

Protecting the Public Interest: The Role of Long-Term Concession Agreements for Providing Transportation Infrastructure

June 2007

SUMMARY

Lack of cash has led virtually every state in the nation to explore innovative finance techniques that allow important infrastructure projects to move forward while keeping taxes low. In 2004, the City of Chicago rocked the transportation world by leasing the Chicago Skyway to private investors for 99 years and putting \$1.83 billion in the bank. This deal was simultaneously hailed as a stroke of genius and decried as a short-sighted sale of American infrastructure to foreign interests. Several months later, Indiana leased its toll road to another foreign investment group for \$3.8 billion, allowing the state to fully fund its long-range transportation plan. Although many observers hailed this as the long-awaited silver bullet to solve chronic shortfalls in transportation funding, these concessions are tremendously controversial. In the last few months, the exuberance among state policy-makers has cooled somewhat as they have wrestled with the tradeoffs inherent in these decisions. How are public sector decision makers to know whether they are advancing the public interest when they consider these agreements? In *Protecting the Public Interest: The Role of Long-Term Concession Agreements for Providing Transportation Infrastructure*, Jeffrey N. Buxbaum, and Iris N. Ortiz synthesize the recent history of private equity participation in hitherto public enterprise, summarize public concerns related to long-term concessions, and review the information that was provided to decision-makers before recent concession agreements were executed. The goal of the report is to help the public gets the best value from long-term concession agreements for providing transportation infrastructure while ensuring that public interests are protected.

CRITICAL ISSUES IN PRIVATE CONCESSIONS AND STRATEGIES TO ADDRESS THEM

Tolling Policy. Tolls have historically been used to fund highway projects that were too expensive to be paid for from taxes. Traditional toll facilities financed by municipal bonds and governed by public or quasi-public agencies typically aimed to keep tolls at the minimum level necessary to retire the bonds and fund needed reserves. One of the main advantages cited of switching to the concession model is the ability to raise tolls to track or exceed inflation and to keep tolls in place over a long period to ensure an adequate revenue stream. Despite fears that tolls will rise excessively, the public sector can control the rate that tolls escalate in a private concession by explicitly stating escalation formulas and growth indices in the concession agreement. The policy for toll escalation can also be specified in enabling legislation following public input. Unfortunately, decisions on tolling policy have been commingled with the concession decision—these are two separate decisions, each deserving analysis and debate.

Profit from Highways. The private sector has long been involved in the financing of transportation facilities through the purchase of municipal bonds. As a bondholder, the private sector's main concern is the full and timely repayment of debt. By allowing private entities to take an equity stake in a project, the concession model significantly changes their interest in its financial outcome. Under the private equity model, the private sector hopes that revenue will exceed forecasts and yield returns greater than expected. This transforms the operator of the toll road from an entity tasked with providing a public good, albeit at a price, to one that wants to maximize profit. Because the United States highway system has most recently been a public enterprise, people instinctively reject the idea of the private sector profiting from a toll road. Concession agreements can limit excessive profits and also include arrangements for the public sector to share them with the concessionaire. However, such provisions will reduce the potential value of the concession and lower any upfront payments by the concessionaires.

Length of Concession. The lease periods for the Chicago Skyway and the Indiana Toll Road (99 and 75 years, respectively) are so long that they give the perception that the public sector has given up control of the facilities. Although this is not the case, the perception can be managed by specifying shorter lease periods in the concession agreement and publicly stating that the lease will be re-bid after a specified time period. The tradeoff is that the value to potential concessionaires will be reduced as will the amount they are willing to pay for the opportunity to operate the facility.

Non-compete Clauses. The early concession agreements contained penalty provisions if the public sector provided additional transportation capacity that would “compete” with the private facility and impact its revenue stream. Most notable among these were the SR 91 Express Lanes in Orange County, California which were bought back from the concessionaire in 2002 after additional public capacity was added for safety reasons. Subsequent concessions have recognized that blanket non-compete clauses are a mistake and have included provisions tailored to specific local conditions, such as allowing arterial improvements in urban areas and improvements already planned at the time the concession was executed.

Operating and Maintenance Standards. Although concerns have been raised that privately operated facilities will be inferior to their public counterparts, this can also be addressed in the concession agreement. Contracts include detailed performance requirements and third-party performance assessments. Additionally, the concessionaire is contractually obligated to maintain these performance levels so maintenance funding is not subject to the annual public budget process. If the facility is not maintained to these requirements, it can be taken back by the public sector with the loss of private equity.

The concession model has grown from the reality that our transportation system needs far more money than is available from traditional sources. There are no silver bullets in public finance and there are no easy answers to this fundamental dilemma. The concession approach to project financing has many advantages over traditional methods but there are many concerns with these nontraditional techniques. At this point, very few people have a complete picture of the short- and long-term implications of different approaches and the associated tradeoffs. Many of the concerns with long-term concessions are legacies from past agreements that have been rectified as both the public and private sectors have learned and adapted. Some potential alternatives to private concessions need to be more fully explored but raise difficult political issues generally avoided by elected officials.

A dispassionate, objective analysis of the concession approach is still evolving. Over time, decision-makers will be better able to see the advantages and disadvantages of *all* viable approaches to solving the crisis of paying for transportation. As the transportation industry and elected officials gain more experience with concessions, it is possible that the current polarization of debate will subside, and well thought-out solutions that gain public acceptance will emerge. Florida and New Jersey are taking a much more methodical approach to current deliberations than their predecessors. Ultimately, each state or region will need to determine for itself the proper balance between competing objectives when it comes to delivering an effective transportation system.

ADDITIONAL RESOURCES

Jeffrey N. Buxbaum, AICP is a Principal of Cambridge Systematics, Inc., which specializes in transportation policy, strategic planning, and management. He may be reached at jbuxbaum@camsys.com. Iris N. Ortiz is an Associate of Cambridge Systematics, Inc., and may be reached at iortiz@camsys.com. The complete study may be found at <http://www.usc.edu/schools/sppd/keston/research/index.html>.

THE USC KESTON INSTITUTE FOR PUBLIC FINANCE AND INFRASTRUCTURE POLICY

The USC Keston Institute for Public Finance and Infrastructure Policy is a nonpartisan research organization established at the University of Southern California to help California and the nation address critical infrastructure issues. The Keston Institute supports the formulation of infrastructure policies and practices that will improve the livability of California communities, ensure the economic well-being of its citizens, and promote environmental sustainability.

For more information about the Keston Institute for Public Finance and Infrastructure Policy, please contact Richard G. Little, Director, at (213) 740-4120 or via e-mail at rgliddle@usc.edu.