



“Last exit PPP“ -The role of public-private-partnerships (PPP)

Privatization in the airport sector
in developing countries



airport

airline

cargo



Lufthansa Consulting

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Governments have long recognized the role that modern infrastructure services can play in economic growth and poverty alleviation in developing countries. Increasingly, airports are being viewed as enterprises rather than public services which are expected, at best, to break even. As a result, governments around the world have turned to the private sector for the management and development of airports in order to create viable, bankable and sustainable airport businesses that operate more efficiently than under the public domain.

However, the latest decline in privatization activities and investment flows in developing countries seems to be ongoing; consequently this paper looks into the reasons for, and the failure of, privatizations in developing countries where a strong sense of disillusionment has emerged in recent years with regard to the privatization results in the traditional fields of utilities and transport. A wide range of privatization models has been applied to coordinate and balance the interests of the public sector and private investors, respectively. In cases where the market and the overall framework proved attractive to all parties involved, the majority of privatizations have been successful. Where projects lack market depth and other vital elements that determine the attractiveness of a transaction for the private sector, projects turned out to be unsuccessful or never came to fruition.

Nonetheless, alternative ways of privatizing do exist. Here, the public-private-partnership (PPP) provides one method of bundling public- and private-sector resources after balancing their respective interests. Lufthansa Consulting is currently in the process of structuring such a PPP for Ouagadougou International Airport in Burkina Faso in order to make this challenging transaction possible.

After the worldwide promotion of privatization in the 1980s - predominantly advocated by the World Bank and the IMF's structural adjustment programs in developing countries - a rapid shift towards the private provision of infrastructure services (in both utilities and transport) occurred in the early 1990s. Following the North American and European examples, governments all over the world began to pursue policies to involve the private sector in the delivery and, more importantly, the financing of infrastructure services which were marked by high levels of inefficiency under the public domain. Privatizations reached a peak in the late 1990s. Since then correspondent investment flows have dropped significantly due to a lack of market opportunities and risk patterns in developing countries for foreign investors, but also due to the imperfections of capital markets in those countries where a limited availability of long-term capital hinders the financing of projects.

The concept of privatization

Privatization is generally referred to as “the process of transferring property (assets) from public ownership to private ownership and/or transferring the management of a service or activity from the government to the private sector.



Privatization programs are on the agendas of most countries. While the privatization process is ongoing in Western countries, the latest privatization wave has largely bypassed developing countries, in particular in Africa. Nonetheless there are continuous efforts by governments in those countries to privatize.

When privatizations are professionally structured (poor structuring can be one major cause of failure), it is commonly accepted that privatized entities carry the following arguments in favor of private operations:

- Performance enhancement through higher efficiency
- Transfer of know-how and management expertise
- Improvement in facilities and customer service
- Ability to raise capital and accountability
- Performance-based compensation for the private operator/investor and concession/tax income for governments
- Increased flexibility and responsiveness
- Proximity to private capital markets

Privatization models – an overview and explanations

In order to achieve the above benefits by taking into account and balancing the financial, management and ownership interests of the parties involved, a wide range of privatization models can be applied. Worldwide, various types of models have occurred in the market for the provision of infrastructure. Of course, there is no specific benchmark that serves as a guideline to determine when the interests of the parties are met. This needs to be assessed on a case-by-case basis.

A basic categorization divides privatizations into company privatizations where entire airports or airport systems are removed from the public domain, and project privatizations in which only a section of the airport is subject to transfer to private ownership and management. The concept of ownership transfer also addresses the fact that private investors and/or operators provide substantial financing for required capital expenditures, thereby excluding the alternatives of concluding management contracts under which those private operators are contracted who will not assume ownership of the airport. Overall, the forms of privatization vary according to the needs of the individual country and/or project, which require careful structuring. Besides the forms of company privatization (e.g. placement of entire shareholding, management buyout – MBO, or flotation), many forms of project privatization have been developed as part of various airport privatizations concluded around the world in the last 20 years:

- Build-Transfer (BT): the facility is built with private capital and transferred by lease to the publicly owned airport which operates the facility;
- Build-Own-Transfer (BOT): the private operator builds and subsequently operates the facility for a designated time period at the end of which operation and ownership revert to the airport;



- Build-Own-Operate (BOO): the private operator builds, owns and operates the facility in perpetuity;
- Build-Own-Operate-Transfer (BOOT): similar to BOO except that at the end of a designated period the facility reverts to the ownership of the airport;
- Build-Operate-Renewal of concession (BOR): the private sector builds and operates the facility with the option to renew the concession at the end of the contract period;
- Build-Lease-Transfer (BRT): the private sector builds the facility and enters into a lease to operate it for a designated period at the end of which the facility reverts to the airport.
- Rehabilitate-Own-Transfer (ROT): rehabilitation, using private finance, is followed by a period of private ownership at the end of which the facility reverts to the airport;
- Rehabilitate-Own-Operate (ROO): after rehabilitation with private funds the facility is owned and operated in perpetuity by the private sector.

In addition, there are a number of other terms that describe the various forms of project privatization, in particular the so-called “hybrid” by which any combination of the above is meant.

The forms of privatization listed above assume that the private sector can raise an investment without public support. In the event that the total investment exceeds the financial capability of the private sector or when the project cannot meet investor expectations, the private and public interests are combined by setting up a cooperative venture between the public and private sector: the public-private-partnership (PPP).

The concept of public-private partnerships

In many privatization cases even the progress achieved in the implementation of sound regulatory policy frameworks has not helped the privatization cause in the absence of market opportunities for the private sector. In the case of certain airports, low passenger and cargo volumes coupled with low levels of commercial income render a successful privatization impossible. Where market depth - and thus sufficient cashflow - is lacking and private capital is exposed to various risk factors, more limited forms of private participation have to be envisaged in order to make projects both feasible as well as attractive to the partners.

One possible solution to this dilemma is the public-private-partnership model (PPP), which is generally referred to as “a cooperative venture between the public and private sectors, built on the expertise of each partner, which best meets clearly defined public needs through the appropriate allocation of resources, risks and rewards.” In essence, as part of the PPP, private efficiency is bolstered by government funding to the extent that the project becomes financially viable. In this respect, it should be borne in mind that governments may refinance their project subsidy through long-term concession fees and tax income from the project.



Successful examples of PPPs have often combined private expertise and capital with governmental project subsidies from public budget sources and/or international development finance, which is also the only way for the privatization and relocation of Ouagadougou to be a success. Overall, the focus will therefore have to be shifted towards strengthening project cash flows where user fees may not be sufficient, e.g. through subsidies and restructuring of charges, and the further mitigation of risks for the private sector - regulatory, legal, financial and political - to provide appropriate instruments that are more likely to attract private financing.

Balancing of risk and success factors

While it cannot be finally assessed at which point a project is attractive enough for private investors in the absence of generally accepted investment policies, benchmarks and hurdles, the following provides a brief overview of vital risk and success elements as part of privatizations. All parties involved, i.e. the government and private parties such as investors, banks and operators, will have a keen interest in mitigating risks to the extent necessary to structure a sustainable and successful project with a long-term concession. Prior to the placement of international tenders the following factors shall have been assessed:

- **Political risk:** Often referred to as country risk, governmental stability and governance, but also domestic and regional strife cannot be assessed on a long-term basis (country ratings and country reports with outlooks can aid the risk assessment). The same applies to macroeconomic risks such as foreign exchange risks, inflation etc. Political risk greatly affects the terms and conditions of debt capital and/or the willingness of financial institutions, and investors alike, to provide a project with capital at all in a specific country.
- **Project risk:** Often used as a summarized term for various risks which arise from the structure of a project which has an impact on the availability and pricing (terms and conditions) of private capital (both debt and equity). Essentially it incorporates the risks below (financial, market and legal risks), as well as the partner and shareholder structure, and in PPPs the level of government involvement.
- **Regulatory environment:** The quality and continuity of the regulatory framework in the sector (in this case civil aviation authorities and their pricing policies) may greatly affect the quality of a project in terms of investor willingness to provide capital and to ensure long-term income for the project. Volatile regulatory policies will prove disadvantageous for the entire project.
- **Legal framework:** Legal due diligences should assess the quality and stability of the legal framework in a country which is of great importance for the feasibility of a project and the availability of capital, both domestic and foreign (in particular in terms of investment security and laws, registration of security in the project, enforceability of security, etc.)
- **Market risks:** Sound business planning and scenario testing can mitigate this risk, which greatly affects the willingness of all parties to become involved in the project. Market and competitive studies equally provide an overview of the potential and risks for the project.



- Sources of funding / Capital markets: Knowledge of local, regional and international funding sources – and their respective investment policies – will prove advantageous for the structuring of a project. The availability of capital – both short-term and long-term, and in PPPS for both private and public capital –and the respective pricing will determine the feasibility of the project.
- Management quality: Expertise of the management / operator for a specific project is a long-term risk for a project when it is not available. A positive track record in the respective sector will speak in favor of the prospective management. The same applies to technical partners in a project (in particular construction companies).

Implications of the Ouagadougou project

In the case of the privatization and relocation of Ouagadougou International Airport, conventional airport income sources (passenger fees, landing charges, and cargo and commercial revenues) do not generate sufficient cashflow to justify a full privatization. Due to the magnitude of the required financing for a new airport outside of Ouagadougou (~220 million EUR), but also to enhance the attractiveness of the project to private investors, public participation is indispensable for the feasibility of the transaction. Private involvement in the project will not materialize without public subsidies of between 40% and 50% of total project costs. The sourcing of this finance – public and private – will be one of the most challenging tasks involved in this transaction. The fact that the relocation of the airport presents green-field risks which would not apply in the case of a modernization and expansion of the existing airport poses further challenges in the structuring of the project.

As part of the privatization strategy and based on market findings, Lufthansa Consulting has defined a PPP structure which takes into account a 25-year concession with a renewal option, the creation of a public-private airport operating company including local, regional and international shareholdings, and a thorough analysis of all financial and operational facets of Ouagadougou International Airport.

Some preliminary results of the analysis have shown that:

- The start-up debt-equity ratio will have to reach a level which satisfies all lenders in the project,
- A combination of commercial and soft loans will have to be sourced from local and international financial institutions, both for the government subsidies as well as the operator's financing requirements,
- Independence of the local civil aviation authority is required,
- Certain increases in charges, of which some have already been implemented, will be required,
- The integration of all income sources in the airport operating company will be required,
- The government will be able to refinance its subsidies via long-term concession fees and tax income.



As a next step, the structuring of tender documentation will take place to find prospective partners for the project.

Globally, privatization activities have been declining. Developing countries in particular have been bypassed from privatization activities since the late 1990s. The specific market, income and risk structure have not helped the cause of privatizations in infrastructure, in particular in the airports sector. Here, it is believed that PPPs can provide a solution when the resources of private and public partners are bundled wherever conventional privatizations are not possible. Long-term success can be achieved when private expertise and capital are combined with public funding and support for a project in order to create a viable transaction which would not materialize if those resources were not brought together. In many developing countries where projects tend to lack market depth while being exposed to various risks, PPP can mitigate those risks and equally – if there is a professional structure – it can meet the demands of all the partners to ensure a successful cooperation. In this sense, the Ouagadougou transaction may prove to become a showcase for a successful cooperation between public and private partners in a country which is generally associated with a higher degree of risk and fairly low market volume.

- Build-Own-Transfer (BOT): the private operator builds and subsequently operates the facility for a designated time period at the end of which operation and ownership revert to the airport;
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