Case Study of LMM Airport Concession in Puerto Rico

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ABSTRACT
When the Federal Aviation Reauthorization Act of 1996 established the Federal Aviation Administration (FAA) Airport Privatization Pilot Program, it was the intent of Congress to explore new sources of capital and investment from the private sector and the benefits and improvements to the users. During the existence of the Pilot program it has received 10 applications; the first successful concession in 2000 of the Stewart International Airport in New York was ended prematurely in 2007. The second closing has come through the use of a Public-Private Partnership (P3) in Puerto Rico. This deal is very different to a privatization because ownership of the asset remains in the public hands and benefits to the users are linked to specific operating standards and required improvement to the asset inside the concession agreement. Puerto Rico's project involved the 40-year lease for the financing, operation, maintenance and improvement of the Luis Muñoz Marín (LMM) International Airport, a transaction worth $2.6 billion. A case study of the LMM airport concession is presented, and features of it are compared with two other transactions in the Pilot Program.

INTRODUCTION
In 2011, the total number of airports in the United States was 19,782; of these, 547 were certified airports: “certified airports have air-carrier operations with aircraft seating more than 9 passengers” (US-DOT, 2013). The need for enhancement of facilities and services among the certified airports has been recognized for some time, which was part of the motivation for the creation of the Federal Aviation Administration Airport Privatization Pilot Program in 1996. Worldwide a number of alternative delivery arrangements have been implemented. Data from the International Major Projects Database (PWF, 2014) indicates that 245 airport projects utilizing alternative delivery arrangements with 145 of these achieving financial close. This illustrates a robust pipeline in the airport sector with a total value of planned and closed projects of $160,613 million.

This paper briefly explores the evolution of the FAA Pilot Program during its approximate 17 year life and examines the procurement of the LMM International Airport by the Commonwealth of Puerto Rico. Development of a case about the LMM Airport allows comparison of key aspects of the project with other attempts in the FAA Pilot Program. This case study illustrates features of a successful procurement for states and municipalities to consider when undertaking a concession of an airport under the FAA Pilot Program.
BACKGROUND

The Federal Aviation Reauthorization Act of 1996 established the FAA Pilot Privatization Program (Pilot Program) to determine if privatization of airports in the USA could be a source of new capital and improvement to customers. Initially, only five airports were allowed in the Pilot Program, but in 2012 this number expanded to 10; only one large hub commercial airport was permitted in the program and at least one general aviation airport was required (“public airport that is located in a state and that, as determined by the Secretary of Transportation, does not have scheduled service or has scheduled service with less than 2,500 passenger boardings each year” (FAA, 2012)). Although the name of the program utilizes the word privatization, Congress does not allow a sale of any commercial service airport (“public airport in a State that the Secretary of Transportation determines has at least 2,500 passenger boardings each year and is receiving scheduled passenger aircraft service” (US Code, 2009)) only lease arrangements. The benefits for participating in the Pilot Program are the possible exemptions of repayment of grants or other federal assistance utilized in the airport and the possible use of proceeds from the lease for non-airport related expenses.

The Pilot Program has received 10 applications since its inception, but only two have reached closure and received final FAA approval: 1) Stewart International Airport (SWF) in New York, which ended prematurely in 2007 when the Port Authority of New York and New Jersey purchased the remainder of the 99 year lease; and 2) Luis Muñoz Marín (LMM) International Airport. Other attempts have failed such as: a) Midway International Airport in Chicago (first attempt in 2009), the only large hub airport inside the Pilot Program, that “collapsed amid the global credit crunch...because private investors could not raise the necessary money” (Tarm, 2009); b) Niagara Falls International Airport in New York where the selected proponent Cintra Concesiones de Infraestructuras de Transporte, S.A. pulled out of the transaction citing that its original business plan was no longer valid; and c) Rafael Hernandez Airport in Puerto Rico which had a preferred operator, and after a change in administration in the government the application was withdrawn (FAA, 2004). As of March 12, 2013, three projects had active applications in the Pilot Program: 1) Re-launch of the Midway Airport, 2) Hendry County Airglades Airport in Florida, and 3) LMM International Airport.

METHODOLOGY

A case study of the LMM International Airport is developed to examine a “successful” transaction – one that achieved financial close and FAA approval. Data to assemble the case was gathered from publicly available procurement documents from the Puerto Rico Public-Private Partnership Authority (PRP3A) and of publicly available documents from the FAA Pilot Program. Basic content analysis of these documents was completed, and this was supplemented by interviews with the former Executive Director of the PRP3A to clarify more details of the transaction. The financial elements of the LMM International Airport transaction are compared with the SWF Airport and the initial attempt to lease the Midway Airport to contrast features of each.
LUIS MUÑOZ MARÍN INTERNATIONAL AIRPORT CONCESSION

The LMM International Airport concession was the second test of the new public-private partnership (P3) legislation in Puerto Rico, and it was the first P3 airport concession in the FAA Pilot Program. This transaction provides an example for other jurisdictions to consider since an appropriate legal framework brought world class companies and private investment to Puerto Rico.

Purpose and Setting

The Commonwealth of Puerto Rico is a recent player in the P3 industry, but since the inception of its enabling act it has become one of the most active P3 markets in the United States. Given lagging infrastructure investment and the high debt of public agencies, the governor of Puerto Rico promoted the legislation to explore P3s as another tool for investment in infrastructure. In June 8, 2009 the enabling Act (P3 Act) that established the PRP3A was approved. This public agency was created as an affiliate of the Government Development Bank for Puerto Rico to be in charge of public policy on P3s in Puerto Rico. The P3 Act was intended to create the framework and investment environment to attract best in class companies to Puerto Rico.

After the passing of the enabling act, the PRP3A received proposals for projects from different public agencies in the Commonwealth; one of them was the concession of the LMM International Airport. The LMM project was submitted to the PRP3A by the Puerto Rico Ports Authority (PRPA), a public corporation headed by an Executive Director and a Board of Directors. The PRPA is responsible for the air and sea transportation infrastructure in Puerto Rico; it provides the administrative, financial, maintenance, engineering and planning services to the LMM, 10 other airports, and nine maritime ports.

The PRP3A did two internal analyses; 1) an initial review of the project, to review precedents, etc. and 2) a fatal flaw test, to analyze any legal issues, etc. Once the project passed this internal test it went to the Board of Directors (BoD) of the PRP3A for approval, which was granted.

On December 1st, 2009 the PRPA filed a preliminary application to the FAA Pilot Program and on December 22nd the application was accepted for further review by the FAA. In addition to final approval of the transaction by the FAA, the enabling act required that the final concession agreement be approved by the BoD of the PRP3A, the BoD of the PRPA, and the Governor of Puerto Rico (who delegated this responsibility to the Secretary of State).

Scope

The project consists of a concession to finance, operate, maintain, and improve, the LMM Airport for 40 years. The LMM International Airport is classified by the FAA as a medium activity installation (medium hub), “in the 2008 calendar year, the airport was ranked number 41 nationally in the total movement of passengers, with 4,635,798 boardings” (PRP3A, 2013a). The Airport covers approximately 1,600 acres of land and is located in the Municipality of Carolina, which is approximately 6 miles from downtown San Juan and is the main gateway to international destinations and the Continental United States (PRP3A, 2011a). The
airport has 43 gates with a total terminal area of over 2.8 million square feet, two runways of 10,000 ft. and 8,016 ft., 4,750 parking spaces, and eight primary fixed based operators (FBOs).

**Procurement**

The PRP3A issued a Desirability and Convenience (D/C) study on June, 2010, a type of feasibility study that explores the viability of the project as a P3 instead of the conventional approach (the government continuing operation of the airport) through a value for money analysis with a public sector comparator. This D/C study concluded that “the current issues at the PRPA, including financial performance, credit profile, reliance on GDB [Government Development Bank for Puerto Rico] credit lines, misalignment with the objectives of the airlines, and weak specialized airport managerial practices, limit LMM’s ability to improve its operations” (PRP3A, 2010) and suggested the use of a P3 as the way to improve service delivery. In early 2011, the PRP3A and the PRPA “entered into an Memorandum of Understanding [(MoU)] with the signatory airlines establishing the basic terms of the airport-airline use agreement” (FAA, 2013a) that had to be approved by at least 65% of scheduled air carriers and 65% of the air carriers by landed weight. The PRP3A received 67% approval from scheduled air carriers and 98.2% from air carriers by landed weight (FAA, 2013a). The use agreement is a binding contract among the PRPA, the final winner of the transaction and the airlines. The PRP3A created a Partnership Committee that was in charge of the procurement process with the aid of the PRP3A, PRPA, and its consultants and issued the request for qualifications (RFQ) on June 6, 2011. It received twelve statements of qualifications (SOQs) (PRP3A, 2011b).

On September 23, 2011, the PRP3A announced six consortiums that were shortlisted for the project. The RFP was sent to the consortiums on October 10, 2011, and the consortiums received access to the data room that contained a draft of the concession agreement (Partnership Agreement). On November 15, 2011, the RFP received its 3rd addendum integrating an “Indicative Bidding Process” (IBP) based on the draft Partnership Agreement; following this process, PRP3A planned to shortlist two consortiums. The criteria for selection included: a) technical and financial capability; b) operational plan; c) investment financial plan; d) plan to increase passengers and airlines; and e) leasehold fee. On December 22, 2011, the PRP3A disqualified the consortium composed of GMR and Incheon due to their lack of participation during the process. On February 7, 2012, Goldman Sachs withdrew from the process due to issues it had with the deal structure, and on March 9, 2012 its partner Fraport withdrew from the process as well after asking for a time extension on the transaction to further analyze an unclear passenger trend. On March 15, 2012, the PRP3A received indicative bids from three remaining consortiums except Puerto Rico Gateway Group, which was unable to continue after changes in composition of its consortium (David Álvarez, personal communication, September 17, 2013).

The Partnership Committee decided to continue the process with two consortiums, and they submitted their proposals on July 10th, 2012. On July 11, the consortiums were notified that the upfront fees were considered a tie, so they had to submit a revised upfront fee. On July 16th, both consortiums submitted higher revised upfront fees. On July 17th, the Partnership Committee selected the preferred
proponent, the consortium composed by ASUR and Highstar Capital who created the special purpose vehicle (SPV) Aerostar Airport Holdings, LLC (Aerostar). The final criterion utilized to select the preferred proponent was the highest upfront payment; Aerostar offered $615 million while the GAA consortium offered $567 million for the 40 year lease. On July 24th the Partnership Agreement (Lease Agreement) was executed, successfully achieving commercial close for the project and on September 10th Aerostar and PRPA submitted the final application to the Pilot Program which included the Airport Use Agreement signed by the 12 air carriers. Meanwhile, the Governor who had championed P3s lost the bid for re-election and there was a new majority in the Legislature as well, who opposed the transaction. The newly elected Governor publicly said that he would let the FAA continue with the evaluation of the transaction because the annulment of the contract would have affected Puerto Rico’s credibility in the investment community and he would await the FAA decision (González, 2012). After a process of review which was extended by 45 days and public hearings in which the FAA received 275 public comments against and in favor of the transaction, the FAA approved the deal on February 25, 2013. On February 26th after long hours of deliberation between the new Governor and his economic team, the Governor of Puerto Rico announced that Puerto Rico was going to finalize the deal because “although he was not in favor of the transaction the word of Puerto Rico was given and serious countries and people keep their word” (Álvarez, 2013). Ultimately, the project achieved financial close with an upfront payment of $615 million. Table 1 provides a chronology of events.

<table>
<thead>
<tr>
<th>Event</th>
<th>Date</th>
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<tbody>
<tr>
<td>P3 Act Enacted</td>
<td>June 8, 2009</td>
</tr>
<tr>
<td>Preliminary Application Submitted to the FAA</td>
<td>December 1, 2009</td>
</tr>
<tr>
<td>Desirability and Convenience Study Published</td>
<td>June, 2010</td>
</tr>
<tr>
<td>MoU with the Signatory Airlines</td>
<td>Early 2011</td>
</tr>
<tr>
<td>Request for Qualifications</td>
<td>June 6, 2011</td>
</tr>
<tr>
<td>Shortlisting</td>
<td>September 23, 2011</td>
</tr>
<tr>
<td>Request for Proposals</td>
<td>October 10, 2011</td>
</tr>
<tr>
<td>RFP Received its 3rd Addendum Integrating an IBP</td>
<td>November 15, 2011</td>
</tr>
<tr>
<td>Indicative Bids Received</td>
<td>March 15, 2012</td>
</tr>
<tr>
<td>Proposals Received</td>
<td>July 10, 2012</td>
</tr>
<tr>
<td>Preferred Proponent Selected</td>
<td>July 17, 2012</td>
</tr>
<tr>
<td>Partnership Agreement Executed (Commercial Close)</td>
<td>July 24, 2012</td>
</tr>
<tr>
<td>Final Application Submitted to the FAA</td>
<td>September 10, 2012</td>
</tr>
<tr>
<td>FAA Approval of Deal</td>
<td>February 25, 2013</td>
</tr>
<tr>
<td>New Governor of P.R. Approved Deal and Financial Close</td>
<td>February 26, 2013</td>
</tr>
</tbody>
</table>

**Financial plan**

The proposal from Aerostar consisted of $615 million in an upfront payment, $552 million in payments during the concession period, and the investment of $1.4 billion in improvements, of which $195 million are required in the first three years of the concession (PRP3A, 2012). The PRPA will receive annual lease payments of $2.5
million for the first five years of concession, 5% of the gross airport revenues for the next 25 years, and 10% for the final 10 years of concession. The equity provided by the consortium is $327 million and the debt was acquired by the private placement of $350 million of investment grade bonds with a coupon of 5.75% and a 2035 maturity to 15 US insurance companies (Cavenagh, 2013). The project has a debt/equity ratio of 56:44, with a total value of $2.6 billion (including the upfront payment, revenue sharing and investment in improvements) (modified Infra-Deals, 2013).

COMPARISON OF LMM WITH SWF AND MIDWAY

Table 2 illustrates several key differences between the LMM transaction and SWF and the first Midway transaction. An important difference is the length of the contract. SWF and Midway were 99 year lease concessions and the LMM is a 40 year lease. The original Midway transaction was designed to receive the maximum lump sum according to Paul Volpe, Chicago’s chief financial officer ($2.521 billion proposed in the winning bid). This did not allow them to exact property taxes, have revenue sharing mechanisms or have a shorter concession (Joravsky, 2008). Buxbaum and Ortiz (2007) have explained that use of long term concessions is a way to maximize the upfront payment and provide tax benefits if for example the length of the concession is greater than the life of the asset. Among the issues they mention with long term concessions are: a) conflicts of private sector interests with public sector interests and b) contract terms and how they affect price and public control. According to Puerto Rico’s P3 Act, the term of a partnership or the duration of a contract could be a maximum of 50 years and extended an additional 25 years with legislative approval.

In the case of LMM the term of 40 years was selected for three main reasons: 1) legal consistency, 2) value, and 3) political. The legal consistency arises from a previous 40 year highway concession that the PRP3A closed in 2011; in a sense this created a “precedent” that the PRP3A did not need to follow but for consistency in the P3 Program the PRP3A decided to utilize. The value of the upfront lump sum payment was a very important one; different iterations were made to analyze the term that would have provided the better value. The PRP3A team analyzed 30, 35, 40 and the maximum of 50 years allowed. The team found that extending the concession from 40 to 50 years did not provide a substantial addition to the lump sum payment and going below 40 years lowered the payment too much and was seen as too short by the industry. Leaving the 10 year buffer to the maximum legal concession term also gave the government a negotiation tool if a compensation event is triggered. This can be particularly useful to a government entity that would prefer to extend the concession instead of providing a payment (David Álvarez, personal communication, January 8, 2014). Lastly, the political issue is a very significant one; generally speaking, the public sees 75 and 99 year leases poorly.

There are also differences in the revenue sharing clauses; SWF received an upfront payment of $35 million and 5% of gross revenue sharing after the tenth year (FAA, 2000); the LMM transaction will provide more considerable profit sharing.
Table 2: Comparison of LMM, SWF, and Midway

<table>
<thead>
<tr>
<th></th>
<th>LMM</th>
<th>SWF</th>
<th>Midway</th>
</tr>
</thead>
<tbody>
<tr>
<td>Length</td>
<td>40 year</td>
<td>99 year</td>
<td>99 year</td>
</tr>
<tr>
<td>Upfront Payment</td>
<td>$615 million</td>
<td>$35 million</td>
<td>$2.521 billion</td>
</tr>
<tr>
<td>Profit Sharing</td>
<td>$2.5 million for the first 5 years, 5% of the gross airport revenues for the next 25 years, and 10% for the final 10 years</td>
<td>5% of gross revenue after the 10th year</td>
<td>None, the deal was structured to maximize lump sum payment</td>
</tr>
<tr>
<td>Carriers Approval</td>
<td>Approved</td>
<td>Not Approved</td>
<td>Approved</td>
</tr>
<tr>
<td>Use Agreement</td>
<td>15 years</td>
<td>None</td>
<td>25 years</td>
</tr>
<tr>
<td>Tax Treatment</td>
<td>10% fixed rate and a 0.5% municipal license tax</td>
<td>Concessionaire has to pay taxes</td>
<td>No taxes imposed on the property to maximize lump sum</td>
</tr>
</tbody>
</table>

SWF was not able to reach the 65% air carrier approval and hence did not have a use agreement with the airlines and created a plan to invest the proceeds from the transaction in the airport. In the other hand, Midway and LMM surpassed the 65% requirement; Midway negotiated the terms for 25 years and LMM for 15 years. Tax exemptions are part of Puerto Rico’s enabling act and give clear guidance of how the SPV will be treated under the Puerto Rico Internal Revenue Code. Puerto Rico has a strong history of providing tax incentives and tax exemptions to foster private investment and the development of certain industries. Due to the economic necessities of Puerto Rico and the wish to develop a P3 Industry in Puerto Rico, the legislators decided to provide a fixed rate of 10% for the partnerships created under the P3 Act. Also a 0.5% Municipal License Tax applied against gross LMM Airport Facility revenues will be paid by Aerostar. The City of Chicago did not excise any taxes in the property to maximize the upfront payment.

Other differences were also present. In the LMM transaction, Aerostar will reimburse the PRPA for its police and fire services up to an amount of $2.8 million as set in the lease agreement for the first year. If for some reason the parties are not able to negotiate a new price, the price for that year will be the price of the previous year plus inflation. As well, Aerostar will provide the PRPA $250,000 a year for the monitoring costs of the contract.
Chicago’s attempt to re-launch the Midway transaction failed again to reach a successful closing. The first transaction failed after the preferred bidder was not able to achieve financial close due to the onset of the economic recession. On September 27, 2013 the City of Chicago withdrew its application losing the large hub slot in the Pilot Program (FAA, 2013b). Only one consortium stayed in the final negotiation and Chicago’s mayor decided to cancel the procurement. According to Bergen and Byrne (2013) the remaining proposal would have provided the City of Chicago a $1.4 billion upfront payment and revenue sharing for 39 years of concession that would raise the value of the transaction to $2.4 billion.

LIMITATIONS AND FUTURE RESEARCH

This research used information that was readily available and interviews with the former Executive Director of the PRP3A, it did not include interviews with private partners working in the LMM transaction or key stakeholders in the other projects in the Pilot Program. Also, this research focuses in the financial elements of the transactions and does not go in depth into the Use Agreement between the Airlines, the PRPA and Aerostar or the Lease Agreement between PRPA and Aerostar.

Future research could explore the perspective of the private sector with the LMM transaction and the consultants involved in it. The Midway transaction and its inability to successfully close for a second time could provide very interesting research and allow for more insight of both failed attempts.

CONCLUSIONS

The LMM International Airport project was able to attract global interest in the project and strong private investment in public infrastructure, in a highly complex procurement process that involved six shortlisted proponents and negotiations with airlines at the same time. The PRPA will be able to defease part of its debt, receive a stream of revenue to utilize in its endeavors and allow increased capital investment in what is the gate of Puerto Rico to the World. The deal is favorable to both the public and private parties. According to Adolfo Castro, CEO of ASUR, the LMM transaction is a “very important step forward for future privatizations in the United States….our goal now is to transform San Juan airport into a world class airport gateway, and while San Juan airport is the Caribbean business airport and a very attractive growth opportunity for us, keep in mind that this is a long-term project” (Bowen, 2013). According to David Alvarez, former Executive Director of the PRP3A, “this is a trend setting project/transaction for Puerto Rico and the U.S. market. Together with our partners, Aerostar, Puerto Rico will achieve a world class airport for the benefit of residents, visitors and passengers in general. Most importantly, we are delivering value for money for tax payers and we are making Puerto Rico more competitive in the global landscape” (PRP3A, 2013b).

With the growing population and air traffic in some cities, the need for improvements and expansions of existing airports will increase. The Government could use public funds for other infrastructure projects and the private sector could operate these assets receiving an adequate return on investment. The successful concession of LMM Airport in Puerto Rico is very different to a privatization because
ownership of the asset remained in the public hands and benefits to the users are linked to specific operating standards and required improvement to the asset inside the concession agreement. This transaction could motivate other states and municipalities to consider the FAA Pilot Program as an option to expand and improve existing airports.

REFERENCES
Buxbaum, J. and Ortiz, I. (2007). Protecting the Public Interest: The Role of Long-Term Concession Agreements for Providing Transportation Infrastructure, the Kenston Institute for Public Finance and Infrastructure Policy Research Paper Series, California, USA.


