Concession or Sale – An Innovative Partnership Approach to Solving a South African City's Airport Problems

a report by

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A 20-year airport concession contract, signed recently in the South African city of Richards Bay, illustrates how public-private partnerships are becoming essential tools in sustaining rapid economic development in some of South Africa's fastest-growing urban areas. The Richards Bay deal also illustrates an innovative approach through which the municipal owners of these facilities can make the sometimes difficult choice between concession and sale as the best option for dealing with their assets.

Thirty years ago, Richards Bay was a fishing village of 200 residents, located in the north-eastern section of KwaZulu-Natal Province. Today, with a population of over 110,000, it is one of Africa's premier deep-water ports and a busy gateway to many tourist attractions to the north. Port development initially triggered the city's growth, and growth came rapidly in the form of a host of heavy industries that relocated to the municipal area. Transport facilities played a key role in cementing this growth, and business at the municipal airport expanded constantly over the years.

However, by the late 1990s, the city had clearly exceeded its ability to manage and maintain the airport in a way that met regional needs. By 1998, the airport was running at a ZAR1.5 million annual deficit. Business potential clearly existed at the airport – annual passenger movements had reached 80,000 per year and were expected to continue increasing by 10% per year over the next decade – but local government rules and procedures for managing such a facility meant that the city was unable to exploit its full business potential.

Richards Bay ("the city") began the process of identifying a private partner who could take over airport operations by conducting a thorough project feasibility study, with the help of outside consultants. The study looked at the condition of the airport and the potential for business growth, as well as the viability of several public-private partnership options. The city's goals in seeking private sector help were factored carefully into the analysis, as follows:

- The city wanted the facility to remain a functioning airport, but wanted its operating deficit from the municipal budget.

- The city also wanted to receive some income from the airport, in order to pay off the debts associated with the infrastructure, which had added to the burden on the city budget.

- It was also clear that some capital expenditure for development and expansion of airport operations, although not an immediate problem, would be needed eventually.

The city's transaction consultants assessed the options and determined that either a concession or a sale would satisfy the main objectives of the city. City officials learned how a contract of sale can impose various conditions on the new owner of such a facility, including the stipulation that it remain a functioning airport. The airport was not viewed by the city as an essential municipal service, so there was no particular legal or regulatory reason why it could not be sold. City officials also learned that, with a concession, the city could maintain ownership and perhaps sell the airport later at a better price, but would also have to monitor compliance with the terms of a usually complicated long-term concession contract.

Either way, the city decided to insist that aeronautical tariffs be charged according to official government levels published in the *Government Gazette*, with other tariffs adjusted in accordance with consumer price index changes, so there would be no proposals or negotiations regarding tariffs. Also, the airport had no municipal staff (all airport services were already contracted out), so the deal involved no union problems and no staff transition issues – another potential source of complication in public-private partnerships developed in South Africa. There was nothing for potential private partners to propose or negotiate regarding staff.

All things considered, a sale probably would have been the most beneficial option for the city, particularly in terms of total income, but this was a small, marginal business, with set tariffs. There were opportunities to increase overall revenue (e.g., via airport advertising and increased efficiencies), but it would have taken a long time to recoup the purchase price. (The airport was expected to continue losing

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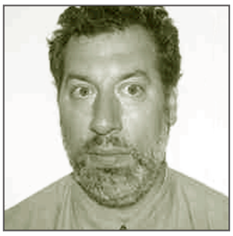

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money for a few years regardless of who took it over.) Most private firms clearly preferred not to buy the airport, but rather to operate it, making a modest profit from management efficiencies, without paying the upfront price. The city's transaction consultants confirmed this by doing a preliminary market survey as part of the feasibility study.

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The transaction consultants concluded that a concession was the option with the highest realistic potential for a successful, completed deal with strong benefits for the city, while city officials still preferred a sale. The overall level of private sector interest in either sale or concession was low and somewhat volatile, therefore the consultants suggested that the city avoid prematurely excluding either option from consideration and possibly ending up with few or no offers for the airport. Accordingly, the decision was taken to let firms prequalify for either sale or for concession, or both (as long as they indicated what they were prequalifying for), with the clear understanding that the ultimate award would be made on the basis of overall income for the city, plans and capabilities of the bidders and other considerations important in the South African environment.

It is important to remember that tariffs, employees and capital investment were not issues in this deal. If they were, they probably would have been best handled in a long-term concession contract, with review procedures and sanctions to ensure compliance over the long term (because it is simply more difficult to hold a purchaser to such commitments than a concessionaire). If these were issues in Richards Bay, it would have been difficult to justify bidding out for sale in addition to concession; it would also have been difficult to compare the two kinds of bids because potential concessionaires would be offering the city continuing control over important aspects, in addition to offering income. It is possible that the city could have 'priced' its willingness to give up long-term concession-style control over these issues; then that price could have been added as a premium to sale price offers. Determining the premium ahead of time and adequately informing bidders would have been a difficult process, particularly for local managers and politicians, to manage and fully understand.

Three firms prequalified for the airport project, and all three indicated that concession was their first choice, although one said it might also still consider a sale. The request for proposal was written to accommodate both options, with a term sheet (rather than a specific contract) attached to apply to either sale or concession. The two final bidders both preferred a concession arrangement. A 20-year concession contract was eventually negotiated with the preferred bidder, Black & Veatch, a US-based engineering firm with a strong corporate presence in South Africa.

If the council had been forced to make a decision between sale and concession, the decision would have depended on a judgement regarding which is larger – the discounted value of the concession fee cash flow over the lifetime of the contract (minus costs of contract compliance monitoring, plus capital investment commitment, plus empowerment benefits) or the value of the sale price offer (plus/minus the same factors).

City officials and their consultants felt that such a comparison was fair, as the potential concessionaire could estimate what a reasonable sale price offer would be, and then adjust the cash flow of its concession fee proposal to be competitive. City officials also noted that this approach was fair in the sense that it allowed firms without the upfront purchase price capital to compete (via a concession offer) with firms that did have such capital and chose to make an offer to purchase.

The 20-year concession contract was modelled to a significant degree on another water and sanitation concession, signed in early 1999, in the same province. The Richards Bay contract involves ZAR13 million in payments to the city, which will be used to repay the debts associated with the facility, plus a probable investment of another ZAR7 million in runway upgrading (depending on the results of an independent assessment later in the contract period). In addition, 20% of the concession company and 20% of its dividends will go into a 'community trust' dedicated to the development and support of the local community, particularly the traditional communities near the airport. The council will make grant decisions for this fund based on grant-making procedures already prepared.

Pursuant to the contract, the private partner must arrange for a performance bond that will eventually expand in size to 12% of annual turnover. They must also arrange for a maintenance bond towards the end of the contract to ensure that money is available to maintain the assets as the concession winds down. The private partner must commit to service levels and investments that will be formalised in a masterplan for the airport, along with annual business plans. Annual service level reports will help the council monitor operations, plus the council can use an independent 'maintenance consultant' who will have the last word on required maintenance expenditure.

Other municipal airport public-private partnerships in South Africa include Johannesburg's Rand Airport, sold in 2000, and Margate Airport, a small facility south of Durban that has recently gone out to tender. Both of these deals have faced the same choice, between concession and sale, which Richards Bay successfully managed. In both cases, either a sale or concession would have met the needs of the municipalities involved; in both cases, the cities' first choice would have been a successful sale, but the first choice of most potential private partners would probably have been concession. Fortunately, in situations like these, where tariffs, employee transition and capital investment are not major issues, and thus not major factors in evaluating proposals, sale and concession can compete together, as the basis for the award of either is the same (total income to the local council, minus monitoring costs, plus capital investment and empowerment commitments). In the case of Rand Airport, Johannesburg officials eventually decided to go only for a sale – they were lucky to get a single bidder who made an attractive offer. Margate will probably use the more flexible approach used successfully in Richards Bay.

The careful, often innovative, preparation of all of these airport projects, along with other municipal public-private partnerships (water, sanitation, solid waste, electricity), has been made possible by the South African government's commitment to making full use of the private sector in improving the quality of essential urban infrastructure-related services for its citizens. A key aspect of that government commitment is the role being played by the Municipal Infrastructure Investment Unit, a government-supported company that is helping to guide the process of preparing and negotiating concession contracts and other forms of public-private partnerships at the municipal level across South Africa. ■

Further information about the Municipal Infrastructure Investment Unit (MIIU) can be found on their website www.miiu.org.za