact on its immediate stakeholders. When news of the deal's financial troubles surfaced in April 2009, a Republican mayoral candidate in Toledo, Ohio, who had floated the idea of selling shares in a local airport, told the *The Wall Street Journal*: "The mere fact that the [Midway] sale concludes is all I care about. That lets me know we can do it."<sup>176</sup> But the privatization's significance lies in the deal's details, which carry important implications for those involved and raise several issues for consideration more broadly across the U.S. aviation landscape.

The driving idea behind airport privatization is the liberation of wealth from transportation assets. Public- and private-sector proponents believe it will result in extra cash to local governments, returns to the private investors, improvements to airports, decreased airport congestion and reduced airfares. To assess how likely the Midway deal is to achieve such goals in addition to those articulated for the privatization, it is useful to analyze the transaction and what it may deliver – intended or otherwise – from each stakeholder's standpoint.

### *THE CITY OF CHICAGO*

Given its predilection for privatizing the infrastructure assets on its balance sheet, it is not unexpected that the City of Chicago would embark on the first long-term lease and concession of a large hub airport in the United States. While the privatization of Midway would fill city coffers with cash, the manner in which the privatization was pursued could prove both fiscally irresponsible and politically untenable. It is questionable whether the deal meets its awkwardly articulated "risk adjusted value optimization" objective. For whom has the risk been adjusted

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<sup>176</sup> Michaels, Daniel and Amy Merrick. "Debt threatens takeover of Midway Airport." *The Wall Street Journal*, April 2, 2009.

and the value optimized? It is unclear with the information currently at hand, but what is evident is that the public interest risks were compounded by the City's myopic insistence on equating value optimization with largest upfront financial windfall.

From the outset, the city made revenue maximization the avowed goal of the transaction: "The City's primary objectives are...maximize sale proceeds." The city opted to maximize sale proceeds in the price tag, rather than in a financial arrangement more suited to the lease's long lifespan. As discussion of the Stewart Airport privatization revealed, long-term leases can be structured with a lease payment feature that provides the government with a percentage of the airport's gross revenue. Thus, the public entity is ensured both an immediate financial gain and a steady revenue stream that could increase throughout the lease's lifetime as the airport becomes more profitable. While such an arrangement would have forced the leaseholders to lower their initial bid, the city would recoup the difference and perhaps more over the lease's lifespan.

The argument that a profit-sharing lease payment structure exposes the city to more risk since the private operator's future performance is unknown is not convincing for two reasons. First, experience with management contracts in the United States illustrates that the private airport operator is often incredibly effective at increasing revenues and driving down costs, virtually ensuring increasing future returns. Midway Airport's profile – growing passenger traffic, location in an economically robust region, and lack of immediately necessary large capital expenditures – also provides no indication that a private airport operator would not be able to increase its profitability. Moreover, if bids are awarded on the basis of upfront revenue maximization, the risk to the city of an asset overvaluation with ensuing underinvestment, poor service and eventual default on the part of the private airport operator is increased. In light of the lease's 99-year length, neither the risk nor the value is optimized for the city as any financial

upside accruing to the city from the airport is limited in its longevity. By approaching the privatization with the narrow and conventional motive of immediate revenue generation, the city forfeited the opportunity to secure the diversion of long-term sustainable cash flows from a privatized Midway.

On the surface, the \$2.5 billion landed by Chicago is breathtaking in its magnitude and could generate long-term benefits for the city by helping it fund its other obligations. However, as the details of the Midway deal demonstrate, the city saw much of the sticker price siphoned off to obligations both internal and external to the deal. For instance, almost half - \$1.17 billion – goes toward retiring Midway’s existing debt obligations. The \$225 million the city socked away for 20 years to fund police and fire service at the airport seems meager especially since there is no mention of how the cost of these services will be covered later in the lease. Moreover, the city is already having trouble covering the cost of police and fire service in light of its large and persistent yearly operating deficits. The city remains on the immediate hook for another \$126 million in capital investments at or surrounding the airport, with MIDCo footing the bill for only \$38.1 million in capital investments. These details are significant for other public authorities in understanding their bargaining power vis-à-vis private investors.

Given the long time frame of the lease, the city should seek to match maturities and plow the money into its pension fund obligations. This will help counter any claim that Chicago is spending 99 years of proceeds today. With Illinois law mandating that Chicago sink 90% of the \$1.1 billion in net proceeds into infrastructure improvements or pension obligations, the city is somewhat constrained into fiscal responsibility – yet therein lies another potential pitfall of the privatization. The city finds itself in a catch-22: It should funnel the privatization proceeds toward obligations like pension funds, yet the obscurity of this important action fails to translate

into visible benefits for the taxpayers to tangibly offset any potential increase in the cost of using the airport.

In fact, research on transportation privatization reveals that budgetary gains to the public authority are achieved through losses incurred by other groups. This contention necessitates a return to the other two core objectives articulated for the privatization, namely to “protect the public interest” and have a “fair and transparent process.” In protecting the public interest, the city said it would seek to create value for the city and the airlines, but this may work at cross-purposes with the public’s perceived best interest. Although both the city and MIDCo acknowledge that Midway is a low-cost carrier airport, serving price-sensitive customers with low willingness-to-pay, there is every reason to expect that the private operator’s profit-seeking behavior will translate into increased costs for airport users. In order for the privatization to proceed, the city and MIDCo locked in the airlines at low, long-term rates. This means that the airlines will not have to raise ticket prices, thus ensuring the passenger volumes that create demand for landside services – the airport’s main profit driver. Although MIDCo will seek savings in operational costs, it is highly likely that prices for parking, food and other airport services will escalate. According to the *Chicago Sun-Times*, only 1,400 of the airport’s 13,500 parking spaces will be capped at the rate of inflation.<sup>177</sup>

While landside price increases may remain hidden to passengers for a while – owing to their indirectness – the city would have been wise to retain financial flexibility in the form of lease payments. Such payments would enable the city to make visible investments that could counteract any potential political fall-out or public dissatisfaction with the deal – either at the outset or later on in the lease. Future lease payments based on a percentage of the airport’s profitability and/or a shorter lease life span and the concomitant prospect of a competitive

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<sup>177</sup> Spielman

renewal would have brought the city the financial and political flexibility needed to truly serve the public interest.

Midway also enjoys high passenger captivity for two main reasons: The Chicago air transportation market is heavily segmented with O'Hare serving a different airline and passenger base thus limiting immediate substitution effects, and Midway's urban location and public transportation link make it highly convenient. Of course, the private operator will recognize pricing limitations in its provision of services, but prices are sure to creep upward. Therefore, while the upside for the city and the airlines in the Midway privatization is clear, it is less obvious what benefits accrue to airport users in offsetting the welfare loss from the airport's increased market power – especially since comparative international studies reveal that efficiency gains are nebulous at best.

Lastly, city council members complain regularly to the Chicago press of not having enough time or details on the city's privatization initiatives to adequately consider and account for the blockbuster deals' implications. After engaging in slight political posturing, the council has voted overwhelmingly in favor of these transactions, but Mayor Daley would be unwise to translate this into a mandate for privatization. Again, his forfeiture of a future cash stream circumscribes his ability to counter traction-ready arguments of "borrowing against the future" and to neutralize any aldermanic distancing from the deal. For example, State Representative John Fritchey's remarks at a recent forum for candidates hoping to fill Rahm Emmanuel's vacated congressional seat illustrated the potency of the counterargument to Daley's privatization push:

"Privatization of public assets is like selling off your furniture in order to pay your mortgage," Fritchey said to loud applause from the 500 observers who turned out on Super Bowl Sunday. "I don't think it's a prudent fiscal policy. In the long run what you are going to see are parking meters that

cost \$6 an hour, airport concessions that have tripled in price and it's going to cost you five times what it used to cost you to cross the Skyway. Your job as a congressman is to represent the people, not simply to be accountable to Mayor Daley and take what he says as gospel."<sup>178</sup>

Although the Midway Airport privatization is not optimally structured, getting to the gate first to secure the only available slot for a large-hub airport in the FAA privatization demonstration program was a smart move by Mayor Daley. While the Midway Airport privatization exhibits the classic privatization revenue tradeoff dimension, it differs significantly from the Skyway and parking meter experiences since in those instances the city itself could have levied and retained the profits from higher tolls or rates. Given the federal revenue retention requirement, the only way for public airport owners to gain any *direct* financial benefit from a profitable airport is to privatize it.

*MIDCO*

While Chicago pursued the privatization in a manner that elevated the risk of a potential overvaluation of Midway Airport, it is difficult to ascertain whether or not this is the case with the currently available information. Using the data presented in **Table 1**, the Midway deal's 28-times EV/EBITDA is much higher than the historical average of 17.25 for comparable airport privatizations and is about 20% higher than the next highest on the list.

**Table 1: Cost of Airport Privatization**<sup>179</sup>

Airport	Sale Price	FY 1997 EBIT	PE ratio
<b>Auckland</b>	NZ \$751,400,000	NZ\$69,900,000	10.8
<b>Australia (all 14 phase 2 airports)</b>	A \$730,000,000	NA	17.6
<b>BAA</b>	NA	NA	18.0
<b>Coolangata</b>	A \$104,700,000	A \$5,000,000	21.0
<b>Melbourne</b>	A \$1,307,000,000	A \$58,800,000	22.2
<b>Melbourne, Brisbane and Perth</b>	A \$3,340,000,000	NA	18.3
<b>Mexico Southeast Group</b>	US \$593,300,000	NA	13.4
<b>Wellington</b>	NZ \$150,000,000	NZ \$9,000,000	16.7

<sup>178</sup> Pallasch, Abdon. "Rahm looms over candidates' debate." *Chicago Sun-Times*, February 1, 2009.

<sup>179</sup> Robert J. Aaronson, Strategies for Airports Inc. in Sander, Charles. *Airport Privatization: Trends and Opportunities*, Unisys Global Transportation (accessed November 2008)

Since neither MIDCo’s cost of capital nor NPV threshold are known, any rudimentary financial analysis is limited in its efficacy, but serves nonetheless to reveal a few interesting points. A few simple calculations reveal that the privatization begins to post a positive NPV at net operating revenue growth rates above 15%. **Table 2** presents an NPV sensitivity analysis for a range of discount rates and straight-line profit margin growth rates. For all scenarios, net operating revenue for year 1 (2008) was assumed to be \$8.5 million, an incremental rounding up of the \$8.1 million in net operating revenue in 2006. From the table, it is evident that in order for the privatization to post a positive NPV, MIDCo must grow the revenues by at least 15% per year. Although a range of discount rates is presented, the upper band, between 9% and 12%, most closely approximates MIDCo’s cost of capital. Citigroup, the parent company of Citi Infrastructure Investors, which owns approximately 89% of MIDCo, had a cost of capital of 11% as of May 4, 2009.<sup>180</sup> While transportation assets are typically viewed as low-risk investments, airports are more susceptible to swings in the economy than other modes and their revenue generation is built on the volume of passenger or cargo traffic. This could factor into any risk premium in MIDCo’s cost of capital. At the same time, however, MIDCo retains access to federal grant and PFC funding on essentially the same terms as the City of Chicago.

**Table 2**

<i>Sensitivity of NPV (\$M) over 99 years to discount rate and profit margin growth rate</i>					
		Growth Rate			
		5%	10%	15%	20%
Discount rate	3%	\$ (2,664,410,912)	\$ 69,030,698,030	\$ 3,365,823,222,920	\$ 154,110,678,618,680
	7%	\$ (4,542,388,037)	\$ (1,162,754,206)	\$ 111,362,083,998	\$ 4,632,132,280,413
	11%	\$ (4,665,094,154)	\$ (4,341,852,965)	\$ 1,164,932,858	\$ 172,118,816,033
	14%	\$ (4,649,583,696)	\$ (4,551,626,804)	\$ (2,521,000,000)	\$ 14,086,360,043

From table 1, it is clear that the privatization was green-lighted on the assumption that MIDCo would be able to grow Midway’s net operating revenue by at least 15% each year.

<sup>180</sup> Wikiwealth: The Future of Stock Research (accessed May 4, 2009); available from [http://www.editgrid.com/user/wikiwealth/Wikiwealth\\_Investment\\_Data-WACC-Discount-Rate](http://www.editgrid.com/user/wikiwealth/Wikiwealth_Investment_Data-WACC-Discount-Rate)

This assumption appears optimistic, but not entirely unattainable. The stellar landside revenue growth results BAA achieved at Indianapolis reveal that private airport operators can tap and develop substantial new profit sources. The City of Chicago's recent investments in a new terminal and new parking garage reduce MIDCo's immediate capital outlay to update and improve Midway facilities. There will also be no delay in readying the airport to receive international flights as the city already obtained the requisite infrastructure.

However, there are reasons to be concerned about MIDCo's moneymaking abilities at Midway. The first and most obvious limitation to MIDCo's profitability is the fact that it is hemmed in on all sides by urban development. There is no available land for capacity expansion and at approximately one square mile, accommodating a much larger number of flights and passenger or cargo traffic is simply not an option. Midway's terminal size – at 53,000 square feet – is also not overly large and MIDCo will need to be exceptionally adept at developing more retail, food and concession space within it. While parking is always a key revenue generator, Midway's public transportation link is a pricing limitation for MIDCo.

In fact, MIDCo may encounter several pricing limitations at Midway Airport given the market niche that the carriers in residence serve. As a low-cost carrier airport, the demand for valet parking and other high-end services that YVR plans to introduce will be more limited at Midway than at other airports. Moreover, MIDCo will need to remain cognizant of its relationship with the airlines. Due to the positive externality of air traffic volume on the demand for non-aeronautical services, MIDCo will need to find a price point for its services that is amenable to both the low-cost carrier's customer base and its need to earn a return on investment.

The limited opportunities at Midway for greatly expanding capacity or facilities for commercial services may make meeting an average yearly net revenue growth rate of 15% difficult. The airport's customer base also makes product offerings and pricing trickier than at other airports serving a wider range of carriers and passengers. Midway Airport may not prove an easy place to maintain consistently high levels of revenue growth and the price MIDCo paid means it will have to be very "aggressive" indeed.

#### *AIRLINES*

The carriers in residence at Midway net perhaps the clearest benefits of the entire Midway deal, but the sustainability of their competitive position hinges on MIDCo's activities. The deal terms proffered by Mayor Daley and codified in the new use- and lease-agreement with MIDCo are an improvement over the status quo. They provide for cost savings in the first six years and stability over the duration of the substantially longer contract. This means they will not have to pass on any higher airside charges to their customers.

However, if MIDCo keeps airside charges low, it will be forced to increase landside charges and this works at cross-purposes with the customers both the airport operator and airlines want to retain. The airlines do possess significant countervailing power vis-à-vis MIDCo given the 65% approval clauses. The dominance of Southwest Airlines also reduces the airport's market power, as does the flexibility of the low-cost carrier business model whereby the sunk costs are not as great as with network carriers. Moreover, if MIDCo does greatly enhance efficiency at Midway, the better service and higher quality of the overall airport experience directs more business in the airlines' direction.

### *AIRPORT USERS & CHICAGO TAXPAYERS*

Although not all Midway Airport users are Chicago taxpayers and not all Chicago taxpayers are airport users, the impact of the Midway Airport privatization on these stakeholder groups is sufficiently similar to consider them jointly. It is hard to predict exactly how the benefits or costs will accrue to airport users and Chicago taxpayers, and whether or not one will offset the other or they will cancel each other out. Both groups face higher prices for landside services at Midway Airport. The cost of traveling to and from Midway Airport will increase, but by how much is unclear. Moreover, whether quality of service increases to the point that it offsets the higher cost is an open question. Studies are inconclusive as to whether or not efficiency increases under private ownership and a causal relationship is even harder to establish for US airports given the already high level of private sector involvement.

The benefits to Chicago taxpayers of increased infrastructure investment from the Midway proceeds may also offset any increase in cost of using Midway Airport. Depending on how the money is spent within the city limits, airport users from the surrounding region may also indirectly benefit. The City of Chicago would be wise to make visible investments that might not otherwise have been possible to counter any public dissatisfaction. Although Midway Airport may be in private hands, the public at large will still view it as a public good and expect politicians to be attune to any negative impacts stemming from the privatization.

### *THE BROADER U.S. AVIATION SYSTEM*

Despite discussion of valuation risk and whether or not the deal is optimally structured, it is clear why Midway Airport is an attractive privatization target. It possesses sufficient commercial passenger traffic, is located in an economically robust region, and presents opportunities – although limited – for further business development. Unfortunately, only a

minority of airports in the United States fulfills the necessary criteria for garnering private sector interest. Therefore, the FAA should revisit its Airport Privatization Pilot Program to determine its longevity and efficacy, given that it allowed for the lease of only one large hub air carrier airport, and that observers believe global infrastructure investors are in pursuit of large, mature airports in metropolitan markets.<sup>181</sup>

The pilot program has additional potential shortcomings that may come to the fore in the Midway privatization. Although there are very strong arguments in favor of a check on the private airport operator's power, it is unclear to what degree the 65% approval clause wielded by airlines may cause deadlock in development or serve to further drive up landside prices after privatization. In addition, MIDCo retains access to federal grant and PFC funding on essentially the same terms as an airport's public owner. This naturally raises the question as to whether or not privatization fundamentally changes the structure and use of funds available for airport development and expansion in the United States.

#### *CONCLUSIONS*

While airport privatization can deliver benefits to aviation stakeholders, it is clear that this is not necessarily achieved in the form and manner in which the City of Chicago pursued it. The Midway Airport privatization transaction is structured such that the financial upside to the city is limited in its longevity, while the return on investment needed by MIDCo may prove vastly difficult to attain. In seeking to recoup the cost of the airport's price tag, MIDCo's pursuit of profit may undermine the customer base and market niche Midway Airport has cornered. In short, the risks are high while the returns are questionable. Checks and balances are built into the privatization program and articulated in the contract, but the lease's length basically ensures an incomplete contract.

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<sup>181</sup> Barner

The City of Chicago incurred the majority of these risks through its approach to the Midway Airport privatization, which appears foolhardy in light of the theoretical and empirical evidence that strongly suggests that privatizing in a way that maximizes economic efficiency is better than privatizing in a way that maximizes revenue for the divesting government: “There is simply no alternative to competition as a spur to lower prices and better service, so policy makers should always make engendering competition the principal objective of privatization.”<sup>182</sup> The Midway Airport privatization could have assumed the form of a shorter lease with the prospect of renewal, and with a lease payment structured as a percentage of airport profitability. A shorter lease length would mitigate some incomplete contract issues, the renewal option would inject an element of competition and incentive to set and meet targets, and the lease payment structure would serve as a due diligence link between the parties. While the City of Chicago would have netted less money initially, the money forgone upfront could have served to put MIDCo and the city on a much more solid future financial footing.

## **VI. FINAL REMARKS**

According to transportation economists, there are five conditions favorable to successful privatization: effective competition, large efficiency gains, few transfers, limited environmental problems or other externalities, and reasonable but not excessive profitability.<sup>183</sup> In the airport industry, competition is limited, if not non-existent in most markets; efficiency gains hinge on competition and not ownership; the interdependence of stakeholders creates a web for benefit-cost transfers; and externalities abound. In fact, the only condition that a majority of airports

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<sup>182</sup> Megginson, 391.

<sup>183</sup> Gomez-Ibanez, 276.

seem to fulfill is being reasonably and not excessively profitable – and that is exactly why they attract so much interest from privatization advocates and opponents.

Unlocking the profit potential of airports is at the core of the privatization push with the public airport operator and private investors seeking and believing that they can simultaneously acquire profits. But the Midway Airport privatization reveals that the prospect of attaining corollary profits will prove difficult – if not entirely elusive. In business, there are sellers and there are buyers. In public policy, there are “winners” and there are “losers.” An airport privatization of Midway’s magnitude is a business transaction that amounts to a public policy decision – and it needs to incorporate the due diligence fundamentals of both its facets.

The Midway Airport privatization may well serve as a template for further privatizations, but it is instructive less for any trailblazing quality than for how it exemplifies a conventional approach that fails to transcend a narrow conception of how these deals deliver revenue and disarm risk. As such, the City of Chicago failed to shore up its financial situation in any truly sustainable way; MIDCo must prove itself exceptionally adept at increasing cash flow; the airlines must contend with market pressure on two fronts; and the public is presented with the prospect of precipitous price increases. Within this context, the Midway Airport privatization fails to achieve its articulated objectives, yet it illuminates the trade-offs that can be calibrated to achieve a more sustainable and stable outcome.

At the same time, the Chicago experience exemplifies the rationale and motives for the building momentum behind airport privatization in the United States. Public owners of U.S. airports are seeking funds for other obligations and private investors are seeking new asset classes that provide steady cash flows. Although a complex undertaking that defies clear delineation and assignment of costs and benefits, airport privatization propels money in parallel –

yet opposite -- directions to stakeholders seeking to improve the status quo. Whether this transpires to the betterment of the broader public interest is a function of the form in which and how the privatization is pursued – for which Midway Airport provides the pioneering example.

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