

**The Economic Regulation of Airports: Recent Developments in
Australia, North America and Europe
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THE REGULATION OF US AIRPORTS

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1. INTRODUCTION

This paper considers the traditional regulatory framework within which US airports operate and describes recent developments which have occurred. It begins by identifying the distinctive features of US airports which tend to distinguish them from airports of most other regions. These have a major impact on how the airports are regulated. The paper then goes on to discuss the legislative and policy issues as regards airport revenue generation and use. The potential for privatisation of US airports is also assessed. The paper concludes by considering future possible developments.

2. CHARACTERISTICS OF US AIRPORTS

The distinctive features, which differentiate US airports from most other airports, can be divided into four categories, namely ownership; finance sources; the airport-airline relationship; and the provision of facilities and services (Graham, 2002).

2.1 Ownership

Most US airports are owned by cities or counties although a few are not operated directly by the government body but by a separate public organisation such as a multipurpose port authority (an example is the Port Authority of New York and New Jersey) or an airport authority such as Metropolitan Washington Airports Authority. They have no share capital, do not pay dividends and are not liable for corporate taxes.

2.2 Sources of Finance

The main sources of finance are (Ashford and Moore, 1999):

- Tax exempt bonds.
- Airport Improvement Program (AIP) grants from the Airport and Airways Trust Fund which is financed by user taxes on various sectors of the aviation community (eg passenger tickets, cargo and fuel) and disbursed by the Federal Aviation Administration (FAA).
- Passenger Facility Charges (PFCs) of up to \$4.50 per passenger which have to be approved by the FAA for identifiable projects.

2.3 Relationship with the Airlines

US airports enter into legally binding contracts with airlines known as airport use and lease agreements which detail the fees and rental rates which an airline has to pay; the method by which these are to be calculated; and the conditions for the use of both airfield and terminal facilities. The use agreements often guarantee that certain airlines play a significant role in the making of airport capital investment decisions. This is specified in the Majority-in-Interest (MII) clauses of the agreements, so-called because they involve 'signatory' airlines which together carry the majority of the airport's traffic. The signatory airlines often pay lower levels of landing charges.

2.4 Provision of Facilities and Services

The airport operator normally provides the basic aeronautical facilities and services. This excludes air traffic control which is provided by the FAA, handling which is provided by the airlines and agencies and security which used to be provided by third parties but has become the responsibility of the Federal Government as a result of the events of September 11. At many of the airports the airlines will lease or rent terminal space or gates on an exclusive- or joint-use basis or may even own and operate whole terminals as at JFK airport in New York.

3. THE EXISTING LEGISLATIVE AND POLICY FRAMEWORK

The generation of revenues at US airports is subject to a number of statutory requirements determined by Congress and policy statements issued by the FAA/Department of Transportation. These primarily focus on the Federal Government requirement for 'reasonable' aeronautical fees at the airport and the prohibited use of airport revenues for non-airport purposes.

3.1 The Setting of Airport Fees and Charges

There are two major pieces of legislation which cover the setting of airport charges. The 1982 Airport and Airways Improvement Act states that, on accepting federal AIP grants, an airport is under an obligation to charge 'reasonable' fees to its aeronautical users. Similarly the 1973 Anti-Head Tax Act allows publicly-owned airports to collect 'reasonable' charges from the airlines which are using the airport facilities. This 'reasonableness' requirement in these two Acts only applies to aeronautical users and does not require the Department of Transportation to regulate the reasonableness of non-aeronautical charges and rents.

In 1996 the Department of Transportation/FAA issued its Final Policy Regarding Airport Rates and Charges as required by the 1994 FAA Authorization Act, which incorporated all the statutory obligations (Federal Aviation Administration/Department of Transportation, 1996). This states that fees for the use of the airfield and public-use roads should be established on the basis of costs and it provides detailed guidance on how costs are to be determined. Assets must be considered at their historic cost value. The policy reconfirms that the fees should be 'fair and reasonable' and not 'unjustly discriminatory'. For other facilities there is a more flexible approach, with the policy permitting fees to be set by 'any reasonable method'. In addition it restates the principle, required in the 1994 FAA Authorization Act, that airports should set charges that make the airport as self-sustaining as possible, given the specific circumstances of the airport.

3.2 Use of Airport Revenues

There are a number of statutory requirements related to the use of airport revenues. The 1982 Airport and Airway Improvement Act established the rule 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 or other local facilities which are owned or operated by the owner or operator of the airport and directly related to the actual air transportation of passengers or property. This is known as the 'revenue retention' requirement. There is a 'grandfather' exception which allows airport revenue to be used for non-airport costs if the debt is pre-1982. Grandfathered airports include Boston, New York and San Francisco. The 1987 Airport and Airway Safety and Capacity Act set further limits on the use of airport revenues, by for example, considering how taxes from aviation fuel could be spent.

In 1994 and 1996 Congress enacted additional statutes (the 1994 and 1996 FAA Authorization and Reauthorization Acts) which supplemented the original 1982 requirements. These focused on the identification of revenue diversion and the enforcement process for revenues which are unlawfully diverted. As mentioned above the 1994 Act also required that airports should set charges that makes the airport as self-sustaining as possible, given the airport specific circumstances (the 'self-sustaining' requirement). The 1996 Act extended the revenue use rules to any federally assisted airport.

In 1999 the Department of Transportation/FAA issued its Final Policy on Airport Revenue Diversion (as required by the 1994 Authorization Act) which incorporated the

revenue retention, self sustaining and all the other relevant statutory obligations (Federal Aviation Administration/Department of Transportation, 1999). This policy lists the permitted uses of airport revenues such as destination marketing (if the airport is mentioned); co-operative airline-airport marketing; reimbursements to the state or local government for actual airport services and a portion of the costs of general government under certain circumstances; attorney/lobbying fees to support airport activities; community activities related to the airport; and certain airport ground access projects. Prohibited uses of airport revenues include payments which exceed the value of services or facilities provided to the airport; payments which are not based on appropriate cost allocation methods; costs associated with general economic development and marketing activities; payments in lieu of taxes that exceed the values of services provided; payments to compensate government bodies for lost tax revenues; loans to government agencies at less than the prevailing interest rate; and the direct subsidy of an airline service.

As regards the self-sustaining requirement the policy states that the airport operator must generally charge a fair market rental rate for non-aeronautical facilities (except for transit facilities and for property for community and recreational purposes in certain circumstances). Aeronautical charges should cover airport costs. The policy also describes the reporting and auditing requirements (such as the requirement for airports to submit annual financial reports) and explains the action which the FAA may take if the revenue is unlawfully diverted (such as withholding AIP grants or withholding the approval of PFC applications) (Federal Aviation Administration, 1999).

3.3 Legal Challenges

These statutory requirements and policy statements related to airport revenues have been strongly influenced by the outcome of legal action at particular airports. For example, back in 1988, the Massport Authority implemented a Program for Airport Capacity Efficiency (PACE) in an attempt to tackle the capacity problem at Boston Logan airport with a change in pricing policy. This introduced a movement charge for runway use as well as a weight based charge and had the effect of significantly increasing the landing fees for smaller aircraft. However, in response to complaints from airlines and other affected parties, the US Department of Transportation ruled that Logan airport had violated federal law since its landing fee structure unjustly discriminated against smaller aircraft and represented an unscientific approach to airfield cost allocation. As a result of this, the airport resorted to its former pricing structure. Had it not done so it would have ceased to be eligible for its \$10 million federal AIP grants in 1989 (Graham, 1992). As a result of this legal case, the Department of Transportation's policy regarding peak pricing was established – namely that under certain conditions, a properly structured peak pricing system could be found to be reasonable and would not be considered unjustly discriminatory. The airports argue, however, that this policy is somewhat unclear. An interestingly related development is the proposal that peak pricing should be used with a new runway planned for Boston (ACI-North America, 2002).

In the 1990s legal action brought about by airport users concerning the interpretation of the statutory requirement for 'reasonable' fees and the diversion of airport revenues,

particularly at Grand Rapids airport in Kent County and at Los Angeles airport, played an important role in prompting Congress and the FAA to re-examine the existing airport charging policy which led to the passing of the 1994 and 1996 FAA Authorization Acts and the establishment of the 1996 and 1999 FAA Policy Statements. At Los Angeles for example, landing charges were tripled in 1993 and it was proposed that \$30 million of these airport revenues would be used for general municipal purposes. This led to a series of legal challenges by the airlines who claimed that the fees were based on market rather than historic cost asset values and could not be diverted to other uses. Eventually in 2000, the US Supreme Court agreed with the Department of Transportation's conclusion that the fees had been based on an improper cost calculation method.

4. RESIDUAL AND COMPENSATORY APPROACHES

There are two basic approaches to establishing the airport charges and fees: residual and compensatory. With the residual approach the airlines pay the net costs of running the airport after taking account of commercial and other non-airline sources of revenue. The airlines provide a guarantee that the level of charges and rents will be such that the airport will always break even and so take considerable risk. By contrast with the compensatory approach the airlines pay agreed charges and rates based on recovery of costs allocated to the facilities and services that they occupy or use. The risk of running the airport is left to the airport operator. The residual approach, therefore, is more akin to the 'single till' practice when revenues from all airport activities (both aeronautical and non-aeronautical) are taken into account when setting the aeronautical charges. The compensatory approach is more similar to the dual till when just the aeronautical aspects of the airport are considered when the aeronautical charges are set.

Airports have applied these two different approaches in various ways to suit their particular needs and some have adopted a hybrid approach, combining elements of both the residual and compensatory methodologies. A study in 1998 showed that for the large US airports the residual and compensatory approaches were each used by 41 per cent of the airports with the remaining 18 per cent of airport using some kind of hybrid model. For medium sized airports the relative shares were residual (38 per cent), compensatory (19 per cent), and hybrid (43 per cent) (Federal Aviation Authority/Department of Transportation, 1999). Airport such as Los Angeles, San Francisco, Dallas Fort Worth and Miami use a residual approach, Chicago, Newrak at JFK in New York use a compensatory approach and examples of the hybrid methodology can be found at the Washington airports and Orlando airport.

5. PRIVATISATION OF US AIRPORTS

As in many other parts of the world, airport privatisation has been considered in the US -primarily as a means of bringing some much needed additional private money for investment (Butterworth-Hayes, 2000). It should be noted, however, that the private sector already has considerable influence at the airports because of commercial bond financing and because most of the airport's functions are provided by airlines and other private organisations. In addition some small airports such as Albany, Burbank, Teterboro and Atlantic City have been operated by a private management contract.

In 1995, BAA won a 10 year management contract for operating the much larger airport at Indianapolis. Under the scheme, BAA was not to receive any fixed management fee but to share in the savings it generates. The company guaranteed average annual savings of more than \$3 million (\$32 million over a ten-year agreement) and was not to be paid any fees until after it produced average annual savings of nearly \$6 million (\$58 million over the ten-year agreement). BAA expected to save the airport \$100 million during 10-year contract by increasing non-aviation revenue and reducing expenditure from energy supply, equipment and payroll costs. The airport board was to continue to set policy and control rates and charges. In 1998 an amended new 10 year contract was signed. BAA has also acquired commercial management contracts at Newark, Boston and Pittsburgh and there have also been discussions regarding the long-term management of JFK and La Guardia when the current lease expires in 2015. In another development in 1997, the financing, construction and operation of the international arrivals building at JFK New York airport was handed over to a private consortium (which includes Amsterdam Schiphol airport) for 25 years. This is first such BOT (Build, Operate and Transfer) project at a US airport. With all these developments, the legislative and regulatory framework within which the airports operate remains the same.

Various issues would have to be resolved if more radical privatisation moves, such as the total transfer of the assets to a private sector company, were to take place (American Association of Airport Executives, 1992; Mew, 2000) For example, would private airports survive if they could not use AIP, PFC or tax-exempt debt financing? Would they have to pay back AIP grants? Would private airports have to pay property taxes? At many of the airports, the use agreements with the airlines may mean that the airports can only be privatised as the agreements expire or that privatisation will have to be limited within the bounds of the agreement.

In 1995 the full privatisation of John Wayne Airport in California's Orange County was discussed as part of the solution to the county's bankruptcy. However the likelihood of litigation by the airlines who would have claimed that this was an unlawful use of airport revenues for non-airport purposes led to the conclusion that airport privatisation not being feasible. This revenue diversion issue, namely the inability of local and state governments to reap the financial benefits of the airport sale, is seen as one of the key obstacles to airport privatisation in the US.

In 1996 an airport privatisation pilot program was established by the FAA in order to explore privatisation as a means of generating access to sources of private capital for

airport improvement and development. This made provision for five airports to be exempt from some of the legal requirements that impede their sale to private entities. At least one of airports had to be a general aviation (GA) airport and no more than one could be a large hub air carrier airport. The GA airports could be sold or leased whereas the hub airport could only be leased. Five airports could be chosen, at least one had to be a GA and no more than one a large hub air carrier airport. GA airports could be sold or leased whilst hub could only be leased (General Accounting Office, 1996)

Under these program the airports are exempt for repaying federal grants or returning property acquired with federal assistance. The restrictions on prohibiting the proceeds of the sale or lease to be used exclusively for airport purposes have also been waived. Such privatisations do, however, need approval of the majority of the airlines using the airport (sixty five per cent of the airport's airlines in terms of landed weight) The airport can apply for AIP funds, or to levy PFCs, and it is still subject to the requirement to set 'reasonable' fees (Federal Aviation Administration/Department of Transportation, 1997).

There has been only limited interest in this scheme particularly because of slow and rather complex approval procedures and the majority airline consensus rule. The first airport to be approved under the scheme was Stewart International Airport in New York which was given a 99 year lease to the British company, National Express. The airport transferred management in April 2000 (Federal Aviation Authority, 2000; McCormick, 2000a). Other airports which have been involved with the scheme and are at various stages of approval are Brown Field (a GA facility in San Diego); Niagra Falls, Aguadilla in Puerto Rico and New Orleans Lakefront (McCormick, 2000b).

6. FUTURE DEVELOPMENTS AND CONCLUSIONS

The events of 11 September 2001 in the short-term have shifted much of the focus away from issues of airport capacity and congestion or airport charging and funding for investment to more immediate concerns such as the provision and financing of security services. However there have been two developments in the last year or so which have indicated that the basic principle that airport charges must be determined by strict cost formulas is beginning to be questioned and that a more market-based approach could have a role to play in coping with the congestion problems which exist at many airports.

The first development was when the Department of Transportation issued a 'Notice of Market Based Actions to Reduce Airport Congestion and Delay'. (Federal Aviation Administration/Department of Transportation, 2001a). This discussed market-based approaches to charging at airports such as peak pricing, minimum landing fees (which in fact have already existed at airports such as New York, Los Angeles, Boston and San Francisco) and slot auctions. Airlines and other interested parties were asked to comment on this notice by July 2002 before any changes are suggested. Clearly any shift away from cost based and towards a market based methodology would require significant changes in the statutory requirements and policy statements which have been described in this paper and could also have implications for other legislation, such as the Airline Deregulation Act of 1978, which prohibits local regulation of routes and services and states that proprietary powers

must be reasonable, non-arbitrary and non-discriminatory (Air Transport Association of America, 2002)

The second related development is specifically concerned with JFK's La Guardia airport. This is one of four 'high density' airports in the US where slots have been restricted, co-ordination of schedules by airlines has been allowed and where a certain degree of slot trading has been permitted. However the Aviation Investment and Reform Act (AIR21) of 2000 made substantial changes to the slot rules at these four airports. At La Guardia all restrictions are to be eliminated by 2007. In the interim new long-haul entrant carriers and airlines operating regional jets were given slot restriction exemption. This led to major overscheduling and congestion in La Guardia in 2000 and so the Port Authority of New York and New Jersey imposed a moratorium on peak hour flights. However the FAA claimed that the airport authority did not have a legal right to impose this moratorium and instead it was agreed that the number of new flights would be capped and a slot lottery would be undertaken. This took place in December 2000. This temporary solution is due to end in October 2002. In the meantime the industry has been consulted about more longer-term solutions (Federal Aviation Administration/Department of Transportation, 2001b). These include market-based initiatives such as congestion based pricing or slot auctions or administrative processes such as favouring operations with larger aircraft.

The implementation of a market-based solution could potentially raise another problem at La Guardia airports related to revenue diversion. Long standing financial arrangements of the Port Authority of New York and New Jersey means that this airport has grandfathered status as regards the diversion of revenues for non-airport uses. A market-based pricing system might produce a large volume of revenues well in excess of the airport costs and some of the industry is concerned that this could be diverted off-airport rather than used to reduce the congestion problems (Reason Foundation, 2002).

In summary, this paper has shown that the regulatory and legislative environment within which US airports have traditionally operated has been very different from most other parts of the world. Whilst generally this is always likely to be the case, in recent years there have been some significant developments in the United States which have been in some ways more similar to changes which have been occurring elsewhere within the airport industry. These have arisen largely from the need to provide additional finance for investment and/or to reduce congestion. In particular, airport privatisation and market based pricing are issues which are likely to continue to raise considerable debate in future years to come.

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