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PRIVATIZATION OF BRITAIN'S AIRPORTS: A MODEL FOR THE U.S.

INTRODUCTION

Most Americans probably consider their city airport to be a core function of local government, much like the fire department or the police. This long had been the situation in Britain also. No longer. In 1987, the government-owned British Airports Authority (BAA) was sold to the public for £1.2 billion, or $2 billion, on London's stock market. As a result, the largest airports in Britain, including London's Heathrow and Gatwick, now are privately owned.

The new owner is BAA, plc,[1] a corporation with about one million shareholders. The British government sold the airports because it was convinced that a privately owned BAA could make better use of the valuable assets, to the benefit of the British economy and the approximately 60 million travelers served each year, than was the government agency that had been running the airports. In the short time that it has been private, BAA appears to be succeeding, although it is too soon to make final judgments. What is clear already, however, is that private ownership of major commercial airports is a practical and workable idea. Of this, American policy makers should take note.

At about the same time that BAA was sold, a new privately owned airport opened in the heart of London. Known as the "London City Airport," this small facility near London's financial district is yet another example of private airport operation. While its financial success is not yet assured, this airport shows that private firms are able to fill perceived needs for airport services.

1 The abbreviation "plc" stands for "public limited company" and is the British equivalent of the U.S. term "incorporated" or "inc."

With the continuing increase in air traffic in the United States, American policy makers are searching for ways to improve the U.S. "aviation infrastructure" – the system of airports and airways through which air traffic flows. They should study the British example as a way to draw in private capital and innovation. To be sure, there are many differences between the British and American airport systems. Privatization, moreover, will not cure all of America's aviation problems. Nevertheless, private ownership could make an important contribution toward solving many of them.

THE SALE OF BRITAIN'S AIRPORTS

As in the U.S. and other countries, airports in Britain traditionally were government-owned. From the beginnings of commercial aviation until 1966, most major British airports were operated directly by the British central government, as was the nation's air traffic control system. Several regional airports were operated by local governments.[2]

In 1966, operation of most of the major British airports was transferred to an independent government agency known as the British Airports Authority (BAA). Airports put under BAA control included the London area airports of Heathrow, Gatwick, and Stanstead, and those airports serving the Scottish cities of Edinburgh, Glasgow, and Aberdeen. BAA enjoyed considerable freedom from government regulation, and for most purposes operated as a commercially-minded enterprise. It generated its own revenue, and even provided net income to the treasury. It was, however, still ultimately responsible to political authorities, and needed government approval for major borrowing and other actions.

Reorganizing As a Private Firm. In Prime Minister Margaret Thatcher's 1983 Conservative Party election manifesto, it was announced that ownership of the BAA airports would be transferred to private hands. Legislation authorizing this was passed by Parliament in 1986. Thatcher's government already had privatized a number of major firms, including the country's telephone system and Jaguar automobile company. In privatizing the airports, the British government hoped to improve the operation and financial performance of the airports, in the same manner that other privatized firms had been improved.

The mechanics of airport privatization were relatively simple. Rather than seek an existing private sector firm to purchase the airports, the British Airports Authority was itself reorganized as a privately owned firm, known as "BAA, plc." The management of the old government agency continued at the new private company. On July 16, 1987, 500 million shares of BAA, plc were

2 The government announced in late 1988 that these airports also will be transferred to the private sector.

sold to the public on the London stock exchange, earning £1.2 billion (or approximately $2 billion) for the British treasury.[3]

The new company retains control of all of the British Airports Authority airports, although they are managed by separate subsidiary companies. In addition, BAA owns several other subsidiaries, including British Airports Services, which provides technical and management services not only to BAA airports, but to non-BAA airports in Britain and around the world.

THE REGULATION OF BAA

Although BAA essentially is free to operate its airports as it sees fit, the government regulates the fees that BAA charges. The form of regulation, however, differs dramatically from that normally used for regulated industries in the U.S. Under traditional U.S. "public utility" type regulation, a firm is allowed to charge prices that allow it to cover its costs and make a "reasonable" profit. This creates enormous problems for the regulator, which must determine the real costs and how they are to be allocated among different users. Making matters worse, of course, such rules eliminate the incentive for the regulated firm to increase efficiency. After all, if the firm reduces costs, the regulator simply reduces the prices the firm can charge.

The British government's regulation of BAA avoids these problems by placing a simple cap on the amount of revenues per passenger that BAA can receive from its aeronautical services. Under a formula known as "RPI minus X," the cap is adjusted each year for inflation (as indicated by the retail price index), minus a certain percentage – initially set at one percent. Thus, not only is there no need for any elaborate review of BAA's costs, but the company has a continuing incentive to increase efficiency – since savings mean increased profits. Moreover, because the annual increase in revenues is pegged at one percent below inflation, BAA customers share in efficiency increases.[4]

Generally Free Hand. Non-aeronautical BAA services, such as airport shops and parking, are unregulated. They will remain this way for at least five years, after which Britain's Civil Aviation Authority (CAA) can review BAA's base revenue amount, the size of the "X" factor subtracted from the inflation rate, and the revenue sources excluded from regulation.

Aside from price regulation, BAA, of course, is subject to CAA safety regulation and to general antitrust regulation by the British Monopolies and Mergers Commission. It is, too, barred from engaging in price discrimination,

3 See *BAA Offer for Sale by County NatWest Limited on Behalf of the Secretary of State for Transport*, p. 1, and "Soft Landing: The Painless Privatization of British Airports, *International Management*, March 1988, p. 24. Dollar figure calculated using July 1987 exchange rate.
4 This regulatory system applies to the BAA airports of Heathrow, Gatwick, and Stanstead, as well as Manchester's locally-owned airport.

and is constrained by various aviation treaties entered into by the United Kingdom which require Britain to ensure access to British airports by certain foreign carriers. Otherwise, BAA management has a free hand in running its airports, deciding what services to provide at what locations, and where or if to make capital investments. Though not yet tested, it even has the right to sell or close airports.

HOW PRIVATIZATION IS IMPROVING AIRPORT MANAGEMENT

When the decision to privatize BAA was made, few expected any dramatic changes. Unlike most government-owned firms, BAA was a well-run and profitable enterprise. So it is not surprising that travelers have seen few, if any, significant airport changes. According to BAA's internal traveler surveys, as well as the general reputation of Britain's airports, travelers continue to be very satisfied with the level of service.[5]

While this may not seem newsworthy, in some ways it is the greatest success of privatization. Contrary to critics' warnings, the new BAA demonstrates that some of the world's largest and busiest airports can operate smoothly and effectively in private hands. The longstanding myth that airports are a "public good" and can only be run by the public sector has been shattered.

Aside from the simple fact of proving government ownership unnecessary, however, BAA appears set to demonstrate that it will, over the long term, improve the efficiency of airport operations because of the incentives and flexibility provided by private ownership. Factors that will enable BAA to improve airport operations include:

1) Better access to financing.

Like other government-owned enterprises in both Britain and the U.S., BAA's access to capital was limited by government borrowing constraints and red tape. Gaining better access to capital has been among the important reasons for Britain's privatization policy. Britain's telephone company, British Telecom, for instance, was privatized in 1984 in large part because it was having difficulty raising enough capital to finance its much-needed modernization. Some experts had warned prior to privatization that the firm's lack of capital could have a "disastrous" effect.[6]

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5 See BAA, plc., *Financial and Operating Information: Supplement to the 1988 Report and Accounts*, p. 6. It should be noted that, among international travelers, Heathrow has a reputation for congestion. This is due in large part to bottlenecks in the customs and immigration operations, which still are run by the British government.

6 See Cento Veljanowski, *Selling the State* (London: Weidenfeld and Nicolson, 1987), p. 192.

The capital problems of BAA were not as severe as those of British Telecom. For the most part, according to BAA officials, the firm received the borrowing authority it needed.[7] The most recent major airport expansions, such as Heathrow's widely acclaimed Terminal Four and a new terminal at Gatwick, were approved before privatization. Nevertheless, the lack of independent financing authority did delay BAA modernization. Completion of Gatwick's new terminal, for instance, was postponed shortly before privatization because of government borrowing limits.[8] Moreover, according to one BAA official, uncertainty about funding meant many innovative ideas were not pursued.[9] Says BAA chairman Sir Norman Payne: The "great advantage" of privatization is "getting away from political control of your finances."[10]

2) Fuller use of airport-related assets.

The new BAA is using its assets more productively than the government-owned BAA. At BAA airports, for example, over 1,300 acres of land are not used directly for airport activities; close to 500 of these acres could be used as sites for new offices, industrial complexes, or retail stores.[11] When the airports were in government hands, this land just sat idle. BAA now plans to develop it.

Similarly, BAA plans to make fuller use of its non-tangible assets. Foremost among these is the buying power represented by the tens of millions of passengers annually passing through its airports. Even before privatization, BAA made substantial use of its retailing opportunities, through stores and restaurants at its airports, most of which are managed by independent operators. Example: BAA sold more than 1.3 million bottles of perfume alone in 1987, 230 percent of total British sales.[12] Gatwick Airport's Burger King is the busiest such outlet in the world.[13]

Keeping Charges Lower. Income from such retailing activities provide a large share of BAA's total revenues. In 1987, BAA received about £158 million ($232 million) in income from concessions, compared to £212 million ($311 million) in revenue from aircraft charges.[14] Without these retail activities, the company would have finished the year in the red.[15] These retail

7 September 27, 1988 conversation with Martyn Booth, Manager of Special Projects, and Richard Sharp, Commercial Strategy Manager, BAA.

8 Avmark Aviation Economist, December 1987, p.17.

9 Conversation with Martyn Booth, September 27, 1988.

10 *International Management*, *op. cit.*, March 1988.

11 County NatWest WoodMac, *BAA plc: Gearing Up for Higher Growth on Top of Quality Cash Flow and Assets*, September 5, 1988, p. 23.

12 Johnson Kane, "When VIPs Are Very Important Purchasers", *Airport*, July 1988, p. 31.

13 *Ibid*.

14 Using the January 1987 exchange rate.

15 *Offer for Sale*, p. 12.

revenues can benefit travelers by keeping direct aircraft landing charges lower than they otherwise would be.

3) Diversification of BAA activities.

Under government ownership, it was difficult or impossible for BAA to expand into other fields. The company operated strictly as a manager of airports; other activities were not contemplated or permitted. As a private enterprise, of course, BAA can diversify — and plans to do so. Activities planned or contemplated include:

♦ ♦ **Construction of a rail line from Heathrow to London.** Under a plan approved by the government last summer, BAA and government-owned British Rail jointly will construct a high-speed rail link between London and Heathrow airport.[16] BAA will finance 80 percent of the 190 million pound system, scheduled for operation by 1993.[17]

♦ ♦ **Construction and operation of hotels.** Not long after privatization, BAA set up a subsidiary, known as BAA Hotels, with the intention of building four hotels at BAA airports. In addition, BAA has worked to secure contracts to manage hotels in other areas.

♦ ♦ **Management of non-BAA airports.** Through its British Airports Services (BAS) subsidiary, BAA hopes to win contracts to manage non-BAA airports in Britain and abroad. Already, BAS has helped plan and finance projects for many foreign airports, including Osaka and Mexico City. BAS also manages four small airports in Britain, including that in Southend-on-Sea, under a contract begun in 1985. Since privatization, BAS aggressively has sought airport management contracts in other countries, including Canada and the U.S; so far, none have been awarded.[18]

♦ ♦ **Property development.** In addition to developing its own property, BAA has acquired a large property redevelopment firm in London, giving it expertise on how best to manage and use its own surplus property, as well as a role in non-airport related development.[19]

♦ ♦ **Retailing.** Supplementing expanded retail activities at its own airports, BAA is using it retailing expertise in other areas. It has an agreement, for instance, to manage shopping arcades at hospitals in Cambridge and London.[20]

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16 British Rail is itself scheduled for privatization in the near future.

17 John Petty, "Paddington Line to Heathrow 'Ready by 1993,'" *London Daily Telegraph*, July 21, 1988.

18 See Cecil Foster, "U.K. Airport Firm Trying to Touch Down in Canada," *Toronto Globe and Mail*, July 7, 1988.

19 "Gateway to Change," *Airline Business*, September 1988, p. 34.

20 County NatWest WoodMac, *op. cit.*, p. 21.

BAA officials point out that these supplementary ventures fit their expertise, making them natural business activities for BAA. BAA, for example, BAA rightly boasts some of the world's most skilled airport managers. Similarly, BAA officials feel that they have advantages in running hotels and other travel related ventures. Such diversification is not always successful, as many U.S. airlines have learned. When it is, however, it can lead to increased efficiency and substantial benefits for consumers.

COMPETITION: A MISSED OPPORTUNITY

Despite the substantial success of BAA's privatization, the British government missed an important opportunity to inject even stronger market incentives into Britain's airports. Because it sold all the BAA airports as a unit, the government lost the chance to create some economic competition between the major airports. Instead, the government has relied on regulation to curtail the market power of the combined BAA airports.

BAA handles about 75 percent of the passenger traffic passing through U.K. airports,[21] and is expected to have almost 93 percent of the total airport capacity in the London area in 1990.[22] This, of course, does not give BAA an actual monopoly in airports. It faces stiff competition from other European cities, such as Frankfurt, for international "hub" traffic — the business of passengers changing planes on their way to other destinations. However, for traffic beginning or ending in London, BAA now has a tremendous market advantage.

Because of this, British policy makers felt it was necessary to regulate the aircraft fees charged by BAA. Although this system is better than most other regulatory systems, it is still a poor substitute for marketplace competition. For example, BAA has little incentive to allocate capacity to those willing to pay more for it because it is not allowed to increase its overall revenue per passenger. Thus the incentive to allocate capacity to those who value it most is diminished.

Failing to Avoid Shortcomings. These shortcomings could have been avoided had the airports been privatized as individual firms. As such, Heathrow would have only about 60 percent of London's airport capacity in 1990, and Gatwick 31 percent. Stanstead, currently with 2 or 3 percent, also would be a strong competitor, as its capacity is expected to grow to perhaps 17 percent by 1995.[23] Organizationally, separating the airports would have presented little difficulty; even under the privatization plan adopted BAA was divided into independent airport subsidiaries. The government, however, kept the airports together primarily because of the expected financial

21 Avmark Aviation Economist, *op. cit.*, p. 15.
22 Derived from figures in *Offer for Sale, op. cit.*, p. 38.
23 *Ibid.*

advantages that a larger airport company would enjoy, and its perceived need for centralized planning.

THE LONDON CITY AIRPORT: A DIFFERENT TYPE OF PRIVATIZATION

The sale to shareholders of the old BAA has not been Britain's only example of airport privatization. At about the same time that BAA shares were first sold to the public, the new London City Airport, located only about six miles from London's financial district, was opened.

Until a few years ago, the "docklands," the area of London in which this new airport is located, was among the most depressed in Britain. Hopes of reviving it were dim until 1981, when a portion of it became one of Britain's first "enterprise zones" – areas in which taxes and regulations are reduced to spur revitalization.

Encouraged by the area's enterprise zone status, John Mowlen and Company, plc, a construction company which owned several abandoned docks, decided to use two of them as a site for an airport close to Central London.

Superb Location. The result is London City Airport. It is not a large facility. With only one airstrip, and no plans to build more, it has no hopes of replacing giant Heathrow or Gatwick as a primary London airport. Moreover, with limited runway space, and a downtown location, it cannot handle large aircraft.

What it does have, of course is superb location. It is but a few minutes' drive from the heart of London's financial district, compared to the hour or so it could take to reach Heathrow or Gatwick. As such, London City Airport is very convenient for businessmen's short-haul flights to the continent's business and political centers. Airlines at the airport provide regular service to Amsterdam, Brussels, and Paris. If jets are approved for use at the location, as is expected soon, flights to Frankfurt could begin. To further facilitate business use, the airport provides a business center conference rooms, telephone and computer connections, and secretarial services for use by travelers. London City's owners expect their airport eventually to handle 1.2 million passengers per year.

LESSONS FOR THE U.S.

British airport privatization provides a valuable case study for U.S. policy makers. In recent years, congestion and overcrowding have become major problems at many U.S. airports. Since 1978, the number of American airline passengers has soared over 60 percent and is expected to increase about 5 percent per year through the end of the century.[24] Yet no major new commercial airport has been built in the U.S. since 1974. Thus, policy makers will have to find ways to make existing facilities serve the anticipated further buildup in traffic, and encourage construction of new facilities.

Encouraging Innovation. The British experience suggests that privatization may help in resolving these capacity problems. By giving airport managers the incentive to operate more efficiently, privatization encourages managers to make better use of airport facilities at a lower cost to travelers. By reducing governmental restrictions on managers, like limitations on financing, new and expanded facilities could be constructed more quickly and economically.[25] More generally, by opening the airport business to a larger number of entrepreneurs, policy makers would help encourage individuals and firms to step in with new, innovative ideas for solving aviation problems.

Privatization, of course, cannot by itself solve all capacity problems. Many of the most daunting roadblocks to airport expansion stem from such things as local zoning and noise restrictions, which add to the bureaucratic problems in trying to expand existing airports, or construct new ones. These would not disappear with privatization. Nevertheless, the introduction of private sector incentives and flexibility would increase the incentive and flexibility of airport managers to address and resolve these problems.

Privatization already is being considered in some areas. Example: the Mackinac Center, a research group in Michigan, has proposed the sale of Detroit's Metropolitan Airport to the private sector.[26] Officials of Wayne County, Michigan, which owns the airport, are reported to be interested in the idea.

Contracting Out. Short of full privatization, there are several options that may allow policy makers to capture some of privatization's benefits without relinquishing all control of the airport. Management of an airport, for instance, can be contracted out to private firms on a long-term basis. The British Airports Services subsidiary of BAA already offers such services, as does Lockheed Terminal Services, which manages the Burbank airport near Los Angeles,[27] and Pan-Am World Services, which operates the Westchester Airport in New York.

24 Apogee Research Inc., *The Nation's Public Works: Report on Airports and Airways* (National Council on Public Works Improvement, May 1987), p. 15.
25 Unlike those in Britain, most airports in the U.S. do not have severe limitations on their financing, and generally are able to raise capital without prior governmental approval. But for many, especially those directly operated by a city or county, rather than an airport authority, restrictions on financing do exist.
26John M. Kost, *Detroit Metropolitan Airport: A Case for Privatization*, Mackinac Center Report, October 27, 1988.
27 Until 1978, Lockheed owned the Burbank airport outright.

Under such arrangements, airports can harness some private-sector incentives to increase efficiency. Of course, since political authorities still keep the ultimate authority over these airports, management contracts are decidedly inferior to full privatization.

POTENTIAL OBSTACLES TO PRIVATIZATION

There are potential obstacles to privatization in the U.S. that did not exist in Britain. Among them:

♦ ♦ **The role of airlines.**

At most U.S. airports, airlines use terminals under long-term leases. Most of these are negotiated in return for airline investment in the facilities and give airlines the exclusive rights to particular gates. Some contracts even give the airline the right to veto expansion or changes to parts of the airport that they do not occupy, or to block increases in landing fees. Metropolitan Airport in Detroit, for instance, is bound by 50-year leases, signed with its tenant airlines in 1959, which limit the fees that the airport can charge; in effect, this prohibits the airport from making a profit.[28]

For many airports, these contracts may present major barriers to privatization. Perhaps some way could be found to share the benefits of privatization with the airlines, inducing them to permit reform to proceed. Profit-conscious private managers would be more likely to devise such amicable revisions in contracts. In any case, because of these contracts, construction of new, privately-owned airports may be an easier route to privatization than the sale of existing airports.

♦ ♦ **Federal airport subsidies.**

Under the federal Airport Improvement Program (AIP), federal money, collected through passenger ticket and fuel taxes, are in part used to fund capital improvements at U.S. airports. In fiscal 1989, these funds are projected to total about $1.6 billion. In total, federal grants account for about one-third of the investment capital for commercial airports, with the rest coming mostly from bonds issued by the airports.[29] The legislation establishing the AIP, however, bars funds for privately-owned major airports.[30] Thus AIP creates a bias favoring government-owned airports, discouraging transfers to the private sector.

This bias should be eliminated. The best way to do so would be to eliminate the grant program altogether. Short of that, the position of public

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28 Kost, *op.cit.*, p. 11.

29 Apogee Research, *op. cit.*, p. 86.

30 Smaller, non-commercial airports are eligible for this program regardless of ownership.

and private airports could be equalized, either by reducing passenger and fuel taxes for private airports, or by making them fully eligible for the AIP program.

♦ ♦ **Inability to issue tax-exempt bonds.**

In the U.S., public enterprises enjoy a financing advantage over private firms because their bonds are exempt from federal taxation, lowering their cost for capital projects. Yet this disadvantage should not make private airports infeasible, as private firms can compensate through higher overall efficiency. In the long run, however, policy makers should examine ways of equalizing the tax status of public and private airports.

♦ ♦ **Tort liability.**

The scope of tort liability in the U.S. is much greater than that in Britain. Huge jury verdicts and extended theories of liability are relatively rare in Britain. Thus potential exposure to tort claims, and the resultant high liability insurance premiums, apparently were not a major area of concern by either BAA or London City Airport. In the U.S., by contrast, such costs would likely be large, and could deter many potential investors.

The financial risk inherent to exposure to liability suits, however, need not be an insurmountable obstacle to privatization. In fact, in recent years the liability of governmental agencies has been gradually increasing, diminishing the advantage of public firms in this area. Moreover, the total liability of a private airport likely still would be small compared to the burden borne by the already privately-owned airlines. In any case, if the liability burden appeared to inhibit private ventures, state legislation limiting liability to a reasonable level could be enacted.

CONCLUSION

With the sale of the British Airports Authority and the construction of the London City Airport, Britain is proving that the operation of airports is not necessarily a government function. The British experience shows that airports can be operated smoothly and efficiently by private owners, to the benefit of travelers and taxpayers.

Creating Flexibility. While the plan of privatization pursued by Britain for BAA was not perfect — more competition could have been introduced into the system — the result has been the creation of a company that has more flexibility to respond to the needs of consumers and to make better use of its assets. Moreover, the privately-owned London City Airport shows that although most airports are large enterprises, there is a role for smaller entrepreneurs in filling the needs of travelers.

Britain's airport privatization experience can be a model for the U.S. Although there are, of course, many differences between airport operations in the two countries, the privately-owned major airport is an option which should be considered seriously by U.S. policy makers.

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