Recommendations to Promote the Success of Future Toll Road Privatizations

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Relatively few toll road privatizations have occurred over the past decade in the United States. This is due, in no small part, to the political and regulatory hurdles that act as significant headwinds to any privatization momentum. Nonetheless, as municipalities, states, and even the Federal government have, despite laudable efforts, been unable to curb burgeoning budget deficits and close large infrastructure funding gaps, the use of private financing for US toll roads will necessarily have to increase.

Over the coming decade, private capital will provide an essential source of funding for our nation's transportation infrastructure, and toll roads are prime assets for consideration. For deals of this complexity, all financial implications for sound transaction structuring and execution should be considered. The success of future privatizations, and the level of public benefit that results, will be influenced, in part, by the lessons that are learned and incorporated from previous deals. Two such major deals were the privatizations of the Chicago Skyway and the Indiana Toll Road ("ITR"), which were leased to private investors in 2004 and 2006. Takeaways from these deals, as well as several other suggestions for toll road privatization, are presented below.

- **Shorten Lease Durations**. The uncertainty of micro and macro internal and external factors associated with financing, operating, and maintaining toll roads makes truly long-term lease durations incredibly risky. Forecasting traffic demand for a 50-99 year period is a daunting and seemingly impossible task. Often, the effects of mistaken assumptions compound as the lease period transpires. The lengthy durations of these leases are a principal reason for the significant variation in asset valuation. For example, bids for the Skyway ranged from $505 million to $1.82 billion – more than 300% of the lowest bid. Similarly, an independent valuation of the ITR (conducted for the State) at $1.92 billion was less than half of the actual winning bid. For the private sector, this variability in valuation represents a dangerous risk to investment returns. For the public and the sponsoring entity, the demand risk could lead to privatization for an amount that is below the value of the asset (i.e. if demand is higher than projected). Although large investor appetite and broader economic conditions have yielded aggressive forecasts that have been shown to have overestimated actual demand, this may change going forward as investors adjust bidding processes and revise risk tolerances downward and as economic conditions improve. Shorter lease durations would mitigate these risks considerably. For instance, leases could be set for 30 years or less (approximately the useful life of a highway) with optional renewal periods and terms defined up front. Assets can still be privatized for long periods, but these privatization agreements should provide for periodic adjustments to ensure that both parties receive a fair shake.

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- **Increase Project-Based Agreements**. Funding deficiencies often prevent public agencies from the development of new, much-needed infrastructure. Private financing can be used to advance specific projects, and may be better suited for this purpose rather than the assumption of existing roads given the (a) increased level of risk associated with new development (i.e. there is no historical demand benchmark); (b) potentially smaller level of funding required, compared to a full, long-term privatization; and (c) speed and efficiency with which the private sector can deliver new projects. The public sector can turn to private investment to make possible projects that lack sufficient funding, and determine the lease duration based upon the payback period required to cover the cost of investment plus a reasonable return, with the asset reverting to public ownership at the end of the lease.

- **Create True Partnership Over Time**. The public and private sectors should create agreements that reflect true partnership, meaning that both parties are able to adjust to changes in conditions affecting the agreement. For instance: the public sector should structure the agreement in such a way that it can benefit from improvements enacted and efficiencies gained over time. This may entail revenue sharing, as opposed to the receipt of solely an upfront payment. Should the public sector structure such a revenue-sharing agreement, it should endeavor to establish a minimum annual revenue stream or require a mandatory set aside of a portion of the upfront proceeds in an interest-bearing account. Likewise, a true partnership would allow for the development of future roads and address the issue of competition, which represents a challenge in all privatizations. For instance, in Indiana, the State is restricted from building or expanding highways within 10 miles of the toll road for 55 years without compensating the concessionaire for lost toll revenue. Due to the monopolistic nature of transportation assets, it is difficult for the public sector to encumber its ability to construct additional roads that may compete with the leased asset. However, externalities such as congestion on alternative roads may arise as travelers seek to avoid newly implemented and/or tolling rates that are perceived as prohibitively high. Thus, instead of limiting and fearing competition through non-competes for the duration of the lease, the parties should work together to create new roads as needed. This may have the additional benefit of making more affordable for the public sector the creation of new roads in the future.

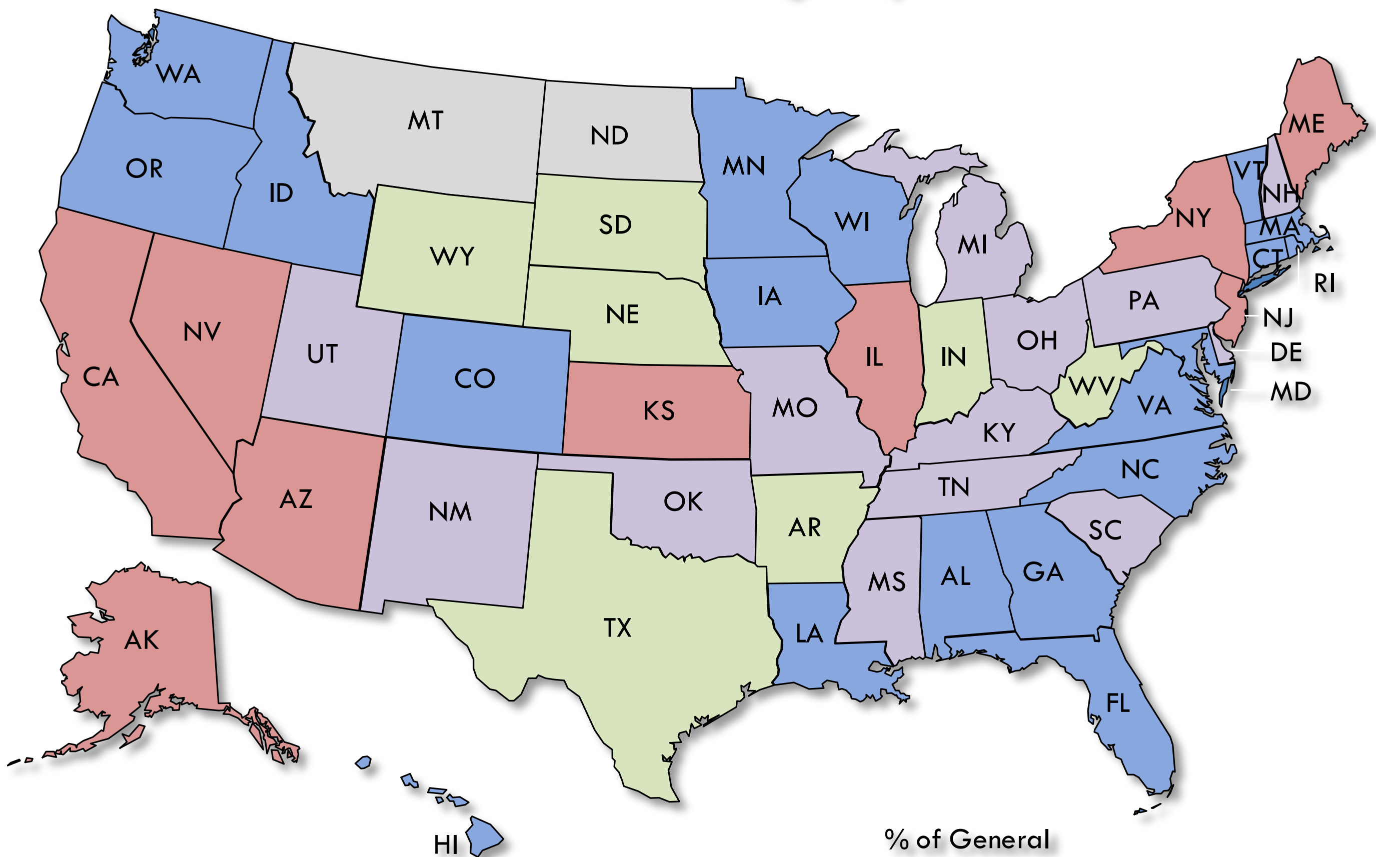
- **Encourage Pooled Investment**. The financial crisis triggered in 2008 has changed the nature of private funding for infrastructure deals. While demand still exists (investors have allocated more than $200 billion to private equity investment funds that remains un-invested), access to debt funding has become more difficult and costly. Consequently, billion-dollar deals that may have previously been financed by a lone investor are now pursued by consortia of multiple firms. Thus, the public sector should recognize that larger investor teams may be necessary to deliver the funding required for the transaction. Indeed, this carries positive benefits for the public sector. Pooled investment promotes risk sharing and increases the collective stability of the investment funding. In cases where demand fails to materialize as projected, or temporarily decreases due to economic conditions or other external factors, this stability assumes increased significance. Furthermore, a pooled investment decreases the risk that the investor group will default on its investment and consequently the likelihood of a bankruptcy event.

- **Promote Coordination Among Public Entities**. For too long, municipalities and states have acted independently to design transportation programs and pursue road development with little consideration of the tangential implications of such transactions. These entities should instead increase the level of collaboration, working together to adopt consistent practices, procurement approaches, and project support. Hopefully, this will streamline the privatization process and promote information sharing of lessons learned, consequently increasing the collective benefit provided to citizens across state lines. In addition, coordinated government efforts to privatize roads that cross state lines may garner additional investor interest.

- **Educate and Contain Public Expectations**. Despite the potential for success that privatization offers, public sector agencies must act responsibly in containing the expectations of their stakeholders. Policy makers and project sponsors must not over-promise at the risk of under-delivering. This mismatch in expectations constitutes one of the most significant reasons for

the headwind in the privatization movement. Managing expectations is a critical factor in marshaling the requisite support to execute a deal and to maintain support post-implementation. Community outreach and education – a large part of this effort – should occur in advance of the transactions, as well as throughout their operation. Public agencies must practice transparency and communicate clearly the expected benefits for each deal, as these factors will serve to increase public acceptance of privatization.

The Skyway and ITR privatizations have provided undeniable qualitative and quantifiable benefit to the public, based on several major criteria of success by which privatizations are evaluated, including quality of service, job preservation, and, of course, financial gain. The single and fundamental factor of privatization success – whether the asset operates better under private control than state control – suggests that these deals have been successful. The benefits of toll road privatization have been amplified in the wake of the economic crisis that has transpired over the past 12-18 months. Although neither the City of Chicago nor the State of Indiana has been spared subsequent financial difficulty, especially throughout the crisis, these cash windfalls made possible other needed investments in transportation and social services. Overall, the Skyway and ITR privatizations have provided great benefit to the public sector and the public at large. Further, they lend compelling evidence



in the ongoing argument to more fully involve private funding for the execution of additional domestic road privatizations over the coming years.

Going forward, it is unlikely that vast sums of money will be proffered upfront for domestic toll road leases. Nonetheless, private investor appetite for infrastructure investments remains, as does the public need for this funding. As of November 2009, 48 states were projected to have fiscal year 2010 budget deficits, 42 of which had deficits exceeding 10% of their general fund. Thus, toll road privatizations may offer opportunities for states and municipalities to fund and develop vital infrastructure over the coming decade. Governments considering privatization can benefit significantly from public-private partnership expertise that advisors can provide to structure and execute a smooth transaction that provides lasting value to the public.

The criticism of privatized toll roads is often rooted in the escalation of tolls to higher levels under private operation. Yet, over the coming decade, increased investment in our nation's infrastructure is a necessity; both higher gas taxes and more frequent and appropriate tolling rates provide a means to cover current funding gaps while providing a system of equity that allows drivers to pay for only what they use. Higher toll rates under private operation still fair, affordable, and below comparable rates paid in other jurisdictions and countries.

Privatizations of toll roads within the United States have incredible potential for success from the public perspective. Executed properly, they provide financial benefit to the sponsor, reduce public risk exposure, increase asset service quality to the consumer, and offer greater overall stability of infrastructure operation and maintenance. Large shocks to the economic system, such as the recent global recession, underscore the value of these deals for the public, reducing the financial exposure of the public sector and, in effect, establishing a guaranteed financial benefit with decreased volatility through an upfront payment invested wisely. To the extent that these privatizations can be executed with demonstrable and unequivocal value to the public, minimal negative impact on labor, and lasting stability, they can serve as a model for the sustainable financing of our nation's roadways.

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