Difficulties in privatising airports, the case of Schiphol airport

Introduction

European airports operate in a dynamic and competitive environment. Competition between airports is heavy. It is fiercest for European gateway traffic -that is passengers on long-haul flights from the US and Asia flying into a European airport before taking further flights.
At the same time most airports are struggling to cope with massive congestion while facing limits to expansion and the longer–term challenges of bigger aircraft and even more passengers. As some of the main European hubs have limited space to accommodate the growth capacity shortages become clear. The combination with worsening congestion implies the building up of pressures for airlines to stop elsewhere.
Increasingly there is a growth of the point to-to-point service from regional airports The capacity and environmental constraints, deliberate governmental policies and services from various airlines have spurred growth at these airports. They are expected to take on an increasing part of the future growth in air traffic. However though regional airports could take more passengers, they would need fast road and rail links to attract passengers. So there are natural capacity limits to this substitution.
Yet some regional airports have already had some success even without such links.

The September 11 terrorist attacks on the US had dealt a heavy blow to an aviation industry already reeling from global economic slowdown.
As the effects of on air transport are waning and the economic tides seem to improve once again the major European hubs are planning to be able to cope with growing numbers of passengers. Massive investments to increase capacity and so additional financial resources are required. Moreover many of them are in need of new resources to participate in new ventures in foreign countries. These opportunities arise as quite some governments all over the world have decided to privatise airports so as to enable modernisation of their premises and take part in the economic globalisation process. Significant funding needs for capital expenditures programs are to spur sell-offs. The large investments require resources larger than can be provided by public budgets. So according to a recent study[1]) worldwide some 150 to 200 airports are to be privatised in the next five to seven years.

Schiphol as a major hub

One of the European hubs is Schiphol. This airport is a major international transfer hub. It has a relatively small domestic market so a large amount of transfer traffic is required. Competition with other European airports in the vicinity for non-direct traffic is however stiff. Schiphol has as a main attraction that it has very consumer friendly transfer facilities in a single terminal. The economics of this airport is moreover cushioned by a wide spread of business. It not only has been aggressively stimulating additional income resources like non-aeronautical revenues such as duty-paid/duty-free concessions and revenues from property, hotel, and car parking lots.
However Schiphol airport has its limitations:

- It has to operate in one of the strictest regulatory environments when compared to other airports. The airport faces relatively stringent noise-pollution related requirements and operational restrictions, that cap both the annual growth of aircraft movements and the airport's medium term growth.
- There is a strong local opposition to airport expansion
- It is mainly depended on one airline. KLM is the key to financial and operational growth at Schiphol.
- Its shares are wholly owned by the public sector restricting investments and outward looking policies.

Strategy of Schiphol

Against this background Schiphol wants to improve or at least maintain its market position.
It developed the airport city concept, with its individual customer oriented all kinds of retail facilities and services. These are available for individual and corporate travelling customers as well as shoppers.

It aggressively markets the airport as regional hub. It has pitched itself as an alternative hub for the smaller British airports given the relative proximity.
It has pushed through aggressive expansion plans, amongst others building a fifth runway.

As to entering foreign markets the strategy of Schiphol has been to tie up with other partners in its bids. While still a government owned corporation Schiphol owns 15% of Brisbane Airport corporation consortium which runs Brisbane airport and owns 40% via its US subsidiary Schiphol USA, of JFK International Arrivals Terminals, a consortium building an international arrivals terminal at JFK for non-US airlines
However quite some opportunities for participating in other privatisations were lost to competitors. Yet it reached a preliminary agreement with Malaysia to take a 30% participation in Malaysia Airport holding.
To further its ambitions it entered into an alliance with Frankfort airport (Fraport). This alliance, the Pantares alliance is very ambitious . It is aimed at creating an integrated airport network by combining activities such as handling of passengers, cargo, retail, e-commerce, purchasing and international acquisitions.
Schiphol continues to look for management and ownership opportunities overseas where publicly owned airports are scheduled for privatisation. The management is looking to raise capital publicly in order to finance its international expansion. It has been positioning itself to go public for several years. Its chairman stated several foreign airport alliances had been undermined in the past by uncertainties over the airport's likely listing. However a host of other arguments were also used at one time or another:

- The government cannot always release investment funds in the face of pressures from other expenditures.
- The airport is freed from political interference and arbitrary funding cuts by non-aviation minded legislators.
- The income earned is applied to the needs of the aviation customers with no funds diverted to non-aviation projects.
- It allows faster decision making, increased operating efficiency, reduced excess staff and lowered operating costs. This is particularly due to the separation of regulatory and operational functions.
- It could lead to reductions in user fees and a modernisation of air traffic control.

The public sector view

Dutch governments have traditionally favoured industry development through private enterprise, intervening only when the national interest or many jobs are at stake. Policies tended to emphasise improving competition and protecting consumer rights. The cabinet has been particularly active in recently liberalised sectors such as gas and electricity, telecommunications and public transport.
The government was willing to accommodate the wishes of Schiphol 's management. As the Dutch government holds 75.8% of shares in Schiphol, while the remainder are held by the cities of Amsterdam (with 21.8%) and Rotterdam (with 2.4%) it wanted to float 49 % of the existing shares on Euronext. It was expected that the size of flotation and the airport's clear investment and expansion strategy would lead to a good acceptation.

The willingness by the public authorities to privatise Schiphol seemed to be motivated mainly by budgetary considerations and in particular its reluctance to fund the expansion plans of the airport.

The budgetary view implied the Schiphol Group's liability for tax payments from 2002. (een van de twee punten aan het eind van deze zin vervalt)
To accommodate hesitating political parties the government decided that Schiphol would obtain an operating licence. To obtain this licence the airport would have to transfer all its real estate to the Dutch state in exchange for a no-cost leasehold. If the state should ever to decide to withdraw Schiphol 's licence it would have to compensate the company for lost commercial activity.
The airport authority however hoped in vain for a positive decision from the Dutch parliament on a floatation. A green light for an initial public offering of shares in Schiphol, initially planned for early 2001 and than for early 2002 was impossible thus far as the Labour Party turned doubtful on privatisation.

What went wrong?

Vital to the expansion plans is government support. Recently the political environment for privatisation deteriorated drastically. In the past privatisation was quite successful. Former state owned companies like DSM, Hoogovens and KPN were successfully floated.
Parliamentary support for privatising the transport sector (railways and Schiphol airport) waned in 2001.
The national train company - a monopolistic provider of transport services- was put at arms length control of the public sector as a major step towards a possible flotation. However this approach turned problematical: the company became much more commercial however with declining train services, neglect of repairing and replacing trains and priority for profitable retail and office investments at the stations. Trains did not run in time anymore. In the end mismanagement led to a replacement of the top management.
In other sectors mistakes in privatisation designs became apparent. E.g municipalities had been encouraged to sell their cable nets to private parties, who then became in effect local monopolists. Once it became clear that this implied a reduction of quality of services provided and that market forces were neglected measures were taken to open up markets.
Negative privatisation experiences abroad like the declining services of train and water companies accompanied by sky rocketing salaries of the new management in the UK also influenced Dutch political thinking negatively.

Furthermore there also came warning sounds from the academic world. It was stated that there may be a trade off between internal (productive) efficiencies and allocative efficiencies of privatisation. Privatisation may not be desirable if its less efficient and if public monitoring arrangements are no less efficient than what the private sector has to offer. In that case public ownership is better in terms of both internal and allocative efficiency. A proper functioning market with several providers of services is a prerequisite for a successful privatisation. Then efficiency gains can be transferred to customers while the other suppliers are also stimulated to be more efficient.
In a monopolistic environment there is need for adequate rules and regulations to ensure that efficiency gains realised by privatisation are transferred to management and shareholders but also to customers.
A necessary condition for superiority of private ownership is to have a significantly more effective monitoring system.

Parliamentary opinion as to privatisation turned around. The prevailing view in opposing parties in parliament -among which the reigning labour party- became that public policies had been too much focussed on liberalising important markets. Too little thought was given to the new environments and possible consequences of privatisation. A transfer from public to private ownership alone was not sufficient to improve productivity.
So considerable political debate arose concerning the plans to privatise Schiphol, as Schiphol is considered to be a key economic transport mode in Holland. Moreover there was the view that in the future in an privatised environment an abuse of monopoly position was possible. Opponents were against privatising this macro-economically vital company. To relinquish political control over this company of national importance met political resistance, the more so as it would imply a transfer of an already efficient system to a profit making private organisation. Privatisation would most likely imply ensuing policies to maximise profits and become at odds with national objectives. Moreover

quite a few parliamentarians considered environmental and safety aspects so important that privatisation should only take place under the strictest conditions.
Other views were that privatisation could result in an increase in cost of capital and business risks and in risky adventures abroad in other countries at the expense of the Dutch airport. Of importance was also the view of KLM, the major airline using Schiphol as its main hub. The airline was of the view that tariffs would be raised, investments in the infrastructure of the Amsterdam airport neglected in order to realise satisfactory profits and market-reflective dividend payments.
The government the took some further measures. It defended its pro privatisation stance with vigour. Many arguments were presented. E.g. that by legally prescribing that Schiphol had to negotiate its tariffs and quality of services with its customers, the airlines and that future changes in tariffs had to be economically justified. In case the continuity of the airport would be thwarted government could impose changes or even withdraw the operating licence.
Public interests were protected by the public ownership of the soil and a say of the minister of transport with respect to new investments. Measures were taken to prevent possible foreign ownership of the airport. As to environmental concerns the Dutch cabinet stated that the operating licence that Schiphol was to receive from the state already required clear guarantees on noise abatement and other environmental issues.
However for the majority of parliament the uncertainties were not taken away completely. The oncoming elections than led the labour party to the conclusion that privatisation would not be in the public interest. So a decision for future floatation actually depends on the vision of the next government. Parliament is expected to address the issue of airport privatisation once again in 2002 after the parliamentary elections

Neglected economic and financial considerations

Up till now scant attention has been paid to other more economical arguments and considerations concerning the corporates that form Schiphol.
The plans of Schiphol airport's management require additional capital not only to modernise and enlarge its home base but also and foremost to participate in foreign airport opportunities. This could lead to an increase in debt leverage and moreover weaken cash flow interest coverage. This implies the need for sound financial engineering and financial risk management. The recent down grading of the ratings of Schiphol owing to the loss of its sovereign status underscores this need. Wrong policies can lead to further down grading and so increase the cost of capital.
Accustomed to being a public company with its accompanying priorities, it furthermore takes much effort to make changes in management targets to keep shareholders satisfied. To that end one has to keep track and if possible control a number of factors influencing the image of the company and have the right instruments in place to control information so as to prevent insider trading.

So its financials have to be right while the capital market conditions for new issues also have to be favourable. To finance new projects further risk taking capital has to be issued, as floating publicly owned shares only implies substitution of shareholders.

The quality of management should also be satisfactory: management must be able to balance the increased financial pressures of huge capital investments, foreign financial participations in the context of a privatised corporate situation with significant public side conditions.
There is moreover need for appropriate staffing levels and manpower. This not only to export its expertise but also to cope with foreign cultures, customs and rules and regulations in new markets and in particular economic market conditions.
Proper market and risk analysis is of utmost importance as two examples show: Fraport as part of a consortium project financed a new international terminal in Manila, Philippines. This deal turned sour with corruption and changing governmental conditions. Schiphol representatives made a major mistake in its participation in a consortium operating terminal 4 of Kennedy International Airport. Rather than the usual setting of fixed rents in their leases with tenants, they let the rents float, based solely on the number of passengers passing through the terminal. So the effects of the economic downturn and the Sept. 11 terror attacks were rather severe. To intensify the misery the airport operator was besieged by the effects of political disputes between the owner of Kennedy and its operator. The consortium had to make provisions to repay its debt earlier and take higher than originally envisioned financing costs.

These two different examples show that foreign markets are risky and that the quality of the organisation itself has to live up to the ambitions. As this takes time it goes without saying that a very good acquisition and expansion strategy has to be developed. Schiphol has to be very selective in choosing its overseas participations as each participation ties up scarce management time and financial resources.

Though possible opportunities for participation have been missed by the lengthy parliamentary process, this can also be seen as possible opportunities for failures. It even can be considered a blessing in disguise as enough other possibilities will arise in the future. Not much has been lost as the relatively depressed equity markets were unfriendly for a public floatation.

As can be concluded from the foregoing advantages of privatisation can be little while risks can be important. A positive business case can be made and subsequently executed but it requires a good effort from the side of management.

www.TheSovereign.nl
The Hague, April 2002

---

[1] Airport 2010, Accenture airline industry practice, February 2002