# Airports: Runway success?

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Following years of deliberation, construction of a new international gateway at St Petersburg Pulkovo airport is about to begin this year.

The planned facility, known as terminal Pulkovo-3, has been on the drawing board for five years, with the work much buoyed by winning approval from the European Bank for Reconstruction and Development for a $36 million tranche. Overall, construction costs are set at between $150 million and $170 million. The bulk of financing is to come from the EBRD which has made a commitment to extend a total of $100 million, with the rest to be raised internationally with the help of sponsors.

Among other EBRD-backed airport projects in the CIS, Pulkovo-3 is the only one that does not hinge on government guarantees. ?It is a purely commercial venture involving co-financing exclusively from the private sector?, notes airport director Nikolai Kolesov.

The project has been stalled for a long time because of investor reservations about risk management. ?To minimise risks, foreign partners set a number of conditions?, explains Kolesov. ?We failed to meet them because the airport is wholly in the state hands?.

One key requirement was to open an offshore bank account for the airport. The other demanded that its currency earnings be exempt from repatriation through mandatory conversion into roubles. ?All this requires nothing less than a presidential decree and looks improbable for the time being?, says Kolesov. But he adds optimistically: ?To date, many similarly unrealistic conditions have been moderated or withdrawn, which clears the way for a hands-on approach to fundraising?.

Since its inception, the project has been managed jointly with the US firm Strategic Partners. An open-end joint stock company was set up to seek access to capital markets and search for investors to buy shares in Pulkovo-3, once a stock issue is launched.

Deutsche Morgan Grenfell came up with the scheme to arrange a syndicated credit line subordinate to the EBRD funding. However, its redemption terms and credit risks appeared to be at odds with those of the EBRD loan, while the interest rate was prohibitively high.

Last year, the project management team took a decision to diversify funding efforts. Pulkovo Aviation Enterprise, which runs the airport, formed a consortium with Aeroports de Paris, Skanska AB and French construction firm GTM. Initially, they contracted to build and operate Pulkovo-3 but now are also supposed to put up the fundraising shortfall for the project.

The airport operates within the framework of a state unitary enterprise that also incorporates Pulkovo Airlines (PAL). In contrast to many other regional divisions of Russia's civil aviation system, its former north-western department, centred on Pulkovo, remained intact. Both airport and airline refrained from being privatised and splitting off from each other.

Some analysts believe that the best way forward for Pulkovo is to corporatize. Kolesov admits that the EBRD shared this view and attempted to make financing contingent on Pulkovo's transformation into a joint stock company. But the management opposed privatisation plans for fear of this hurting the airline's financial position. Being part of a unitary enterprise, PAL benefits from reduced charges at Pulkovo airport. Another advantage is an opportunity to consolidate revenue streams and better allocate financial resources.

Last year, PAL recovered from the severe effects of the rouble's devaluation in 1998, but increased jet fuel prices almost wiped out the gains of recovery. However, the enterprise as the whole continued to be in the black due to revenues from non-airline activity.

In the first 10 months of last year, Pulkovo handled 1.9 million passengers, down 10.9% from the same period of 1998. Of that, one million flew domestic routes, with the rest using international services.

Despite the slump in passenger numbers, Kolesov is confident of an upward trend in coming years. He says: ?After all, St Petersburg is Russia's second largest city and the hub for the country's north-west. By this summer, we expect to regain the pre-crisis passenger traffic, first of all on international routes.?

The airport serves about 20 carriers, operating scheduled international services to and from St Petersburg. PAL alone provides connections to 23 destinations abroad, not including chartered flights, and is set to expand overseas operations. This puts a growing pressure on the congested international terminal Pulkovo-2.

Rerouting international traffic to a bigger Pulkovo-1 appears problematic for technical reasons. The terminal opened in 1973 and was originally designed to serve only domestic operations. At the peak of its activity in the 1980s, it handled up to 17,000 passengers a day.

With the break-up of the Soviet Union, volumes dropped considerably and the terminal turned out to be oversized. ?Despite this, it lacks room for developing facilities needed for handling cross-border traffic, such as customs and passport control?, says Kolesov. ?Following the then trend, designers sought to cut the distance between terminal and aircraft as much as possible. As a result, Pulkovo-1 became hostage to that layout when intra-CIS air traffic evolved into international.?

To refit the terminal, the airport authority has launched a modernisation programme funded exclusively with internal resources. Both arrival and departure halls now feature special control areas handling passenger traffic on the CIS routes.

Despite this, enhancing the airport's international throughput capacity remains a top priority. Kolesov believes that building a new facility is the best solution and counts on getting the go-ahead for Pulkovo-3 shortly. He says: ?Jointly, with partners, we are putting the finishing touches to the business plan. The EBRD is waiting on when it comes to fruition and we hope to start on the construction work this year?.

There are, however, fears the consortium may fail to pull in a $50 million loan package for the project and it does not take off as scheduled. An alternative plan is to focus on only upgrading the existing international terminal Pulkovo-2 without resorting to foreign loans.

Russia's firm Aeroproject has proposed a scheme to almost double its annual throughput to 2 million passengers without disturbing airport activities. Over the last few years, the facility has already seen patchy renovations costing $25 million. They were made on and off depending on availability of funds allocated from operating profit. To do away with the capacity crunch at peak hours, Pulkovo-2 still requires a $40 million upgrade.

?Given the mounting congestion, we cannot waste time,? explains Kolesov. ?The work will proceed on a phase-by-phase basis. Unless Pulkovo-3 takes off, the consortium will follow an incremental approach to modernisation, while continuing to look for affordable credits.?

One of the options, mulled by project managers, is to turn to Russia's banks. Before the rouble devaluation, they pursued a purely short-term investment strategy. ?No great loss without small gain,? quips Kolesov. ?With the demise of get-rich-quick opportunities, domestic bankers now have to consider longer-term investment in viable infrastructure developments, of which expansion at Pulkovo-2 is an example?.

Another project postponed for financial reasons envisages a $100 million construction of a hotel and attached business centre. A mandate to build the complex went to Grassi GmbH of Austria. But operating it appears financially feasible only in conjunction with the expanded international gateway.

On a more positive note, financing arrangements for the construction of a new cargo terminal, with the first phase handling capacity of 30,000 tonnes a year, is nearing completion. A deal with the EBRD provides for extending the $8 million facility. Another $4 million is to be funded by the airport and its joint venture partner Lufthansa's subsidiary, Global Ground Handling.

Despite last year's credit squeeze, Pulkovo managed to complete a $3.5 million overhaul of the catering facility, producing 25,000 meals a day. It also continued upgrading airside facilities at domestic terminal, with both developments funded from internal sources.

Progress would have been greater, had the enterprise had a freer hand in using its earnings. Under the current regulations, it derives little benefit from developing non-aviation activities as receipts from them almost entirely go to the state budget, while the retained money barely covers airport's operating expenses. ?This is because the bulk of budgetary organisations, such as customs, border and sanitary control units, don't pay rent to the airport anyway?, laments Kolesov.

As a result, non-aviation revenues account for only 10% of the total.

Russia's bill on airports has been stalled in the parliament for four years and hopes are high that the newly elected Duma will pass it this year. In contrast to privately owned enterprises, government-owned airports cannot fully use such potentially lucrative revenue sources as parking lots or renting out for retailers. But, according to Kolesov, they are increasingly lobbying these issues. Regulators are also coming to realise that airports need a bigger access to their earnings to have opportunity for development.

Once the law comes into force, Pulkovo expects the share of non-aviation revenues at its disposal will jump to 20% within a year and up to 40% within two years. Kolesov believes that at some point it will be able to continue with modernisation plans without borrowings at all.