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PUBLIC-PRIVATE PARTNERSHIPS: INNOVATIVE FINANCING AND PROTECTING THE PUBLIC INTEREST

(110–7)

HEARING

BEFORE THE

SUBCOMMITTEE ON
HIGHWAYS AND TRANSIT

OF THE

COMMITTEE ON
TRANSPORTATION AND
INFRASTRUCTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

FEBRUARY 13, 2007

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U.S. House of Representatives
Committee on Transportation and Infrastructure
Washington, DC 20515

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Chairman

David Heynsfeld, Chief of Staff
Ward W. McCarragher, Chief Counsel

John L. Mica
Ranking Republican Member

James W. Coon II, Republican Chief of Staff

February 12, 2007

MEMORANDUM

TO: Members of the Subcommittee on Highways and Transit

FROM: Subcommittee on Highways and Transit Staff

RE: **SUMMARY OF SUBJECT MATTER**: Hearing on Public-Private Partnerships: Innovative Financing and Protecting the Public Interest

PURPOSE OF HEARING

The Subcommittee on Highways and Transit is scheduled to meet on Tuesday, February 13, 2007 at 10:00 a.m. to receive testimony on innovative financing under public-private partnership (PPP) arrangements, how the public interest should be protected when PPP are used to provide innovative financing for infrastructure investment, and whether the model legislation developed by the Federal Highway Administration (FHWA) provides adequate safeguards for the public interest. The Subcommittee will hear from officials of the U.S. Department of Transportation, the Wisconsin Department of Transportation, and the Metropolitan Transit Authority of Harris County, Texas, as well as representatives of the legal, financial, and research/advocacy community who specialize in PPP and transportation project financing.

BACKGROUND

Nature of Public-Private Partnerships

The Government Accountability Office (GAO) defines public-private partnership, in part, as "a contractual agreement formed between public and private sector partners, which allows more private sector participation than is traditional. The agreements usually involve a government agency contracting with a private company to renovate, construct, operate, maintain, and/or manage a facility or system. While the public sector usually retains ownership in the facility or system, the private party will be given additional decision rights in determining how the project or task will be completed." The U.S. Department of

Transportation (DOT) has adopted this definition for its programs. The goal of PPPs is an equitable sharing of risks and rewards among the partners.

Conventional Contracting Approach

Traditionally, delivery of highway and transit projects follows the design-bid-build sequence. The typical pattern that began in the mid-20th Century is for public transportation agencies (departments of transportation and transit authorities) to design a transportation project using in-house engineering staff until it is 100 percent complete. The project is then let out for bids in a competitive process. Generally, the private construction firm that offers the lowest-price bid is awarded the contract to build the project. The project is financed with public (federal, state, or local) funds. At completion, the state transportation agency inspects the project to ensure that it is built according to plan and meets various design and construction standards. The agency then operates and maintains the project during the useful life of the project. The advantages of conventional contracting for the agency are (1) complete control over project design, (2) a competitive bid price for project construction, and (3) a high degree of transparency. The disadvantages are (1) financial exposure to change orders, (2) no guarantee of the lowest final project price, and (3) a need for complete public funding.

Innovative Procurement Models of PPP

In the mid-1980s, federal, state, and local governments began to experience large budget deficits. As a result, they turned to the private sector to tap into its financial resources to supplement government funds.

In the transportation sector, a number of the activities associated with planning and developing transportation projects were outsourced to private contractors. Over time, the list of such outsourced activities lengthened.

As the number of transportation PPPs grew, they were presented as a win-win proposition for governments and the private sector. For the government, it offered the opportunity to encourage entrepreneurial development and operation of transportation projects, take advantage of private-sector management skills and capital, speed up application of advanced technology, and reduce the size of public payrolls. For the private sector, it offered opportunities to participate in infrastructure investment, to expand their customer base, and to diversify their business model.

Early PPPs in the United States were mostly of the innovative procurement type. A number of models evolved, encompassing varying activities for which the private-sector partner was responsible. They ranged from design-build to design-build-operate, design-build-maintain, and design-build-operate-maintain. As more responsibilities were assumed by the private-sector partner, more of the risks relating to project costs and delays were shifted to the private-sector partner.

Hiawatha Light Rail Transit (Minnesota)

The Hiawatha Light Rail Transit (LRT) project is an example of a PPP that used innovative procurement. Hiawatha LRT links downtown Minneapolis with Minneapolis-St. Paul International Airport and the Mall of America. This $675 million transit project includes 12 miles of tracks, 17 stations, and 26 light rail vehicles. It used two separate design-build contracts—one for rail vehicles and the other to install rail and signal and communication equipment along the tracks. A third conventional design-bid-build contract was used to construct two 7,400-foot tunnels and two stations at the airport.

The Hiawatha LRT used an innovative mix of design-build and design-bid-build procurement methods to construct, as well as an innovative mix of federal, state, and local funds to finance, the project. It entered revenue service in July 2004. Ridership has consistently and significantly exceeded official projections. Ridership in 2005 was 7.9 million, 58 percent above pre-construction estimates.

Build-Operate-Own Or -Transfer Concession

Modest federal incentive for PPP involving private financing was provided by the Surface Transportation and Uniform Relocation Assistance Act of 1987, which authorized a pilot program that allowed 7 toll projects to be constructed off the Interstate System with federal assistance at 35 percent of project cost.

Dulles Greenway (Virginia)

Several states explored the use of PPP to develop toll roads in the late 1980s. In 1988, Virginia became the first state to enact legislation enabling private development of highways. The Dulles Greenway was the first purely private toll road built in the United States in more than 100 years. Previously, the Virginia Department of Transportation (VDOT) had built the Dulles Toll Road connecting the Capital Beltway with the Washington Dulles International Airport. It was virtually an instant success and was very profitable for VDOT. VDOT then considered extending the Dulles Toll Road to Leesburg when a consortium, the Toll Road Investors Partnership II (TRIP II), comprised of Shenandoah Greenway Corporation of Virginia, Italy's toll road operator Autostrade, and the Texas-based engineering and construction firm Brown & Root, made an unsolicited proposal to develop the extension using private financing. VDOT awarded a 42.5-year design-build-operate-transfer (DBOT) concession to TRIP II for the 14-mile, $350 million facility. This concession represented the start of a new breed of transportation PPPs.

Construction of the private toll road was completed in September 1995—six months ahead of schedule. When it opened to traffic, tolls were set at $1.75 each way. But initial traffic volume fell far short of pre-construction forecast, with only 8,000 vehicles rather than 35,000 vehicles (or 23 percent) using the facility each day. Tolls were reduced to $1.00 each way, which generated more traffic but not more revenues. By July 1996, TRIP II was expected to default on its loans until its creditors agreed to restructure the debt. Later that year, VDOT extended the concession for an additional 20 years and allowed a toll increase. Revenues grew steadily as more entrance ramps were added to enable more drivers to use the facility. The Australian firm Macquarie Infrastructure Group (MIG) purchased the concession from TRIP II in 2005 for $617.5 million.

SR 91 (California)

A year after Virginia enacted its PPP legislation, the California legislature passed Assembly Bill 680 (AB 680), allowing up to 4 PPP projects to be carried out on a demonstration basis.

The California Private Transportation Company (CPTC), a limited partnership comprised of subsidiaries of Lever 3 Communications, Inc., Compagnie Financiere et Industrielle des Autoroutes (Cofiroute—the world's largest private toll road operator), and Granite Construction Inc., proposed developing private toll lanes as part of the AB 680 demonstration. A 35-year DBOT concession was approved in 1990 by the California Department of Transportation (Caltrans). Four "express" lanes—two in each direction with only 1 entrance and 1 exit at each end—were constructed in the median of SR 91.

SR 91 was the first toll facility to use variable pricing (congestion pricing) in the United States; it was the first fully automated toll facility in the U.S.; and it was the first American project to operate high occupancy toll (HOT) lanes.

The 10-mile facility was opened to traffic in December 1995 at a cost of $135 million. The project was an initial success as peak travel times and average travel speed improved by more than 50 percent. The lanes were generally viewed as a net public benefit.

By the late 1990s, public mood had changed. The concession agreement contained a non-compete clause that prevented public agencies from increasing highway capacity within a 1½ -mile wide area along each side of the toll lanes for the term of the agreement. Caltrans wanted to add merging lanes between SR 91's free lanes and a newly completed public toll road, the Eastern Transportation Corridor, to improve traffic safety. Although the agreement provides for an override of the non-compete clause for safety reasons, CPTC disputed Caltran's safety analysis, and fierce debate of competing public and private interests ensued. In the course of the debate, public opinion turned strongly against the toll lanes. What once was viewed as a facility that provided public benefits in relieving congestion was now seen in a negative light as contributing to congestion or, worse, unsafe conditions.

The controversy was finally resolved in early 2003 when OCTA purchased the toll lanes from CPTC for $207.5 million. The non-compete clause was eliminated. OCTA currently operates the lanes with variable pricing tolls ranging from $1.15 to $9.25 each way eastbound, and from $1.15 to $4.05 each way westbound.

Long-Term Lease of Existing Facility

In October 2004, the City of Chicago entered into negotiation to lease the Skyway, an operating toll road, to a consortium of private operators for a very sizable upfront cash payment. The Chicago Skyway was followed, in quick successions, by the Indiana Toll Road and the Pocahontas Parkway in Virginia. A number of other states, including New Jersey and Pennsylvania, are exploring or discussing similar long-term lease arrangements.

Chicago Skyway (Illinois)

In January 2005, the City of Chicago reached a franchise agreement with the Skyway Concession Company, LLC, a consortium owned jointly by MIG and Spain's Cintra Concesiones de Infraestructuras de Transporte S.A. (Cintra), for a 99-year lease to operate and maintain the Chicago Skyway. The contract price for the concession was $1.83 billion. The consortium is also required under the agreement to carry out capital improvements, including installing an electronic toll collection system, to enhance the throughput and operational efficiency of the Skyway. In return, the concessionaires are allowed to collect and retain all toll revenues during the term of the lease.

Included in the lease agreement is a schedule for toll increases: specified periodic step increases beginning in January 2005 through 2017, thereafter, maximum annual increases would be capped at the greater of (a) 2 percent, (b) the Consumer Price Index (CPI), or (c) per capita nominal Gross Domestic Product (GDP) growth.

The price for the lease of the 48-year old, 7.8-mile long Skyway captured the attention of the transportation community. Political leaders in particular view this as an attractive way to obtain revenues without having to raise taxes. By leasing existing transportation facilities for the long term, large sums could be raised to pay for government services and capital investments, or to pay off debt and other obligations. Chicago would use the proceeds from the Skyway lease in the following manner:

- Refund outstanding indebtedness on the Skyway — $465 million
- Repay City general obligation debt — $390 million
- Fund an operating budget shortfall account — $375 million
- Fund a "permanent" reserve — $500 million
- Fund "visible programs" (e.g., winter heating assistance, homeless shelters, computerized library catalog, etc.) — $100 million

Indiana Toll Road

Indiana closed a 75-year lease deal with Statewide Mobility Partners, a consortium owned by the same MIG-Cintra partners as in the Chicago Skyway deal, on June 29, 2006 for the operation and maintenance of the Indiana Toll Road. The contract price for the 50-year old, 157-mile long Toll Road was $3.8 billion. The consortium is required under the agreement to carry out an estimated $305 million worth of capital improvement, including the installation of an electronic tolling system. The concessionaires are allowed to collect and retain all toll revenues during the term of the lease.

While lease negotiation was under way, Indiana Gov. Mitch Daniels raised the tolls on the Toll Road administratively for the first time in 21 years. The enabling legislation later passed by the Indiana state legislature provides a schedule for further toll increases: specified periodic step increases for 5-axle commercial vehicles from April 2006 through June 2010, and no change for passenger cars during that period. Thereafter, maximum annual increases for passenger and commercial vehicles would be capped at the greater of (a) 2 percent, (b) CPI, or (c) per capita nominal GDP growth.

The concession agreement contains a non-compete clause that prohibits the State from building or improving any limited access highway within a 10-mile corridor on either side of the Toll Road.

Unlike Chicago, which used the lease proceeds largely for non-transportation-related expenses, Indiana proposed to use the money it obtained from the concession for the following:

• Retire outstanding Toll Road bonds	$200 million
• Establish a "Next Generation Trust Fund" (using interest to pay for road and bridge projects)	$500 million
• Fund the "Major Move" construction program (build transportation projects such as I-69 connecting Evansville and Indianapolis)	$3,100 million

In addition, 34 percent of the Major Move program funds will be reserved for highway projects in the seven counties through which the Toll Road runs.

Pocahontas Parkway (Virginia)

In June 2006, Virginia entered into an agreement with Australia's Transurban Group, granting the private company a 99-year concession to operate, maintain, and perhaps extend the Pocahontas Parkway near Richmond. The deal is estimated to be worth about $520 million to Virginia for the 9-mile, four-lane toll road that was open to traffic in 2002. Compared to the Skyway and the Toll Road, the price for the Parkway is considerably lower because the agreement provides for revenue sharing by Virginia and Transurban, and includes a "termination for convenience" clause to allow Virginia to walk away from the contract at will.

As in the case of the Skyway and the Toll Road, the lease agreement includes a schedule for future toll increases: specified periodic step increases from January 2006 through 2016, thereafter, maximum annual increases would be capped at the greater of (a) 2.8 percent, (b) CPI, or (c) per capita real GDP growth.

The agreement includes a non-compete clause that prohibits the State from building or improving any highway within a 6-mile area on each side of the Parkway.

Unique Characteristics of Long-Term Lease Agreements

There is little disagreement that long-term leasing of existing facilities is fundamentally different when compared to the more traditional PPPs that preceded it. Following are some of the unique characteristics of these agreements.

New Capacity vs. Existing Facility

Traditional PPPs are commonly used to help finance new infrastructure development, adding new capacity to the overall transportation system to help relieve congestion or to improve the operational efficiency of the system. What makes a long-term lease to operate an existing facility different is that very little or no new physical capacity will be added. It is possible that existing capacity can be made to accommodate a greater volume of traffic by means of enhanced throughput—i.e., by improving operating efficiency to enable a larger volume of traffic to move through the same facility—thereby relieving congestion.

Very Long Term Lease Agreement

Another distinguishing feature of these long-term lease agreements is the very long duration of the leases—ranging from 55 years to 99 years. A highway is generally designed to have a useful life of about 20-30 years; a bridge usually lasts for about 50 years before it becomes deficient or obsolete. Traditional PPPs involving operation concessions typically last no longer than the life of the facility before reverting back to the public sector owners. A lease that is two to three times as long as the facility's service life may seem to some to be equivalent to transferring ownership to the private firm that is granted the concession.

Tax Benefits

Another important consideration for having such long leases has to do with tax benefits. Chief among the federal tax benefits is accelerated depreciation. Although the lessee (concessionaire) is not the owner of the existing toll road, if the term of the lease exceeds the remaining design life of the asset at the time of the transaction, barring other countervailing factors, the IRS will treat the concessionaire as owner for tax purposes. Tax ownership qualifies the lessee to depreciate the portion of its upfront payment allocated to the tangible physical assets over 15 years for a highway, as opposed to the full term of the lease.

The Chicago Skyway is 48 years old, while the lease runs for 99 years; the Indiana Toll Road is 50 years old, and its lease term is 75 years. Even with meticulous renewal and replacement, the lease terms of these facilities will almost certainly exceed their respective remaining design lives. MIG and Cintra likely will qualify for tax ownership and, therefore, are eligible for accelerated depreciation. Similarly, the Pocahontas Parkway is only 4 years old, but the term of the lease is 99 years. Again, Transurban probably will be eligible for accelerated depreciation.

Another portion of the upfront payment is allocated to the right to impose and collect tolls. This portion of payment is amortized over 15 years on a straight line basis. A third portion of the upfront payment may be treated as pre-paid rent that is amortized over the full term of the lease.

In sum, long-term lease concession of existing toll roads can provide substantial tax benefits in terms of accelerated depreciation, normal depreciation, and amortization, all of which are tax savings that contribute to reducing the real cost of the concession price.

High Concession Price

Private firms/consortia have offered very high prices to public sector owners of the facilities described above for the concession to operate the facilities. Since private companies are in the business to earn a profit, that means the marketplace values those facilities very highly, and it can be inferred that the companies are justified in offering those high prices. Tax benefits discussed above is one reason; they represent a saving that reduces the cost to the private concessionaires.

A second factor relates to accurate information. The greatest obstacle in evaluating the value of a contract is uncertainty, and the greatest uncertainty stems from traffic demand. In the case of existing transportation facilities, much of the uncertainty has already been eliminated. The Chicago Skyway has a 48-year operating history; the Indiana Toll Road, 50 years. Past traffic volumes, revenue streams, maintenance requirements, staffing patterns, and other unique conditions of the facilities are known. This knowledge forms a firm foundation for projecting the variables and for estimating other factors with much greater accuracy and certainty into the future. When combined with scheduled toll increases, the private concessionaires have a very good idea of what future business prospects will be. They are, therefore, in a much better position to offer a higher price based on more certain and accurate information. This is further justified by the long duration of the lease agreements, which provides additional stability and certainty.

Scheduled Toll Increases

Every lease agreement described above contains a schedule for periodic toll increases. This provides security to the private concessionaires for it assures future price increases. As part of the concession agreement, future toll increases are legally binding and will not be influenced by political debate or be suspended due to popular disquiet.

European Experiences

European drivers pay much higher fuel taxes than their American counterparts. But without a dedicated funding mechanism for transportation infrastructure investment similar to our Highway Trust Fund, fuel tax revenues are deposited in the general treasury and transportation programs, including infrastructure investment, must compete against other programs such as education, health care, and social welfare. As a result, transportation programs in Europe often face investment shortfalls.

Spain and France as Trailblazers

Decades ago, European governments began looking toward the private sector for help, and Spain in the 1960s had private concessionaires built its *autopista* network. France followed with private *autoroute* concessions in the 1970s. Typically, these concessionaires were consortia made up of construction firms and banks. That basic arrangement is being used in the United States today.

Britain Nurtures PPPs to Maturity

In the 1980s, the United Kingdom became the leading proponent of PPPs in Europe. In 1981, the Conservative government issued the so-called Riley Rule, which provided for private-sector involvement in transportation infrastructure development when the benefits of doing so exceeded costs.

A group of large construction companies approached the Department of Transport and proposed to build a new Thames River bridge to relieve congestion on a ring road east of London. With recent advances in cable-stayed bridge technology, these contractors were confident that the cost saving brought by the new technology would make the scheme work.

In compliance with the Riley Rule, British transport official issued two simultaneous tenders for the project, one using a traditional government procurement approach, and the other on a design-build-finance-operate (DBFO) basis. Comparison of costs between the two approaches convinced the officials that the government would reap substantial savings by using the DBFO approach. The Department of Transport awarded a concession to the Dartford River Crossing Ltd in October 1986. Construction began in August 1988 and the new 1.75-mile bridge was opened to traffic in October 1991.

The experiment was a success, and it generated significant interest in other projects. A bridge project between England and Wales in 1990 and another bridge project in Scotland in 1991 followed. The Thatcher government adopted the Private Finance Initiative (PFI) in 1992 as the preferred approach for developing infrastructure of all types for the British government.

Shadow Toll

The PFI ushered in the "shadow toll" approach. Under shadow toll, the public-sector project sponsor pays "tolls" to the private concessionaire based on the performance of the facility, often measured in terms of traffic flow, safety, and availability. Drivers themselves do not pay tolls. The major advantage of shadow toll to the private concessionaire relates to traffic risk. By not requiring drivers to pay tolls, their choice of which route to use is based entirely on time and convenience, and is much easier to predict. The downside of this approach is that a payment cap limits the profit that the concessionaire can make in the franchise. For the government, the benefits include speeding up project delivery, bypassing the need to obtain government funding in future budget cycles, and incenting the concessionaire to achieve high performance. A total of 10 DBFO shadow toll projects involving more than 480 miles of roads and a construction value of about $2 billion were awarded by the British Highways Agency.

Other European nations such as Finland and Spain emulated the British approach. But shadow toll is a cumbersome approach that requires a lot of traffic data. The British, Finish, and Spanish projects all involved upgrades of existing assets, whose traffic data already existed This problem was made evident when Portugal wanted to use shadow toll for 7 new road projects costing 2.7 billion Euros. The sheer size of the investment program rendered the approach infeasible. In addition, the experiment would have overwhelmed the

budget of the *Junta Autónoma de Estradas* (the Portuguese highway agency) when an annual outlay of $700 million would have been required for shadow toll payments.

PPP Resurgence in the European Union

With the establishment of the European Union (EU) in February 1992, policies—including those pertaining to transportation and budget—were harmonized and integrated. EU membership requires a nation to limit its budget deficit to no more than 3 percent of its GDP. This has put pressure on governments to seek alternatives to large-scale capital projects needed to help improve—and sometimes completely rebuild—the infrastructure or economy of some countries. PPPs seemed a logical choice.

One way to pursue an integrated European transportation policy is to expand a number of railroads and highways, called Trans European Networks (TEN) to improve transportation connectivity within the EU and with Central European countries that aspired to join the EU in the future. The White Paper that laid out the TEN also advocated the use of user fees to finance the improvements. It did not take long for this impetus to produce results. New PPPs sprang up across Europe in the 1990s.

Availability Payment

The availability payment approach can be viewed as the simplified form of shadow toll. Like shadow toll, the public sponsor of a facility pays the private concessionaire; users of the facility do not. But unlike shadow toll, availability payment does not require large volume of information to determine performance. This simplification has made availability payment the preferred approach for new concessions in which the public sponsor, rather than users, of the facility pays. In the United States, the freight tunnel to the Port of Miami is the most recent example of this approach.

PREVIOUS SUBCOMMITTEE ACTION

The Subcommittee on Highways and Transit held a hearing on PPPs in May 2006. The focus of that hearing was on long-term leases of existing highways in the United States. It was intended for Members to gain a better understanding of how such concessions are structured.

WITNESS LIST

PANEL I

The Honorable Tyler Duvall
U.S. Department of Transportation
Assistant Secretary for Transportation Policy
Washington, D.C.

The Honorable Frank Busalacchi
Wisconsin Department of Transportation
Secretary
Madison, Wisconsin

Mr. Frank Wilson
Metropolitan Transit Authority of Harris County, Texas
President and Chief Executive Officer
Houston, Texas

PANEL II

Karen Hedlund, Esq.
Nossaman, Gunther, Knox & Elliott LLP
Partner
Arlington, Virginia

Mr. Dennis Enright
NW Financial Group
Principal
Jersey City, New Jersey

Mr. Alistair Sawers
RBC Capital Markets
Transportation and Project Finance Specialist
San Francisco, California

Mr. Robert Poole
Reason Foundation
Director of Transportation Studies
Los Angeles, California

PUBLIC-PRIVATE PARTNERSHIPS: INNOVATIVE FINANCING AND PROTECTING THE PUBLIC INTEREST

Tuesday, February 13, 2007

HOUSE OF REPRESENTATIVES,
COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE,
SUBCOMMITTEE ON HIGHWAYS AND TRANSIT,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2167, Rayburn House Office Building, the Honorable Peter A. DeFazio [chairman of the subcommittee] presiding.

Mr. DEFAZIO. The Subcommittee will come to order.

This is a hearing of the Highways amd Transit Subcommittee on Public Private Partnerships: Innovative Financing and Protecting the Public Interest. This is hopefully the first in a series of many hearings, as I mentioned at the last hearing. We have challenges before us. We have an annual deficit in this Country in terms of meeting our transportation infrastructure needs both for maintenance of the existing system and enhancements to that system to mitigate congestion and better move our citizens and our freight and bolster the economy.

Confronted with these sort of twin problems, that is, the need for more investment and the over-dependence upon the gas tax, which has not been increased since 1991, is leading to the point where we may not even have full funding for the last transportation bill, let alone a new transportation bill for the 21st century.

So what I intend to do with these hearings is explore that deficit, the causes of it and the potential ways to fill that gap. In particular, today we are focusing on private-public partnerships. Some would say this is a panacea, it will somehow supplant or eclipse the many tens of billions of dollars raised and spent from Federal gas taxes and State gas taxes. It won't. It can be an adjunct to that if properly used. And as I expressed in the last hearing, I have real doubts about the conversion of existing infrastructure, essentially the modernization, the sale or long-term lease of that and what the benefits might be and how, if you are going to do that, you properly protect both the public interest and you assure that we aren't fragmenting the national transportation system.

Then, secondly, we provided pilots in SAFETEA-LU where you could, with addition of capacity, undertake some pilot tolling projects. And, again, I am somewhat dubious about that but open to discussion.

And then the third would be greenfields and the construction of new projects, again, with private-public partnerships, providing equity protection of the public interest. There are a lot of questions regarding how one protects both the integrity of the national transportation system, how one protects the public interest and still involves private capital in these projects. And I am hopeful that these hearings will provide guidelines either for legislation or some guidance to the States so that some of them in a rush to move forward, for whatever reason, don't basically get taken to the cleaners, which I think we have seen in a couple of the previous agreements, Indiana and Chicago most notably.

So this Subcommittee does not have all the answers, but we are looking for good information from testimony. I hope to have lively discussion among the panelists. I prefer if the panelists didn't just read their testimony. I have read all the testimony that was submitted, and was submitted in a timely basis. I have read all of it, and I assume the other members of the Subcommittee have. So what would be most useful would be if you summarize and make cogent points and/or respond to other people who are on the panel or anticipate other panelists and some of their major arguments, because we can all read and you can't read more quickly than you can talk; most people can't anyway.

So with that, I would recognize the Ranking Republican, Mr. Duncan from Tennessee, for his opening remarks.

Mr. DUNCAN. Well, thank you very much, Mr. Chairman, and I share many of the same concerns that you just expressed about the need to protect the public interest when a State or local government enters into a public-private partnership. I particularly think we need to look very closely at whether or not some State officials might try to get all the money in some sort of up-front way, or most of the money up-front, so that officials 25 or 30 or 50 years from now might be left holding the bag.

I also have already heard a lot of concern expressed about foreign ownership of our infrastructure. I think we need to look into whether we need to put some limitations on that to American ownership or perhaps even prohibiting the sale, years down the road, to foreign companies.

This is a fast-moving development, as we were told in a briefing last week by the GAO, and there is a lot of interest in it. Tennessee, my home State, has no toll roads and has for many years adopted a pay-as-you-go philosophy of spending no more than comes into the State highway fund, and, frankly, if I was to advocate a toll road in Tennessee, it would be one of the most unpopular things that I could possibly do. This does not mean that toll roads do not have a place, though, particularly in States where the people have grown accustomed to that.

It is important, I think, to remember, though, that public-private partnerships are much more than just toll roads. Some are contractual agreements for all kinds of things, really, and many of the innovative procurement models of public-private partnerships, such as design-build and design-build to operate and maintain projects have a proven track record of saving time and money and of being operated more efficiently.

I am also concerned about possible sweetheart deals for private companies. When we first started seeing the private sector take over many government operations, it was done because it saved a lot of money and because the private sector could perform almost anything in a more economical, more efficient way than the government could. However, in recent years we have been seeing that some very large corporations have been hiring so many retired Federal employees or retired admirals and generals and they have been getting sweetheart deals with just ridiculous profits in them, so that we have to see at times whether some of these are good deals for the people or not. Some are and some, unfortunately, now, are not.

I guess we need to point out that we in this Country are fairly new at the business of private sector financing for infrastructure investment. I think we will get better at managing these types of innovative financing tools with time and experience.

But I thank you for holding this hearing, it is a very important topic, and I will yield back the balance of my time.

Mr. DEFAZIO. I thank the gentleman for his succinct and cogent remarks.

Does the gentleman, Mr. Petri, wish to be recognized?

Mr. PETRI. Well, I just—I don't know if this is the time to do it. I am here to introduce a panel member.

Mr. DEFAZIO. Well, you can do it now, because I believe there————

Are there other opening statements that people intend to make? Members obviously can submit statements for the record.

[No response.]

Mr. DEFAZIO. Since there are no other opening statements, I would be happy to recognize you, and then I will make the formal introduction after you make the personal introduction.

Mr. PETRI. Well, thank you. I just wanted to, on behalf of my colleague, Steve Kagen, who is also from Wisconsin, a member of the full Committee, welcome our Secretary of Transportation, Frank Busalacchi, who has a distinguished career in public service in Wisconsin. He comes from the Milwaukee area, where he had for a number of years various leadership positions with the local 200 of the Teamsters Union. He has led an agency with a budget of roughly $2 billion and 3,600 or so employees. He has been recognized and is now—and I think that is why he is here today—a member of the National Surface Transportation Policy and Review Study Commission that is going to be making recommendations on a whole variety of ways of trying to maintain and improve our national surface transportation policy. I just want to welcome him and thank him for the effort that he is putting in to help us.

Mr. DEFAZIO. I thank the gentleman for those remarks and that introduction.

The formal introduction will be that on the first panel is the Honorable Tyler Duvall, U.S. Department of Transportation Assistant Secretary of Transportation Policy; the Honorable Frank Busalacchi, Wisconsin Department of Transportation and, as mentioned, a member of the Commission; and Mr. Frank Wilson, Metropolitan Transit Authority of Harris County, Texas, President and CEO.

With that, I would first recognize Mr. Duvall for his opening statement.

Mr. Duvall.

TESTIMONY OF THE HONORABLE TYLER DUVALL, U.S. DEPARTMENT OF TRANSPORTATION, ASSISTANT SECRETARY FOR TRANSPORTATION POLICY, WASHINGTON, D.C.; THE HONORABLE FRANK BUSALACCHI, WISCONSIN DEPARTMENT OF TRANSPORTATION, SECRETARY, MADISON, WISCONSIN; AND FRANK WILSON, METROPOLITAN TRANSIT AUTHORITY OF HARRIS COUNTY, TEXAS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, HOUSTON, TEXAS

Mr. DUVALL. Thank you, Chairman DeFazio, Ranking Member Duncan, and members of the Subcommittee. I greatly appreciate the opportunity to appear before you today to talk about one of the most important trends in transportation: public-private partnerships.

Under the leadership of Secretary Peters, and Secretary Mineta before her, USDOT has made the expansion of public-private partnerships a key component in our ongoing congestion initiative, which we believe is one of the largest public interest failures we face in surface transportation, along with the high number of highway fatalities that continue to plague us.

Based on a recent internal survey, the Federal Highway Administration estimates that approximately 50 percent or more of States either currently have laws in place or are considering legislation to expand public-private partnerships. This growing State level interest I think tracks closely with congressional interest in promoting PPPs in all of the most recent surface transportation bills dating back to ISTEA. In addition, executive orders by President Clinton and former President Bush have further asked agencies to reduce barriers to these arrangements.

There has been a great deal of discussion, obviously, about the two transactions, one in Chicago and one in Indiana, but I think it is really important that we bear in mind that the opportunities for PPPs extend well beyond long-term lease agreements and certainly well beyond toll roads.

The basic opportunity is for the public sector to allocate various project risks to the private sector that may be in a better position to manage and reduce those risks, and the ability to shift various risks to private operators increases the public sector's ability to manage a large number of projects while also reducing strains on government budgets and the taxpayer. Creative risk-sharing arrangements are possible whether or not the facility at issue generates revenues to pay for its own costs.

The willingness of public authorities to go beyond traditional procurement approaches has been driven largely by several trends. First, as the Chairman noted, taxes that fund transportation activities are being increasingly absorbed by rising costs, the need to dedicate ever more resources to system preservation and maintenance, an increased fuel economy and flattening VMT trends. If anything, these trends are expected to continue in the future.

Deteriorating highway system performance has reached crisis levels in many parts of the country. The cost of wasted time and

fuel for travelers is five times the level it was in 1982, and the economic costs are much higher if you add in uncertainty and lost productivity costs.

Despite the strong policy arguments historically in favor of a user pay system, a mix of political and administrative complexities have pushed the United States towards a surface transportation financial model that is currently dependent on fees that have little or an indirect relationship to costs. Technology breakthroughs in recent years, however, have really reduced barriers, and a substantial change in public opinion with respect to that has followed. Currently, we estimate that the majority of projects over $500 million in the United States will be financed using some toll revenues.

Coincident with these trends, it is very important that we understand global economic patterns. Basically, huge increases in global economic growth and changing demographics have really created massive pools of savings around the globe that have driven down long-term interest rates and increased the attractiveness of medium-risk and medium-return infrastructure assets in energy, telecommunications, and transportation sectors. The certainty of the U.S. legal system and our strong economic growth prospects are critical factors in why the U.S. is such an attractive investment destination.

Any analysis of the policy merits or pitfalls of public-private partnerships must be contrasted to how we are doing now, not an idealized of how we are doing. It is critical that we identify the public policy failures and ask the question: Do public-private partnerships respond to those failures? I think increasingly the answer is yes, they do respond. They are not the answer, but they are a vital tool, we think, going forward.

Despite these opportunities—and obviously the purpose of this hearing is to talk about the pressing public policy issues that are presented—in my written statement I identified several risks. I think the most important of these risks are monopoly pricing risks. In addition, we have corruption risks, thin market risks, system distortion lists, as the Chairman notes, financial exposure risks, and inexperience risks on behalf of the public sector.

The single-most important public interest concern with the transactions that took place in Indiana and Chicago is the inherent tension that is created when governments view the leasing of existing transportation assets as a potential income source. While these transactions can provide large public benefits if properly structured, it is also true that contractual terms that offer substantial pricing power and protection from competition can increase the discounted present value of the revenue stream associated with an asset. Other critical assumptions go into asset valuations, such as traffic growth projections, the ability to control costs, and the cost of long-term borrowing. However, there is little question that pricing flexibility in a potentially constrained market will be a major driver of facility value. As a result, it is imperative that public agencies gain some understanding of a facility cost and risk profile, as well as the degree to which pricing will be constrained by competing facilities or the threat of competing facilities.

Every facility has different economic characteristics, and State and local governments are strongly encouraged to analyze these

characteristics not just from an individual facility perspective, but also from a network perspective, as the Chairman noted. Specific contract provisions that limit the prospect of competition will increase the up-front lease value, but may run counter to the public interest if such a provision is not commensurate with the risk being borne by the private sector. The emerging trend in this area appears to be the inclusion of either no protection at all for the private sector or limited protections.

Public agencies implementing PPP programs are strongly encouraged to run open and transparent processes, to seek input from third parties, and to consult regularly with their legislators and other relevant elected officials. We welcome review by advocates of various kinds of these public sector concerns, and we will all need to be sensitive to cases in which important public sector concerns may not be adequately protected.

I appreciate your attention to my testimony, and I would be happy to answer any questions that you may have.

Mr. DEFAZIO. Thank you, Mr. Duvall.

Mr. Busalacchi.

Mr. BUSALACCHI. Thank you, Mr. Chairman. I am honored to have this opportunity to comment on protecting the public interest in public-private partnerships, or P3s.

I am also a member of the National Surface Transportation Policy and Revenue Study Commission. The National Commission is working to construct a new 50-year vision for our Nation's transportation system. We are in the midst of our deliberations, and my comments do not represent the views of the Commission.

What has been made clear to me at the Commission hearings and by the communities back home is that we have a lot of needs. In Wisconsin, our annual unmet needs are in excess of $500 million for highways alone. If we factor in transit, inner city, and freight rail improvements, the needs increase.

This Nation's interstate system is at the end of its useful life. It cannot be repaired. It must be reconstructed and, in some areas, expanded. Where will we find the funding? Some suggest that P3s can replace what has traditionally been a Federal responsibility. I disagree.

Let me first clarify that P3s come in many forms, and the private sector is a valued partner to Federal, State, and local governments. My focus today is on the deals where a private sector organization leases a highway. The private sector partner is responsible for operating the roadway and they collect the toll and other payments to gain a return on the investments. Let me share four concerns that I have.

First, the public interest is different from the private interest, and, in this case, it will be extremely difficult to assure a win-win situation. In Wisconsin, the DOT partners with private sector to design and construct highways. We have done so for years. But the public sector is the one held accountable for setting priorities, financing, and managing the highway. Can we responsibly delegate some or all of that public sector accountability to the private sector? If we can, how do we integrate the needs of the private sector into what has traditionally been a public sector system?

Some argue P3s will harness the power of the market for the good of the public. But we come to the table with very different interests. Do States have enough information to get the best possible deal for the public? From what I have seen, we do not. The private sector's legal responsibility to its shareholders is to make money. Profit is their purpose. Our responsibility is to ensure that we make wise choices for our citizens. No contract, no matter how effective, can eliminate risk. We simply do not know enough to price or manage such long-term risks.

Second, the public has significant concerns with P3 deals. The public sector needs better tools to evaluate the deals and share the evaluations with the public. People don't seem to like these deals. Citizens tell us they don't think the P3 approach is in their best interest. We need better information to consider the long-and short-term costs and benefits associated with these approaches to projects. We need to show the public what they will pay with gas tax, compared to what they will pay with private sector tolling. With this information, we could all make better decisions.

P3s will likely not generate a predictable revenue stream to replace the current Federal share. In the 1950's, the Federal Government envisioned a national transportation system and funded it. States, in turn, built a first-class system. If the Federal Government had not paid the lion's share of the construction costs for the system, it would not have been built. States cannot create or fulfill the kind of vision on their own, nor can the private sector. The Federal Government should continue to pay its share of at least 45 percent of the Nation's highway system. At National Commission hearings, witnesses tell us the Federal Government's share should increase.

Fourth, there should be considerable problems—there will be considerable problems with integrating private sector financing with public sector policy goals. Congress needs to consider many issues. Will States that do not toll be left behind, with no Federal partner? How will private sector partners be integrated into current planning process? Are Federal tax expenditures for private sector projects preferable to Federal revenue increases for public sector projects?

The Committee also asked that I comment on USDOT's model legislation designed to give States the authority to enter into P3 agreements. Based on our review of the legislation, it poses no restrictions and creates no public protections. States will need to take care of the public interest in the deals they craft with the private sector. The model legislation protects the private sector's proprietary information.

In Wisconsin, these provisions conflict strongly with strongly held values about openness and competition that support a robust and competitive bidding process. The model legislation requires State DOTs to review unsolicited proposals within a certain time frame. P3 bidders are highly sophisticated consortiums represented by large banks and investment firms. We design and construct roads; we are not experts in high finance and investment contracting. For States to negotiate on a level playing field, we need to hire investment finance advisors that will make every project cost more.

The Committee will make critical choices that determine the outcome of the debate on P3s. We do not believe P3s are ready for prime time. In a supplement to my written testimony, I included a list of policy questions that provide a starting point for the debate.

I appreciate the opportunity to testify today, and I look forward to the policy discussions that lay ahead. Thank you.

Mr. DEFAZIO. Thank you, Mr. Busalacchi, appreciate it. Excellent testimony.

Mr. Wilson.

Mr. WILSON. Good morning, Mr. Chairman, Ranking Member Duncan, and members of the Committee. First, I want to thank you for giving us the opportunity to be with you today for this important discussion of the Nation's transportation infrastructure.

I represent Houston Metro, which is a fully integrated multimodal transportation system serving the fourth largest city in the Country. This city is growing at the rate of 3,000 people a week. That is 3,000 a week. This has put our transportation system under immense pressure. And, because of that, we are forced to seek all legitimate alternatives to funding the improvements and expansion of the system. Given the inability to project adequate funding going forward, all options for us are on the table for discussion and utilization. My comments today are derived from my experience in working both the public and private sector.

I have experienced a challenge of infrastructure delivery both as an owner and as a contractor, and have participated in 12 design-build, design-build-operate-maintain in public-private partnerships nationally and internationally, with a combined construction value of over $10 billion in seven States and two countries. I say this not as a summary of my resume, but more to support an observation, and that observation is this: public-private partnerships do work universally and they do work well; however, they are not the silver bullet solution for every infrastructure project.

I have learned that the most successfully structured public-private partnerships are created by necessity, not by ideology, and at the core of every partnership is a clear understanding of control, accountability, and risk. Simply put, the public agency controls policy; the private company controls performance. Each is clearly accountable for the respective roles under the commercial terms and conditions of a contract and each shares a project risk which they are uniquely able and equipped to identify, to mitigate, and control.

I am able to report that the public interest can be protected in public-private partnerships. Good government and good business are not mutually exclusive. In our discussions later this morning, I would be happy to review a six-point checklist of criteria that are used to judge when public-private partnerships offer the most benefit in comparison to the traditional design-bid-build methods of project delivery.

Where appropriately applied, public-private partnerships will deliver remarkable advantages and benefits, starting with a single point of contact and accountability, which provides clear focus and discipline in managing and making decisions on projects; reduce public agency staff and soft costs. These soft costs can generally run as much as 35 percent of the cost of a major infrastructure

project, so it represents an incredible area of economy. There is closer cooperation and collaboration between designers and builders to improve constructibility and lower risk. There is a conversion of ideas on approach to a job so there are no surprises; what the designer designs, the builder can build. Cost of project delivery can be cut as much as 20 percent on major infrastructure projects using a partnership approach, and project schedules can be cut as much as 40 percent. So a project that might take seven years could be implemented in less than four.

The key factor in public-private partnerships which can be overstated is that it minimizes change orders, claims, and litigation, which are project killers for traditionally implemented infrastructure projects. Quality is often built in, since the designer and builder is responsible for the operating and performance and quality risk on infrastructure projects.

Private firms are enablers that can mobilize capital markets, as appropriate, and add new source of income. This income may range between three and ten percent. Not an overwhelming large amount of money, but, in addition to the cost savings, it most often is what—is a deciding factor in the financing capability of a project.

And, finally, I would say the risk of profile due to the single point of accountability and enhanced integration of all the elements of work offer a more efficient method of financing, and this is because the different players—whether they be architects, engineers, contractors, material suppliers, or the owner itself—do not have to add financial premiums to the project to make sure that the have a viable outcome.

I would be happy to explore any and all of these issues during our discussions, and, again, I want to thank you for the privilege of joining you today.

Mr. DEFAZIO. Thank you.

I thank all the witnesses for remaining within the time; that will give us a lot of opportunity for questions, which hopefully will be more interesting than testimony.

I will lead off with the questions.

Mr. Duvall, I want to thank you for sort of personalizing your testimony. I saw two references, one to Oregon, on our early discussion on tolling versus fuel tax. And just perhaps to edify you a little bit, we did actually have two toll projects in Oregon; they were both public and the tolls went away when the projects were paid for. There was no continuing profit from those projects. Those were two bridges over the Columbia River to our neighboring Washington State. So we have some experience with tolling, but we don't believe it should be for-profit tolling.

Secondly, Washington, I was more interested in that. I mean, Washington actually—you have a recent poll, but recent history sort of belies the poll. Washington actually, unlike the Federal Government, increased its gas tax by a nickel in 2003 and nine and a half cents in 2005, and a number of increases in registration, title fees, etc. It was referred to the ballot and it was upheld on the ballot. So I think the real poll of the people of Washington State is they were willing to pay fourteen and a half cents more per gallon in gas tax, so there is not the resistance that you are pointing to, which comes to your charge.

You are Assistant Secretary of Transportation Policy. What have you or the Administration done to augment or update the Federal investment? We all admit that not having raised the gas tax since 1991 isn't meeting it. This Committee unanimously, in a bipartisan way, recommended an increase in the gas tax in the last highway bill; it was rejected by the Republican leadership and by the White House. So what are you proposing, what have you proposed to increase Federal investment, since you are here to advocate for private investment?

Mr. DUVALL. Thank you, Chairman. Obviously, the last highway bill public transportation legislation was the single largest increase in—representing the largest————

Mr. DEFAZIO. Right. But I am talking about the—you have said in your testimony that we don't have enough money. There is agreement, bipartisan agreement. We don't have enough investment. What is the Administration proposing? What are you proposing, other than private partnerships, to enhance the investment in the Federal infrastructure? Are you proposing anything at all to increase that investment?

Mr. DUVALL. Thank you, Mr. Chairman. Obviously, the discussion over future Federal funding is one that needs to take place in the next two years between the Administration and the Committee.

Mr. DEFAZIO. No, but I mean what has the Department recommended or what are they recommending, what are you studying other than the Commission's work?

Mr. DUVALL. I mean, the Commission is obviously going to be a major driver, I think, of the policy recommendations of the————

Mr. DEFAZIO. So right now your bottom line is the one thing you are bringing us is public-private partnerships. Now, let's go to your proposed working draft.

Now, I find it kind of—you raise—you laid out here today, and I thought very well, some of the pitfalls and the potential problems with private-public partnerships, but I don't find any of that reflected in the guidance to the States here or on your website materials in the guidance to the States. You did a good job here today, but it seems like there was a sales job last Thursday at the White House and today we are hearing something else, which is there are real problems here: monopoly rents are a problem, there are a number of other potential issues and pitfalls. It seems that it would be instructive for the Department to have a chart which lays out pro-con, good-bad, pitfalls, prior experience. I don't see any of that. Are you developing some of that real experience, as opposed to something like this model legislation?

Mr. DUVALL. Absolutely, Mr. Chairman. I think that is something the Department is currently working on, and we need to be much more aggressive about articulating what the risks are. I will say that the legislation is intended to be a broad authorizing statute. We have opened it up for public comments————

Mr. DEFAZIO. Sure. When could we expect seeing some sort of enumeration of the risks posted up on your website linked to the model legislation?

Mr. DUVALL. Well, there actually are things on the website.

Mr. DEFAZIO. Well, I have reviewed it. I don't find it anywhere near as cogent as your testimony today, which perhaps was designed for a skeptical audience.

Now, let me go to another inherent conflict I see here. You are a national transportation official. Do you find any conflict, as Mr. Busalacchi points out, between maximization of profits, particularly where you have in here—very puzzling to me—that you would recommend to States that they should have to accept unsolicited proposals outside their planning process and they would have to evaluate them within a certain number of days and go forward. Now, that seems to me overly prejudiced toward an investor who comes along and wants to cherry-pick something out of a State and submit it.

Why would we mandate to the States that outside of their incredibly involved planning process, which has to meet with Federal law, would we require that they accept any out-of-the-air private proposal from a foreign firm or domestic firm, anybody who wanders in the door who is qualified—i.e., they have a pile of money—and have to process it within so many days, when they actually already have a plan on the books?

Mr. DUVALL. Right. To be clear, we are obviously not mandating States do anything. These are provisions borrowed from existing law. The State of Virginia probably has the most comprehensive public-private partnership legislation. It is precisely their willingness to take unsolicited proposals that several of the most important capacity expansions————

Mr. DEFAZIO. But don't you find that conflicts with the idea of orderly planning? Let me read to you from the law. I am certain you are familiar with it; you are a lawyer and you are a Federal official, and not a private advocate or a State official here.

Under U.S. Code, Section 135: "Each State shall develop a State-wide transportation plan, State-wide transportation improvement plan for all areas of the State subject to Section 134"—I will skip ahead here—"that will function as an intermodal transportation system for the State and an integral part of an intermodal transportation system to the United States."

Don't you find, in particular, this kind of cherry-picking and the whole private profit versus public interest issue that Mr. Busalacchi has raised, don't you see some conflict here? Don't you feel a need for balance? I know your background is in business and law, and I am certain you will go back to that when your job is done here, but right now you are charged with the public trust to forward a system that meets public needs in an integrated way, nationally and within States, not stopping at State borders, not within a State, something cherry-picked out. I just see an incredible conflict between what—I don't care if Virginia has that or not. For a Federal official to tell States, as a policy, as a model, they should say they will take unsolicited proposals outside our States, outside our plans and, hey, there go our profit centers for the next 99 years where we could have had a public return.

Mr. DUVALL. Obviously, Mr. Chairman, any proposal from the private sector would have to be—that was accepted would have to be incorporated into the State-wide plan; Federal law requires that.

Mr. DEFAZIO. Well, but you didn't give that in the model legislation. You didn't say it has to be in accordance with, incorporated in, or meet the requirements of the Federal law here, you just say they have to accept these things.

Mr. DUVALL. Actually, it does refer that it has got to be compliant with Federal law. The legislation specifically says that. I think it is very important to think about the possibilities. I mean, we are a little pessimistic about the opportunities for innovation here. The private sector has a very strong interest in looking at what is not working in the current network and making proposals to————

Mr. DEFAZIO. Right. What is not working is in some places people aren't making money on it.

Mr. Busalacchi, would you care to comment on this line of questioning, because I think you have raised these concerns?

Mr. BUSALACCHI. Thank you, Mr. Chairman.

Yes. I mean, this is all about money. I mean, if anybody thinks it is anything other than money is wrong. I mean, the Indiana toll road, after the 10 years is up, for 65 years there is not going to be any revenue. Whatever the————

Mr. DEFAZIO. So you are saying, therefore, this current governor gets some cash up-front, which may or may not equal the value of this particular agreement, particularly with a non-compete and other clauses, but you are saying future governors couldn't revisit it? They have lost that revenue stream?

Mr. BUSALACCHI. I don't know how they do, Mr. Chairman. They have entered into a 75 year contract. The Skyway entered into a 99 year contract. How do they turn their back on that? The revenue is gone.

Mr. DEFAZIO. But these things are so much more efficient than the way they were operated before, aren't they, except————

Mr. BUSALACCHI. I don't————

Mr. DEFAZIO. As I remember the proposal from MIG, it said, "no significant cost savings envisioned." So what was this about?

Mr. BUSALACCHI. Well, I mean, I really don't know. This is part of the unanswered questions, and this is why, Mr. Chairman, there has to be debate. This is a very important thing that is going on in transportation in this Country. In my view, my personal view is this is not the panacea. And I know that there are probably other DOT secretaries that disagree with me, but, for example, in the State of Wisconsin, we don't have tolls. We don't want tolls. Our governor doesn't want them and they are not going to be there. So where do we stand as the Federal Government shifts itself toward this policy? You know, where do we end up? Do we end up out in the cold? That is why, you know, we are asking these questions, that is why I am asking these questions.

There needs to be a national debate on this, because the amount of money that the 3Ps are going to raise is very, very small compared to the overall needs that the Country has, and I am worried that this is a diversion. That is what this is. Let's not worry about the real problem, which is these huge needs that we have; let's talk about P3s, because they will raise this money and they will raise the funds for these needs over here. And, you know, that is something that the Commission is grappling with, Mr. Chairman. We have huge needs in this Country. The last transportation bill came

nowhere near to funding those needs. That is the seriousness of what is going on here, and that is what we need to talk about.

Mr. DEFAZIO. Well, thank you, Mr. Busalacchi. My time has expired, but I do want to say you ended up where I started, which was asking Mr. Duvall of any plans by the Administration to enhance funding in the Federal system, and the answer, by absence of an answer, was no, they are offering us public-private partnerships, and you are underlying the same thing. Thank you.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Secretary, let me just ask you this. You heard me mention it last week. We had a briefing by the GAO in which they said this was a very fast moving development in transportation circles around the Country, and Mr. Busalacchi just mentioned this, they called it a very important development. We have heard a lot about the Indiana road and the Chicago Skyway. Do you know of many other States or local governments that are considering these types of public-private partnerships at this point?

Mr. DUVALL. Yes. I think there is a series of interests across the Country ranging from new capacity, which the State of Texas basically, I think programmatically, has declared that virtually all major new capacity in the State will be done through some public-private model; obviously, the Commonwealth of Virginia. In terms of long-term leases, you know, there has been a lot of press coverage of the State of New Jersey and the Governor of Pennsylvania's interest in exploring the valuations of those two facilities. There is a limited number of existing toll roads in the United States, so I do not view that trend as necessarily the be-all and end-all to solving our transportation problems, despite some characterizations to the contrary.

I think what is important is can the structures of these transactions protect the public interest, as the Chairman has outlined, and I think there are risks and there are opportunities, and, if you structure them correctly, these transactions can protect the public interest and you can free up public resources to make high return investments in other areas.

Mr. DUNCAN. You say there is a limited number of toll roads. I have never heard a figure on that. Do you know how many toll roads there are?

Mr. DUVALL. How many toll roads? No. I can get you the exact number, but obviously it is predominantly the Northeast and Florida. Florida, for example, has not built a non-toll road, a free road, I think, since the early 1980's, so they have got a massive network of toll roads in Florida; and the Northeast obviously has a lot of grandfathered toll facilities; and then there are pockets of toll roads throughout the Midwest.

Mr. DUNCAN. Let me ask you. You have come forward with this model legislation and I wasn't clear. You told the Chairman you put some things about risk up on your website or something. Have you—there is some concern about State or local governments not having the expertise to enter into these deals, these high finance deals and so forth. Have you come forward with any guidance to State or local governments? Have you sent out some reports or suggestions in ways to handle these things, or have you set up any

meetings with State and local transportation officials or are you considering doing things like that?

Mr. DUVALL. In terms of formal guidance by the Department, we have not sent out formal guidance. I think we have had many, many conversations in which we have talked to State and local officials that are interested in this topic about the need for understanding what you are getting into. And I agree with both of you that there is a clear risk that State agencies are not currently equipped to deal with complex financial questions. I think that is solved, however. Obviously, Commissioner Busalacchi mentioned the need to procure outside advice.

I think it is interesting to note that the two transactions in Chicago and Indiana, actually, they had extensive internal financial expertise that was used to contract with outside entities to give them additional financial advice. But you are a hundred percent correct that this is an issue that State governments are going to need to deal with directly in coming months, and we would be happy to think about ways to improve our communications on that front.

Mr. DUNCAN. Well, I am not saying they couldn't develop the expertise, but I think this is certainly an area that you should look into, because, as I said in my opening statement, I think there is some legitimate concern over whether a governor may or might be attempted to take—might be tempted to take some big money on the front end and leave officials holding the bag a few years down the road.

Mr. Busalacchi, you say in your testimony it is not clear that the deal in Indiana would happen if it were being considered today. The last news report I saw, half the citizens polled in New Jersey think the P3 approach to the turnpike is not in their best interest. Why do you say that? What led you to that conclusion, that the Indiana deal would not come about if it was being done today?

Mr. BUSALACCHI. Well, I think the public outcry, Mr. Chairman, is that they are very much against what happened in Indiana. I think the governor's poll show that. We are hearing the same thing coming out of New Jersey. And, of course, we hear it in our own State. I travel through the State extensively talking about this because, as I had said earlier, you know, we are facing basically the same situation that the entire Nation is facing: we have these astronomical needs and how we are going to fund them.

And, you know, you touched on a real good point about the complexity of these deals. In my department, we could not handle these complex legal issues in our department. We have got good lawyers, but there is no way they could handle this. We would have to go on the outside and we would have to spend an awful lot of money to get this done. That would have to be approved by the governor and maybe even the legislator.

Mr. DUNCAN. Has the State of Wisconsin had or have you had some particular difficulty with public-private partnerships on some of your projects that you could give us some examples of?

Mr. BUSALACCHI. We have very little experience as far as transportation goes. I have had personal experience with public-private partnerships. I mean, we built Miller Park. That was a public-private partnership, one that I am very proud of. There are situations

where this can work, but I think that we are just moving way, way too quickly and we are forgetting about the real problem here. The real problem is what is going on with the needs in this Country. You know, we get into the transportation bill and we get into this trap of talking about dollars. We have got to talk about needs. And that is what I am afraid is happening here, we are talking about dollars again. Let's go back and talk about what needs to get done. We are falling far behind.

Tyler is right, our global economy is going to get affected here. I am concerned about congestion just like USDOT is. It is going to hurt us.

Mr DUNCAN. All right, I have already run over my time, but, Mr. Wilson, I understand that you were in New Jersey for a while, is that correct?

Mr. WILSON. That is correct. Busalacchi that half the people in New Jersey are upset with the way the turnpike partnership is working out?

Mr. WILSON. I think there is a disturbing confusion between—maybe it is semantics, maybe not—what is called a public-private partnership and what in other terms is just called tolling of free lanes. There are emotional issues; there are economic issues; there are political issues. If you are going to convert a toll road and sell it, those are economic and political. If you are going to toll a free lane, those are economic and political. Not to be confused with a delivery method, which is public-private in terms of delivering any form of infrastructure.

So, when I was in New Jersey, we formulated a piece of legislation that did much the same as what this Federal regulation is calling for, but, Mr. Chairman, we made it part of the planning process. The notion was that the planning process, as it exists in States—through the metropolitan planning organizations, State Departments of Transportation, local government involved in the cooperating, continuing development of transportation plans—does not capture all the wisdom in the world. And when the private sector can bring a good idea forward, it needs to be vetted through that process.

So the legislation we adopted or the legislature adopted on the basis of experimental endeavor—seven projects were qualified—those encouraged ideas to come forward and then went through this planning process and accepted or rejected. Just because a project or proposal is offered doesn't mean it has to be accepted if it is inherently flawed.

So in New Jersey and elsewhere, I would say the difference is what are we really attempting to do. As I said, the disturbing part about this is public-private partnerships whereas where they might work gets a bad reputation, when really what we are talking about is an economic or public policy to toll free roads or to sell roads. And I don't believe that they are synonymous and necessarily have to be discussed in those terms.

Mr. DUNCAN. Let me ask one last question. You have been a State and local transportation official for some time now. You know, we found in here that mainly because of all of our environmental rules and regulations and so forth, that all these highway projects take an average of about 10 years to complete, so you have

to look way into the future. What do you see if you had to look 10 or 25 years from now? What do you see for the future? Do you think that this is a trend that is really going to take off and explode, that most of our major transportation projects, say, 25 years from now are going to be public-private partnerships?

Mr. WILSON. Let me give you a startling fact that I had the misfortune of discovering when Commissioner of Transportation of the State of New Jersey. The average project there took seven years from the beginning in the conceptual planning stage to the notice to proceed. That is not the completion of construction, that is just where construction began. Seven years.

Mr. DUNCAN. Right.

Mr. WILSON. That is not the startling part; we kind of expected that. The startling part was that the average size of a project was $5 million.

What I am here to illustrate in response to your remarks is that the process we used, implemented for structure projects here, is inordinately expensive and wasteful.

Mr. DUNCAN. Right.

Mr. WILSON. And so we who come before Congress and local legislatures asking you for more money should be sent back and asked to ring out the inefficiencies in our delivery processes, because more money just goes to more waste. So what we need to be looking for is a more efficient, more effective way of delivering this more money.

This is not a speech against additional gas tax or additional revenues in the trust fund at the Federal or local level, but it is a plea to allow folks like ourselves, practitioners in this business, to embrace any delivery method that gives us the leverage to implement projects in a much more affordable way.

I mentioned in my statement here that typically you can expect between 18 and 20 percent cost reduction on a project. What is the difference between 20 percent cost reduction and 20 percent more revenue in a fund? So that is what we are looking to accomplish with this notion of public-private partnerships.

Mr. DUNCAN. Thank you.

Mr. DEFAZIO. I thank the gentleman. Just in noting we did adopt some significant modifications to the review process and the environmental process in SAFETEA-LU—I don't believe they have been fully implemented as yet by the Department of Transportation—which should help with that time problem. And, of course, whether it is public or private, it has to go through the same process, so that is not going to save time. DOT needs to fully implement the provision we provided.

Mr. Altmire was first on our side, from Pennsylvania, perhaps the home of the next great public-private partnership.

Mr. ALTMIRE. No questions, thank you, Mr. Chairman.

Mr. DEFAZIO. All right, then the second person—I am doing questions in order of arrival on our side—Mr. Shuler.

Mr. SHULER. I pass.

Mr. DEFAZIO. All right. Find some Democrat. Mr. Lipinski, any questions? Home of the first great public-private partnership of the recent round.

Mr. LIPINSKI. Mr. Chairman, I want to thank you for doing it in this manner. I was expecting you to go with seniority, so I wasn't quite prepared to go yet, but I am always ready.

Mr. Wilson, you were talking about your cutting costs 18, 20 percent. How much did you say time was cut?

Mr. WILSON. About 40 percent.

Mr. LIPINSKI. About 40 percent. Now, are you saying that there just are always inefficiencies when a government entity does these projects? I mean, the suggestion is that things are just done so poorly if it is being run through a government entity that you sort of need to take it away from them because they just add time, add wasteful spending. I mean, is that what the suggestion is? Well, where is all this time and money saved coming from?

Mr. WILSON. I don't think—having lived on both sides, private and public, I don't think there is any question that the discipline to begin and end a project is much more intense on the private side. I am not going to say it is a dirty word, but there is a profit motive to moving a project. That does not say that you sacrifice quality or utility. You build those into your contracts and make the private enterprise responsible for those as well, and you do that through a variety of ways. One is longer warranties or concessions where they are responsible for the operation, performance, and quality of a job.

But I will say this————

Mr. LIPINSKI. Are those things not done by public entities?

Mr. WILSON. Pardon me?

Mr. LIPINSKI. Are those not done by government entities, governments?

Mr. WILSON. Is what not done?

Mr. LIPINSKI. Putting those kind of incentives in.

Mr. WILSON. Yes, I was going to get to the other point that I wanted to make, is why there are inefficiencies.

Mr. LIPINSKI. OK.

Mr. WILSON. Typically, on a large infrastructure project, you have the owners, engineers, architects, then you have the builders, the material suppliers, the construction managers, the quality control, quality assurance agents, the owner staff itself; and all those are disconnects in a project. All those are inefficiencies in a major infrastructure project, besides the abundant of cost or redundant cost. To manage all those interfaces is incredibly difficult and complex, and when you have an owner that has a different motive than a builder, you tend to run into trouble. And our industry, unfortunately, is replete with examples of where that has consumed large chunks of money and taken long, long periods of time, in some cases a lot of mortality on projects.

When you consolidate the responsibility to deliver the product and integrate the design, the construction, and the operation, you tend to get a much more efficient package of services delivered. That drives the schedules down because the interfaces are managed by one entity, not multiple entities. So the inherent advantage of a public-private partnership is not necessarily in generating new income or magical financing techniques, it is to bring discipline and focus to the effort of delivering the infrastructure project on a respectable budget, on a respectable schedule, not sacrificing quality.

So therein is why the public entity, as good as it is, needs to stretch and invite the private sector in.

There are some things that the private sector cannot do and only government can do, and those are policy-related issues, environmental clearance, funding—not financing, but funding, utility coordination, approvals, permits, real estate acquisition. All those are legitimate functions of government where the private sector doesn't belong. But once you have decided what your project is and you have got a good scope, it is time to let those who have that focus and discipline to deliver that product and then stand behind it and warrant it over a long period of time.

Mr. LIPINSKI. I want to ask Mr. Busalacchi is there anything that you would want to add to that or any comments you have on that?

Mr. BUSALACCHI. Well, I would just like to say this, and, again, I can't speak for any other State, but I do know, in the four-plus years that I have been the Secretary in Wisconsin, we have changed dramatically how we deliver projects. We are delivering projects that are much large now because of the needs, and in delivery of those projects we have found that us managing the project is the only way to go. I don't particularly want to do a big project and let the private sector control the project.

We have a large—one of the largest projects going in the Country right now in the heart of Downtown Milwaukee, and that project could have been ripe for cost overruns and you name it, and that project is on time and it is on budget. It is a $810 million job. So I don't necessarily agree with when you turn this stuff over to the private sector, that they are going to do it better. I don't believe they can do it better. I believe there has to be involvement. We have a responsibility to the taxpayer. I just don't believe we can just take this responsibility and hand it off to a contractor and say, OK, do it and we are going to trust you. I just don't believe that that is what we have to do. We have to hold their feet to the fire, and we are doing that in our State. I can't speak for anybody else.

Mr. LIPINSKI. Thank you.

Mr. DEFAZIO. Thank you.

Mr. Petri?

Mr. PETRI. Thank you, Mr. Chairman. I guess I have a question for the whole panel. I am thinking about this and the question in my mind is what is it uniquely and in a superior way the private people bring to this process. The Federal Government is more efficient than anyone else at borrowing money, it borrows it all over the world. So the argument that there are pools of money out there that could be used for American infrastructure through public-private partnerships, well, it could be, couldn't it, that the Treasury could borrow money and we could have a transportation financing bank the way we do hundreds of banks, going back to the New Deal and before, in agriculture and rural development and 101 other ways. This would get rid of the need for investment bankers and specialized fees and all this kind of thing. It would be a place that States or municipalities—probably States—would go to get approval and funding if we didn't want to use gas tax revenue anymore. If we thought there is excess capital in the world and the government could borrow the money and loan it out, somehow or

another, or even absorb the cost at the Federal level as its contribution and give it interest-free to the States, rather than let the private people get involved?

So could you discuss that? Is there some reason we have to structure this in such a way that each State is supposed to deal, or municipality, in the case of Chicago, with private people? It seems to be dangerous with cherry-picking of fees, complexity, using money up front that mortgages a State's credit and one thing or another that could be avoided, by just setting up some kind of financing bank and letting the Treasurer borrow the money and then having in-house experts manage it with the State and local people.

Mr. DUVALL. Congressman Petri, it is a great question, and I think one of your panelists in the later session is going to get into this question about the cost of capital in public and private sectors, and it is obvious that, certainly at the Federal level, you can achieve very low at capital, and, obviously at the State and local levels, you have taxes and borrowing, which is significantly cheaper than taxable borrowing.

I think that actually misses, though, the point about who bears the risk, and I think, obviously, to the extent you are doing government borrowing, you are putting taxpayers—and one of the reasons that government borrowing is cheaper is because you have got—you know, you are putting the general taxpayer at risk. And I think one of the ideas here is to really shift large amounts of financial risk to entities that want to bear it. Aand can bear it, and that drives—in response to Congressman Lipinski's questions—innovations and performance incentives that simply—it is not in any way a dig at government or government's inability to do things—it is just that simply the rewards for performance and innovation cannot be replicated perfectly in a public model. And I think the point of the contracting mechanism and why it is so powerful is that the public sector can really unleash fairly serious performance requirements in connection with these contracts.

So you are correct that the cost of capital through pure government borrowing can be lower, but it is much more complicated, and ultimately the question is who is bearing risk of failure and costs of failure and then, obviously, who is bearing the upside for success is the policy issue you all are confronting here.

Mr. BUSALACCHI. Congressman Petri, I think the point that you are bringing up is really one of the reasons why I am here today. I think there needs to be more debate about this topic. I am not here saying don't do it. All I am saying is that I think there may be other options here for us to accomplish our goal, and that is one suggestion that you have. But I really don't see that coming out of USDOT, I just see one solution here, and that is what concerns me, and the fact that we are forgetting about this massive problem that we have with needs.

So I think that you are absolutely right, and what we need to do is we need to have more debate about this. I am not saying debate it for 10 years. We can't wait that long; the Country can't wait that long. But I think we need to talk a little bit more about this to find out this to find out really what is going on, because, by my testimony today, I can tell you I am not convinced. Not by any means of the imagination am I convinced.

Mr. WILSON. Congressman, may I just add one observation on this element of risk? You asked what was uniquely attractive with the private sector involvement in these kinds of programs, and let me say that it may not be unique, but it certainly is a different perspective when you consider the notion of ownership and who has the ownership risk in the program. Typically, the public entity is the owner. And after the project is designed and built and is operational, they bear massive risks in terms of quality and performance of the facility.

Through this partnership arrangement, you can effectively transfer that risk for any period of time to the private enterprise, and that becomes an attractive option for a public entity in the sense that it does not have to buy and own the facility in order to get beneficial use of the facility. You can get the performance specified in your contract, you can get the reliability specified, or you don't make payments. In other words, what you are using is the productive capacity and performance of the investment, but you don't have to have "ownership" of it, you don't have to hold the deed to get public benefit from it.

You leave the risk of that performance with the private entity that designed it and built it, and has to stand behind its long-term performance. You can judge for yourself, locally, what long-term is; in some facilities it may be no longer than five to seven years when you have gone through the infant mortality stage of a project, or it may be a longer period of time because they are doing a good and adequate job. If not, then you take it back in your contract you have the ability to buy back, take back the facility, or own the facility at some future date.

But I think it is the important—there are too many examples in our industry where infrastructure built was left to an owner that had to come in afterwards, make repairs they didn't expect.

Mr. DEFAZIO. I thank the gentleman. Hopefully we can keep the answers more brief so we can get to more members.

I would observe that in a project that has been operating for 50 years, there is not a lot of risk; there is a lot known. Taking greenfields, it is a different issue. And there is very little to distinguish what is going on here between assuming and operating existing—and monetizing existing assets—Pennsylvania Turnpike, Indiana Toll Road, New Jersey Turnpike—or building a new project.

Mr. Oberstar.

Mr. OBERSTAR. Thank you, Mr. Chairman.

I want to thank our witnesses for participating this morning and the members for their participation.

And the gentleman from Tennessee, thank you for your leadership in the past in aviation and in water resources, and now lending your skills to highways. It has been always a pleasure working with you.

And Mr. DeFazio, for yeoman service in the course of SAFETEA-LU. We spent an enormous amount of time. I think I saw more of him at times than I did of my wife.

[Laughter.]

Mr. OBERSTAR. I have a number of problems with this public-private partnership idea. In this no tax atmosphere where governors, legislators, the chambers of commerce paint halos around their

head, pose for holy pictures, and saying no taxes, no new taxes. And then they turn around and say, but we are going to toll this and impose a fee for that. The word toll is spelled t-a-x. That is all it is. Don't try to sugarcoat it or disguise it in something else, and don't try to something the public.

Secretary Busalacchi, I want to compliment you on the splendid leadership you have exercised on the Milwaukee Interchange. That $800-plus million project has been languishing for over two decades, and I spent enough hours snarled in its mess, visiting two daughters who graduated from Marquette, to know the job that you undertook and tackled with great aplomb and with great skill. I have been back to Milwaukee several times in the course of the construction, simply flying in to visit my grandchildren down in Kenosha, and also for events in Milwaukee. So you have really done a superb job. And you are absolutely right, the role of the public sector is to oversee.

Now, this idea of public-private partnerships, if we want to go to something that the European countries use, that is a different—that will be a sea tide change in the way we do transportation. The idea of a warranted system, a warranted construction program, where the national government says we want a four lane road, we want it to go 50 miles, and we want it to last 75 years, and you build it and you guarantee it, contractor. We don't do that. We in the United States, in the AASHTO manual, specify to States we are building a 20-mile roadway. It is like a three layered chocolate cake, the frosting will consist of this amount of bakers sugar and this amount of chocolate, and there will be so much cake flour in it and so many eggs and all the rest of the ingredients. We spell them out and then we watch over the contractor to see that they perform the job to those specifications, and we don't hold them accountable except for fraud and corruption.

They are two very different ways of doing projects. And it would take a sea tide change of processing, of management of law and implementation of law to move to the European system, and that is what the public-private partnership idea does; it is a siren's song, frankly, of a quick fix way to put a lot of money out and build a lot of roadways. But I want to tell you that if we had started with the interstate system with each State doing its own design, designing its own program with public-private partnerships, we would not have a national integrated highway system.

To his great credit, Dwight Eisenhower didn't throw his hands up and say, oh my God, no taxes, build it with some incantations and chants. No. Although his secretary of treasury did propose funding it with—funding the interstate highway system by bonds floated on the stock market. Humphreys had been a private sector financier. The Congress said no. This Committee said no. My predecessor, John Blatnik, over in that corner, was one of the five coauthors of the interstate highway system legislation, and they said we are going to impose a user fee, call it a gas tax. Eisenhower signed it and it passed in 1956. It came back in 1957. It was four cents. It came back and said this isn't going to be enough, we need another cent. It passed on a voice vote in the House. I don't think you can pass the prayer on a voice vote in the House anymore. But

there was consensus in this Country, there was political will to do things. That is what this takes, is some kind of political will.

And to say that our former chairman, Don Young, went to the White House, went to the House Republican Conference to advocate for a $375 billion bill that the Transportation Department recommended, consequence of TEA–21. Study the needs, come back and report it, which they did. We took that bill, we introduced it in October of 2003. Gasoline was selling at $1.34 a gallon. Oh my God, the White House threw their hands up, the House Republican Conference threw their hands up, said we can't do this. And where did gas go within a year? It doubled. All that money went overseas to OPEC. Take the five cents, invest it in America. Those jobs are built with American labor, American goods, American steel, American cement and aggregate and asphalt. That is just baloney. We do it right, meet those needs, we have got enough. But we need the political will to do it.

And I heard Mr. Wilson talk about the project delivery. Chairman Young asked me to work on this matter of project streamlining, and so with 32 pages of legislative language we did it. But now I ask Mr. Duvall what have you done? It is 18 months since the bill was enacted. Where are your regulations?

Mr. DUVALL. I mean, obviously, there are a series of regulations in connection with the 6002 process. We put out proposed rules. We obviously greatly appreciate the flexibility you have given the Department to accelerate that, and we will work harder to get them out faster, but————

Mr. OBERSTAR. It is 18 months. Where have you been? Mr. Duvall, I mean, granted, it took me six months to work this out, but I have worked it out with every interested group, Associated General Contractors, ARTBA, AASHTO, Sierra Club, National Trust for Historic Preservation, and go on all the other interest groups, every one of them. I spent hours of my time on this thing. And you have been on this thing for 18 months. Get the regulations done. At least come up and talk with us if you have got a problem. But we are not going to tolerate these projects—we have got the money, but it has taken us seven years to do it because the project approval process is too complicated. Baloney.

Mr. DUVALL. I agree, Mr. Chairman.

Mr. OBERSTAR. Get the message?

Mr. DUVALL. Well, I agree that we have got to work much harder to get the regulations out in a timely fashion. It has been a high priority. As you note, the 6002 regulations, there is a myriad of other regulations, obviously, the Department is putting out in connection with the bill, some of which have been very timely, others have not. And we have got to do a better job to make sure————

Mr. OBERSTAR. I want to tell you the Seattle monorail project, which unfortunately failed for other reasons, projected 44 months of project approvals. They used this process and did it in 40 weeks.

Mr. DUVALL. It is a very important—I think that one of the problems we have got is that the environmental process has obviously become the mechanism to have the public discourse————

Mr. OBERSTAR. It is not just environmental.

Mr. DUVALL. Right.

Mr. OBERSTAR. Don't blame it all on the environment.

Mr. DUVALL. No, no.

Mr. OBERSTAR. There are lots of other issues.

Mr. DUVALL. That is actually what I was saying, is that it has become the mechanism to debate the project, and whether to move forward, and it is an important policy————

Mr. DEFAZIO. I think that the Chairman is making a great point, and I think that the Subcommittee will request a briefing on the status of the implementation of the streamlining. We would think that this Administration would be particularly interested in putting that forward, and perhaps if they spent more time on that rather than developing model legislation for a minor portion of the problem, which is public-private partnerships, we would have the streamlining in place and we wouldn't have to include that as part of this debate. I thank the————

Mr. OBERSTAR. Thank you, Mr. Chairman. It is message delivery, not project delivery here.

Mr. DEFAZIO. Thank you.

Mrs. Drake.

Mrs. DRAKE. Thank you, Mr. Chairman. And I apologize for missing the bulk of the meeting, and I am sure you have covered this in detail. I only have one very simple question for you. I am from Virginia. Virginia, I think, has used public-private partnerships very well, and I wondered, from your perspective of looking at the Nation and you look at States that do use it, States that don't use public-private partnerships, if you can draw the conclusion of are States like Virginia—I think in Virginia we would say we are in a better position because we have used public-private partnerships, but, looking around the Nation, would that be a fair assessment?

And the other comment that I would make is what I have seen from it too, because we have unsolicited proposals, is that there are proposals coming forward on various plans that really generate public debate, debate within the general assembly, and get us looking at transportation a little bit differently and what things might be out there.

So I apologize if you have already covered that in great detail.

Mr. DUVALL. No, thank you, Congresswoman. I did mention the Commonwealth's activities, and there is little question that the Commonwealth has been a leader in exploring these partnerships and has the most comprehensive authorizing legislation that was a substantial public debate with the governor and with the State legislature in Virginia, and continues to—the State legislature continues to provide strong oversight over the implementation of that broad authorizing legislation. But there is little question that Virginia' s willingness to negotiate and enter into discussions has given them a tremendous opportunity to improve their transportation systems, both in the Hampton Roads region and up here in Northern Virginia.

The three major projects that are proceeding—actually, there are more than that, but the ones that are getting a lot of attention are all going to involve some public-private partnership arrangements, and it is unsolicited proposals, in fact, that came forward, particularly with the Beltway widening here in Washington, D.C., that came up with the creative approach to take a fewer number of houses than the State had considered and really stimulated, as you

said, a public debate. If you have told me 10 years ago that the State of Virginia would have been in a position to proceed with a widening of the Capital Beltway without enormous public negative reaction, I would have said that there is no way. But what happened is the private entity working with the government developed a very streamlined and rational approach to the expansion that I think has gained widespread public approval from all the members of Congress, from the constituents in the region, and it is moving forward at an aggressive pace at this point.

But you are right. I mean, I think that the template that Virginia has used—and, again, I think it is clearly in the public interest how Virginia has implemented it—is a really impressive model that other States—in fact, it is what other States have looked at in the U.S.

Mrs. DRAKE. Thank you for that.

Mr. Chairman, I yield back. Thank you.

Mr. DEFAZIO. I thank the gentlelady.

Mrs. Napolitano.

Mrs. NAPOLITANO. Thank you, Mr. Chairman.

I have been listening with great interest to the testimony that has been given, and coming from a State which has undertaken private-public partnerships in the past, it is really an interesting scenario to hear that now the DOT Federal is wanting to make—fling the door open, if you will, not even talking specifically on the 91 Freeway in Los Angeles that began as a 3P and, unfortunately, did not continue in that vein.

But one of the concerns I have is, Secretary Duvall, has DOT sought information input, comments, held meetings with the States Departments of Transportation folks to receive input as to how they perceive this could work or not work, and any of the areas that you have outlined that they feel might require further comment or further input to be able to become more effective?

Mr. DUVALL. Thank you, Congresswoman. Yes, we have absolutely sought advice and input, and, in fact, it is safe to say that the States, at the DOT level, are really screaming for additional flexibility in this area to really pursue arrangements that current State law and legal mechanisms do not allow them to consider. You are 100 percent correct that the experience with SR–91, while receiving a lot of negative attention, has actually been very vital to this national debate, and I agree with Commissioner Busalacchi that we do need a national debate about this topic.

Mrs. NAPOLITANO. OK, but can you determine, can you maybe quantify in terms of the bigger States are for it, the smaller States are against it, or something to that effect? Because, in essence, the larger States have already done the partnerships in some form or another. The smaller States are beginning to want to because of the expansion need, but do they know the pitfalls that the larger States have become embroiled in and have found information that could help them determine whether or not that is the way to go?

Mr. DUVALL. Yes. The small, mid-size, and large States—I would not characterize all large States, though, as having done this. There are actually still a very few number of large States that have pursued this approach to expanding and managing existing capacity. I think what is safe to say is there is a significant degree of

learning that has already taken place among the career officials at State DOTs in the past five to ten years and I am actually fairly well amazed at how much they do know already about the risks, even in States that have not done a single transaction. AASHTO has been a great forum for discussion. There have been numerous conferences in which this has been discussed and debated, and I am constantly amazed, frankly, of how much people already know about the risks. And SR–91, you are right, has been a poster child that has actually helped us in many ways carve out what the policy issues are with non-compete provisions.

Mrs. NAPOLITANO. Well, I was one of the ones that voted against it, and partly because it was built on public land and somebody was going to take private benefit from it, and we knew that it did not have all the questions answered nor coverage of where the infrastructure maintenance was going to come from and for how long. There were a lot of things that were not covered.

Do you have any way of being able to—and I have heard some of the discussion that on your website you have some information—to be able to help those that are seeking information as to whether or not they can make informed decisions or be able to be referred to those cities or States that could assist them in being able to protect their public interest?

Essentially, in 91, the non-compete clause, California has a great need for expansion, yet we could not expand because of that clause in that 91 contract, and that hurt our whole area. In fact, they are still suffering from that; it has not expanded. And I am sorry, but others are going to have to make sure that they look at the non-compete clause, because if they are able to expand, they can't by law.

Mr. DUVALL. Right. I think you will have a panelist later discuss non-compete clauses in potentially more detail, but I think it is safe to say that the state of the practice has evolved to the point where they are either not included or sufficiently weakened relative to what was included in that transaction.

As far as expanding outreach, I think it is important, and I think I basically committed to the Chairman today to develop some written materials related to the risks, and we will do that. But I think it is clear, though, that we have been engaging in a longstanding discussion with States who want—who have asked us these questions, who are inquiring. We have done a lot of conferences, a lot of outreach to States; we have developed, obviously, model legislation, but we have also done a significant number of reports. There is a lot of expertise that does not reside in our Department, however, and I think this is a longer term issue for us, as well as the States.

Mrs. NAPOLITANO. Well, my time has run out, Mr. Chair, but I will submit some questions.

Mr. DEFAZIO. I thank the gentlelady. I think that was a particularly important question.

Mr. Busalacchi, would you like to respond to that?

Mr. BUSALACCHI. Yes. I would just like to say something, Mr. Chairman, in talking about Virginia. And this is why I think we have got to get out there and we have got to have this debate, and I really appreciate what you are doing here today. It is our under-

standing that Virginia is having real problems raising revenues to get highway projects done, and that is why—and, you know, I understand what Mr. Duvall is saying, but that is why we have to get out there and we have to look at these 3Ps and see if they really are this panacea that everybody seems to think they are. I don't think they are. Our legislature doesn't think they are. We are facing, in Wisconsin, opposition to this program. People don't like the idea that their roads may be owned by foreigners. Forgive me for saying it, but that is really—that is part of the problem, and————

Mr. DEFAZIO. You will be on Lou Dobbs tonight, Mr. Busalacchi, I guarantee it.

[Laughter.]

Mr. DEFAZIO. Thank you for that.

But I think, Mr. Duvall, Mrs. Napolitano made a great point here, which is I would really like to see—I mean, you are saying you have had these conversations. I have heard from DOTs, a lot of them across the Country, and they are talking about the hard sell they are getting from their regional Federal officials on 3Ps, they are not saying, gee, they gave us a great list of the pitfalls or problems. You said the practice has evolved, you haven't said your guidance or your advice to the States has evolved to say, hey, look out for non-competes. You don't have to look very far back in history to find non-competes, i.e., the Indiana Toll Road, that's a big one with 10 miles each side non-compete or other projects.

It is not like this is some ancient historic artifact or there aren't maybe some private companies out there trying to get some gullible State DOT to sign off on a non-compete. And I have not seen specific guidance from the Fed saying, hey, this is a big problem, look what happened in California, look at the problems it is creating elsewhere, look at the potential problems.

Just one last question. I pointed out, when we had the financiers in here and Macquarie, good company. I said, there are two ways to meet a congestion standard, aren't there? One is increase capacity, the other is to price people off your asset. And in Indiana, if they priced people off the asset, there is a 10-mile non-compete on either side of that. So you are dumping the traffic into an area where you can't—just like what happened in California. And this was just signed by Mr. Daniels six months ago. So it isn't a historic artifact. Where is the advice?

Mr. DUVALL. Well, Mr. Chairman, again, as I said, we will definitely put out some guidance document related to risk.

Mr. DEFAZIO. I appreciate that. That would be great. I have got to go on to another————

Mr. COHEN. Thank you, Mr. Chairman.

Mr. DEFAZIO. Microphone.

Mr. COHEN. Push my button and clear my throat.

I guess this is for the panel, and I am a little confused on the whole issue, but if you get into these public-private partnerships, does this change the process of determining priorities and where these roads are built? Where you build roads determines the value of property, and does this give the private sector the ability to choose where these roads would be built, whether there would be off-ramps, etc., and have different issues concerning the land that

is pertinent to the road or near the road, and the value that might have? Have those factors been considered or is that an appropriate issue?

Mr. DUVALL. Congressman Cohen, obviously, any project that advances has got to be agreed to by the government officials that are administering the program in accordance with Federal planning requirements. So I am not sure if that answers your question, but there is no way a private project can move forward without full consent and understanding of the officials administering the program. So if it doesn't fit within their transportation plan and proposal, it can't move forward.

I think it is important to note, increasingly, we are seeing, obviously, resources not being allocated towards projects that are really producing the highest returns, and there have been a number of economic studies in recent years that really point to this failure. And one of the reasons we have been excited from a policy standpoint about this idea is we think it will actually free up resources to make what may or may not be considered a low-return investment, but that is still in the public interest, but allocate some of the risk of high-return projects and get resources flowing faster to projects that produce high economic returns. That is the idea, and we are seeing some of it being played out here in Virginia and in Texas. We have a long way to go before that is implemented nationwide, though.

Mr. COHEN. When the private sector gets involved, they make their money by the tolls, is that correct; they invest in the roads and then they get the return on tolls?

Mr. DUVALL. It depends on the arrangement. Obviously, the State of Florida is pursuing what is called an availability payment model, where the State sets aside a set of resources and then has the private entities bid on effectively a maximum ceiling, and if the lowest bid effectively wins and they get a concession for those public resources, however they are generated. That is a model that is used in Europe. So as I said in my opening statement, it is not confined to revenue-generating projects, this concept of risk sharing. Yes, you are correct that the ones that are getting the most media attention are toll road projects, though.

Mr. COHEN. Is there ever an issue concerning the toll roads? You have got to have law enforcement there to police, I presume, and if there is a wreck which ties up traffic, you have got to clear it. Is there ever a discussion about utilizing the public's abilities to clear up road and who gets priorities, and if there is any problems there?

Mr. DUVALL. No. All the agreements provide for full access to law enforcement officials. They also actually—several of them fund the activities of the law enforcement officials as a part of the contract. I also think it is important to talk about the performance requirements that States can impose on private entities to not only—to clear incidents, to move traffic faster, to deploy electronic tolling, to create reversible lanes. All those can be required as part of the agreement. They are in the inherent interest of the private entity because throughput maximization is a good idea if you are trying to generate a high return, but it is also something the public officials can require as a part of the performance.

And a breach of the agreement—I think this is an important topic of further conversation—but a breach of the agreement means that the facility, if it is material, can revert back to public hands, and any payments that have been made to date do not go back to the private sector. So the public sector—and you have got very good lawyers that now are expert at doing this and can greatly protect themselves in connection with these issues.

Mr. COHEN. But does it ever skew the public resources? Has there ever been a situation where you have got maybe political influence and they put a priority on this toll road to go and clear up this accident so that the traffic flow on that road is better and it helps—as distinguished from a public road? Any time you get this private-public distinction and you have got public resources necessary for operation, you have got the possibility that there will be influence used politically to have those public resources used to help the private entrepreneur. And the road-building industry, I don't know about the Country, but in Tennessee we have had a couple of scandals through the people that build roads; I mean, they have kind of got a tendency to get together and decide what the best price would be and do that. That doesn't work real well.

Mr. DUVALL. Right.

Mr. COHEN. So if they kind of get together on that, might they not get together on saying, you know, clear my road first?

Mr. DUVALL. Right. Clear risk of those kind of side backroom deals taking place, I think it just a risk that the public officials have got to be aware of and make sure that there is open transparency to what is being negotiated. As I said, obviously, the private sector is increasingly a tool to finance some of these public services, which, as you said, presents some conflict questions. I just think it has got to be managed on a case-by-case basis.

Mr. COHEN. There was a road I got on one time going from L.A. down to Laguna, and it was a toll road. Was that a public-private partnerships? OK.

Mr. DUVALL. The 91, is that the one you are talking about?

Mrs. NAPOLITANO. That is the one by Irvine, over in that area.

Mr. DUVALL. I think so, yes. OCTA? I don't know.

Mr. COHEN. Whatever. Thank you.

Mr. DUVALL. All right, thanks.

Mr. DEFAZIO. I thank the gentleman.

Mr. Baird.

Mr. BAIRD. I thank the Chairman and our witnesses.

Mr. Duvall, is it your opinion that it is in the United States' best interest to have a domestic fabrication capacity for steel and other infrastructure needs?

Mr. DUVALL. Yes, I believe it is in the Country's interest to have capacity to do that.

Mr. BAIRD. Is it your understanding that part of the reason for the Buy America Act provisions in Federal law are to help preserve that domestic fabrication capacity and ensure that Federal tax dollars are spent to help maintain the capacity and employ American workers?

Mr. DUVALL. That is my understanding, yes.

Mr. BAIRD. Is it your or the Administration's position that private partnerships or privately funded transportation projects

should be exempt from Buy America provisions, even if they become, in some fashion, part of the broader Federal highway system?

Mr. DUVALL. I think the question of application of all Federal requirements, including Buy America, depends obviously on the nature of the Federal involvement in the partnership to begin with. So if there is Federal funding participation, if there are other Federal elements of participation, the requirements should attach with that participation. To the extent the Federal Government is not involved in funding, approving, or otherwise providing oversight to a project, the requirements would not attach.

Mr. BAIRD. Do you see any potential problems if expansion of public-private partnerships were to continue and possibly evade, thereby, Buy America provisions? In terms of the potential to maintain our domestic infrastructure.

Mr. DUVALL. Again, to the extent the Federal funds are flowing, the requirements have to be satisfied, so I don't see that risk.

Mr. BAIRD. Let me give you an example. There is a bridge in Tacoma, Washington being built, the new lane on the Tacoma Narrows span. It is being built with Korean steel. It is a tolled project And not far away are some of the best steel fabricators in the United States of America. They happen to be in my district. Not a bit, or very, very little of that new span is being made domestically, and at some point, if we continue this, we are going to lose our domestic steel fabrication capacity. And one of my concerns about this public-private partnership issue is that we are going to lose that capacity, and when an earthquake comes or an international conflict comes, we are going to be beholden to foreign manufacturers and foreign fabricators.

Do you have any concern at all about that?

Mr. DUVALL. I mean, again, I am not an expert on that business, but I think to the extent the Federal Government's interest—and I actually have not been intimately involved in the day-to-day negotiations of that contract, so I can't speak to the terms there—but clearly the Federal Government has expressed, through the Congress, a clear interest in ensuring the Buy America provisions are enforced, and I don't see the public-private partnership trend as a threat to that in any way, actually.

Mr. BAIRD. Really? In no way at all?

Mr. DUVALL. I don't see it as a threat, no.

Mr. BAIRD. I would ask you to look into that a little and get back to me.

Mr. DUVALL. OK.

Mr. BAIRD. It just seems to me that if increasing numbers of Federal transportation projects are built with private money and thereby evade Buy America provisions, there will be less market for domestic fabricators and construction people, and that declining market would seem to possibly imperil their financial viability and thereby, importantly, the security of this Country. And I would encourage you to look seriously, as you seem to be an advocate of public-private partnerships.

Let me throw out an idea that I have kicked around and welcome the comments of the panelists. First of all, it is my understanding that Macquarie gets a significant portion of their funds from retire-

ment funds from Australian citizens. Is that an accurate understanding?

Mr. DUVALL. Yes.

Mr. BAIRD. That is accurate.

Mr. DUVALL. Yes.

Mr. BAIRD. It is paradoxical to me that we are going to have American citizens driving on roads paid for by foreign retirees and our tolls are going to go to those foreign retirees. That strikes me as funny. We have, in this Country, dual problems: one, an infrastructure deficit that exceeds about $1.6 trillion dollars, according to engineers; and, two, a big question about where we put the Social Security trust funds. Those trust funds, as you know, are declining over the next number of years. Many of us have said they should be put into a lockbox. No one knows quite where that lockbox would be stored; it is apparently stored as a payday loan operation that funds the general fund to hide the cost of the deficit.

Let me throw this out there and see any response you have got. What about putting the Social Security trust funds, over the next 10 years, while we have still got a surplus in those trust funds, into an infrastructure bank that would fund infrastructure, create jobs, and that would be paid back on some timetable to ensure that the baby boomers and others receive benefits?

Mr. DUVALL. I will get really far afield of my responsibilities to comment on that question directly. I will say, however, that the prospect of long-term money, U.S. long-term money, entering into the infrastructure equation in the U.S. is a huge opportunity and it is already happening. CalPERS—my written statement notes—is becoming a major intermodal freight investor in the Midwest. The three major unions in the United States, the Operating Engineers, the Teamsters, and one other—I can't remember the third—are investing actually in Macquarie. Fifty-two percent of Macquarie is U.S. Macquarie Infrastructure Partners is owned by U.S. investors.

And I think you are absolutely right, the Canadian Pension Fund, the equivalent of the Canadian social security, has dedicated 10 percent of their fund, I believe to infrastructure.

So, yes, I think you are onto a major point here, which is that we have got a lot of long-term capital in the U.S. that could be really aggressively, I think, deployed to improve our infrastructure, if we get the policy framework right. And I think that—to me, that is the big challenge for this Committee, is how do we get the policy framework right to tap into that. But you are right.

Mr. BAIRD. Thank you.

Mr. Chairman, can I ask if the others want to comment?

Mr. DEFAZIO. Certainly. Go ahead.

Mr. BUSALACCHI. Well, I just would, you know, again, as I had said earlier, you are raising some really good points, and I think that is what comes out of the debate that we have with this, because, you know, you are right about the materials. You are absolutely right on the mark. And we—this is all about making money, and if they can get the steel cheaper and they can get the concrete cheaper, they are going to get it cheaper. And if they can get it overseas, you can bet they are going to bring it over here if they control the job. And that is what we have got to be careful about.

Insofar as having our own pension funds, you know, in this Country doing this investing, you know, sure, if that is what they want to do, but some of these pension funds are prohibited from entering into these things. So that is another area that you really have to—that you really would have to look at domestically.

But you are raising some good points and it is something that—that is why this Committee needs to really closely watch what is going on with this.

Mr. DEFAZIO. I thank the gentleman from Washington State.

We are going to—this Committee is going to hold a hearing this spring on the Buy America provisions, and I expect we will fully investigate. And I think these are excellent questions you are raising.

The other question you are raising about social security, just for reference sake, I believe it would be like $1.2 trillion that is going to be borrowed and spent of so-called social security surplus over the next decade. Now, just imagine, here is a country of 16 million people, Australia, and a major funder of infrastructure in a Country of nearly 300 million people. Kind of odd, isn't it?

Mr. BAIRD. It is actually, Mr. Chairman, if I may, I believe it is about $1.2 trillion over the next five years.

Mr. DEFAZIO. Oh, it is five, I am sorry, five years. Right, during the budget, yes. Member of the Budget Committee, I stand corrected.

Mr. BAIRD. But the point being there is money there, and we could invest it, create jobs, build an infrastructure, comply with domestic laws, and I sure think the American taxpayers would rather be paying into their own retirement fund, if they are paying a toll, rather than the Australian retirement fund.

Mr. DEFAZIO. I thank the gentleman for that provocative line of thought, and I would like to work with him on that.

I want to thank the panel for sitting and providing good testimony and answers, and your obligations are completed.

We now have a vote on the rule, probably a five minute vote, so hopefully we will reconvene—how many votes? I am sorry, four votes.

I am really sorry about this for the next panel. There apparently are four votes. I would expect—I am not sure how many of those are fifteens. Just the first? And the others are all fives or suspensions. OK. So we would expect it would take a minimum of about half an hour. I won't set a time certain, but we will convene as soon as possible after the last vote, which will probably be about five after or ten after twelve. Thank you.

[Recess.]

Mr. DEFAZIO. The Committee will come to order. It took longer than we thought, but that is the way things are around here.

I appreciate the next panel being patient, and we will proceed immediately. We expect no more votes for the immediate future, so I guess—I don't have the witness list in front of me, but we will just go from left to right.

Ms. Hedlund, why don't you begin? Thank you.

TESTIMONY OF KAREN HEDLUND, ESQ., NOSSAMAN, GUNTHER, KNOX & ELLIOTT LLP, PARTNER, ARLINGTON, VIRGINIA; DENNIS ENRIGHT, NW FINANCIAL GROUP, PRINCIPAL, JERSEY CITY, NEW JERSEY; ALISTAIR SAWERS, RBC CAPITAL MARKETS, TRANSPORTATION AND PROJECT FINANCE SPECIALIST, SAN FRANCISCO, CALIFORNIA; AND ROBERT POOLE, REASON FOUNDATION, DIRECTOR OF TRANSPORTATION STUDIES, LOS ANGELES, CALIFORNIA

Ms. HEDLUND. Thank you, Mr. Chairman, Ranking Member Duncan, and members of the Committee. Thank you for inviting me back. Today, I am going to try to address certain public policy issues that arise in PPP transactions and how these are resolved through statutory and contract requirements.

My firm has had the privilege of advising on PPPs in over 15 States, and our advice is frequently sought on PPP legislation, which I know is of an interest to this Committee. I do live here, but I probably spend more time in the State capitals than I do in this one, and I am going to try to bring you that perspective.

The authorizing legislation in many States I think reflects real thoughtfulness about the proper processes that need to be used to implement PPPs and to protect the public interest. And public agencies also have at their disposal a wealth of contract provisions that are accepted the world to ensure that private partners keep their end of the bargain and do not take unfair advantage of the public in operating public use facilities.

As of today, over 24 States have adopted some form of PPP legislation and, as with other governmental activities, such laws vary greatly from State to State in scope and in detail. What the States do have in common in their approach to PPPs is that they view them as but one tool in the toolbox, not as a panacea. Even if the gas tax were raised, I think we would find PPPs being used to continue to advance important mobility projects for which traditional sources of funding are lacking.

In my written statement, I tried to answer some of the hot button issues related to public-private partnerships that this Committee and others have raised. How can you—how can the integrity of the procurement process be maintained by achieving transparency for the public? How should the term of a PPP be determined, should it be 35 years, should it be 99 years? How can increases in user fees be limited? How can unreasonable private operator profits be controlled? Are there reasonable approaches to this issue of competitive facilities? How do we assure long-term performance? And what is the private operator defaults or becomes bankrupt?

Most legislation will either resolve these issues or require that they be addressed in resulting agreements on a case-by-case basis, so let me address just a couple of these.

To avoid sweetheart deals, State laws provide for competition. Choosing solicited procurements over unsolicited procurements now seems to be the trend, and the State of Oregon is choosing solicited procurements; the State of Georgia has gone from a statute that only permitted unsolicited procurements to add solicited procurements.

As to the appropriate term of the agreement, most State laws do provide from kind of maximum term, but the term of any particular agreement should be established with regard to the financial feasibility of the project. Projects with a weak revenue stream may require a longer term to allow the private operator to be able to achieve its targeted rate of return, and that was the reason for the very long term in Pocahontas. Projects with lower revenue risk can have relatively shorter terms.

The decision on how much and how fast user fees should be permitted to rise is a public sector decision involving significant policy considerations. The final decisions can be implemented through contract terms specifying maximum annual toll rate adjustments, which can be tied to an appropriate index. The maximum profits that a private entity can secure is controlled through the use of other contractual devices such as requiring the private entity, if its rate of return exceeds a specific percentage, excess revenues be returned to the sponsoring agency.

As to this issue of non-compete agreements, there was actually only one project actually built in the United States in the last 20 years that prohibited non-safety related improvements on adjoining free lanes, that was the SR–91. Safety improvements were permitted.

But the market has evolved dramatically from that in the last 16 years. Instead, agreements typically now provide for, if at all, possible compensation to be paid to the private operator if, and only if, the construction of facilities that are not included in the region's long-term revenue unconstrained plan actually result in a proven reduction in a project's revenue. So there is no bar to the public sector to building additional facilities. Under certain circumstances, unlikely to happen, there might be compensation that has to be paid.

As to long-term performance, you will hear Dr. Poole, I am sure, argue, as he has in the past, that the private entity is highly motivated to maintain the facility in order to protect its investment and keep its customers, but we don't have to rely on economic theory. Instead, detailed performance requirements have become standard in these transactions.

Finally, if the operator defaults and goes bankrupt because traffic fails to meet its original projections, the State may terminate the contract and step back in and operate the road. In addition, most public agencies retain the right to terminate a contract for convenience when they deem it in the public interest or as a result of changed circumstances or a change in public policy.

There are other issues that arise only in the context of leasing existing assets. The States, I think, are approaching this issue with a great deal of caution and after a lot of study. If they determine to go forward, I think the governors of New Jersey and Pennsylvania will probably seek specific authorizing legislation that is no doubt going to address issues such as the proper use of the proceeds and the tradeoff to be made between the term and asset value and protecting existing employees.

In conclusion, I would observe that developments in public-private partnerships are just the kind of experiments that Justice Brandeis said in 1935 are one of the happy incidents of the Federal

system. Properly executed, these experiments of individual States are providing new funding to meet mobility and safety challenges that hopefully will serve the social and economic needs of the entire Country.

I look forward to your questions.

Mr. DEFAZIO. Thank you.

Mr. Enright.

Mr. ENRIGHT. Thank you, Mr. Chairman. Thank you for inviting me to speak.

In listening to the prior panel, there seemed to be a lot—in the questions that followed, there seemed to be a lot of confusion between public-private partnerships as a concept and monetization of assets as a concept, and that the rubric between them has crossed. And there is a long history of very successful public-private partnerships in the U.S., but until the Chicago Skyway P3 transaction, success was measured largely by a reduction in cost to the users and shorter terms of 5 to 30 years.

In the P3 asset sales like Chicago and Indiana, they actually produced higher cost to users, not lower, and longer terms of 75 to 99 years. That is a significant difference in the definition of public-private partnership.

The key question, though, is can the public sector get more value from self-help financing approaches, using traditional toll road type of financing.

There is much talk about worldwide privatization experience, it is not new in the United States. Non-U.S. experience actually is driven by credit concerns around the world. Most of the toll road privatizations around the world are actually in third world countries, although there are quite a few in Europe and Australia, and in those markets they cannot possibly provide the governmental funding to build the road, and private capital is an important source of funding. They also have no market for U.S. style governmental enterprise finance pretty much around the world. The U.S. is almost unique in that regard, using revenue bonds as a funding source. And low-cost public funding through tax-exempt bonds is not available in the rest of the world.

In contrast, the U.S. experience has seen success in P3s when there is significant technology, revenue demand, or efficiency challenges. In the U.S., we have a large network of high-quality public employees with extensive experience in the implementation of large public works projects and, therefore, are better able to match the private sector efficiency.

One U.S. P3 success story, which has been around for 20 or 30 years now, are waste energy plants. The key to success in this sector was the sharing of risk between public and private sectors. And I have spelled that out a little bit more in my written testimony.

In the transportation sector, roads, anyway, there is little technology risk to share. The only real risk is production of future revenues to pay for the cost of the road, and that has always been an acceptable risk to the public entities that fund toll roads. The U.S. has a proven track record of using revenue-backed governmental bonds for enterprise finance. The U.S. public mission in toll roads has been one of providing mobility through affordable tolls, designed only to fund the needs of the road. U.S. toll roads authori-

ties have not been maximizing the bottom line with inflation-adjusted increases, since they were never considered. They have been driven by a public policy mandate that treasured minimizing tolls.

Along comes Chicago. In Chicago, which was a groundbreaking transaction for the transportation sector, it was really the first time the P3 mandate was utilized to increase cost to users in a major way, and that revenue stream was then monetized. So what Chicago really proved was that capital markets would accept a long-term projection of revenue increases based upon economic indices as a basis of financing.

Then it was Indiana. They also used monetization of future toll roads, and it is a Statewide roadway. This raised a bunch of new public policy issues. This is a 150-mile stretch of road, not a bridge like Chicago. It is a key link in the interstate highway system, and it is probably the State's most important economic development tool. In the future, as they pursue economic development, they will need to negotiate with the new owner of the road and return profit to the private sector. The cost of capital to the private sector historically and in the future is likely to be 60 percent more than the public dollar, and the private sector has considerable leverage and sophistication in negotiations that really doesn't exist on the public side, as you heard some of the earlier speakers indicate. And remember, the lease is not up for renewal anytime soon, so who has the leverage?

So what convinced the governmental leaders in these two States, two situations, to do these deals? It was really the pitch. And the pitch was that they were going to be able to monetize future growth today. This pitch is made by the private participants most likely to benefit.

Well, surprise. The private sector is not willing to overpay for toll road assets. Chicago and Indiana actually prove that. They can't. The credit discipline in the capital markets, particularly for transactions of this size, limits how much they can do in debt, and that debt limitation then requires additional equity capital to make it up, and equity capital is more expensive. The combination of those two costs of capital drives the valuation. And the valuations in Chicago and Indiana are no greater than the amount of dollars that could have been generated by a public finance option. Public capital is about 60 to 70 percent lower than the private option, and the public solution can deliver greater value or require a significantly lower tolls to get the same dollars. So the bonus of public ownership is really a public ownership dividend: they get to keep the future cash flows the private sector is not paying for.

How can the public interest be protected? Independent evaluations, public agency monetizations without taxpayer risk, capturing the public ownership dividend through future revenue share ownership, and, if private, if you decide that it should be private, you need more sophisticated procurement. You need to evaluate in a combination of factors, including the length of the deal, limits on the return to the investors, risk-sharing parameters for unforeseen events, and the price offered.

In the international world, P3 deals rarely exceed 30 years, and many are much shorter, even for to-be-built projects. Some allow for termination of the concession when the equity returns have

been achieved and return the revenue-producing asset to the public sector. Chicago and Indiana transactions are so exciting because, like Columbus, they found a new world: dollars today based upon a future revenue monopoly. However, there is little risk. If higher toll increases reduce traffic, then increases on free route—it increases traffic on free routes and makes time advantage on the toll route even more valuable. Are these platinum card highways?

So the lessons learned from the public sector point of view are: one, there is no need to sell assets and surrender control; two, because publicly-funded monetization is relatively available without taxpayer risk; three, until higher valuations arrive, if ever, the public option should be the preferred option; four, for existing toll road assets, there is little reason to pursue the P3 option; five, capture the public ownership dividend of future cash flows; six, to-be-built roads, private sector may be more appropriate since there is more inherent risk.

In summary—and I am sorry I went over my limit—the key concerns are: the transportation system integrity, you know, rich roads, poor roads types of problem—the private sector is only going to want to do the rich roads; you are going to be stuck with the poor roads—capturing future cash flows; cost of capital evaluations; the actual toll regime imposed, meaning the formulas for increases; and the term and lengths of the monetization.

I hope I have provided some insight into potential protections for the public sector, and thank you for inviting me to speak.

Mr. DEFAZIO. Thank you, Mr. Enright.

Mr. Sawers.

Mr. SAWERS. Thank you, Mr. Chairman. Just wanted to run through some of the more European experience. You can tell by the foreign accent that I have obvious reason for having foreign experience, but I have worked for over three years in the U.S. as well, so I have a certain amount of insight in both jurisdictions.

I would like to make a distinction between public-private partnerships and privatization. Privatization is much more where markets and price mechanism defines the service provided. With PPP, the public sector is set there to define what is required to meet the public needs and remains the client throughout the long-term. This speaks quite clearly to how the public interest can be monitored in the PPP version.

In general, more international PPPs in the highway and transit sectors are focused on greenfield projects rather than brownfield ones. As we have been discussing, in the U.S. there have been much more brownfield activity. These have varied from the O&M style, the old such as Chicago Skyway, which has been discussed, but they also include refurbishment style deals such as the Missouri bridge's replacement PPP and also enhancement-focused PPPs such as the I–495 managed lanes. So picking on brownfield as being a sort of single homogenous type of project is risky, and in terms of defining the public interest, they all have slightly different characteristics.

In my written evidence I went into some detail describing how public interest and, thus, the public sector objectives have been defined in international PPP programs. In summary, the sort of key points have been to a move to define output or performance speci-

fications. These reflect the user's needs and the broader policy objectives such as minority employment or congestion relief or encouraging innovation. The other issue that has been very much a key focus in the U.K. is value for money, and this has been where a concept that has been applied to not just taking the initial low bid view of a bid coming from the private sector, whether it is just pure construction, but also taking into account all the risks and the whole life costs of the project.

Additional account has been taken to the benefits and the need for protection for public sector workers, though this has been much more an issue on health care PPPs, which are not really a feature here, rather than transportation.

And then the final issue has been as much of perception as anything else, which is that PPP companies, being private, are making an unreasonable profit, especially from user fees, but also in the case of availability payment deals, which Tyler touched on, also from the refinancings of the project debt, which I know the Chairman has an issue with.

The process of defining and entering into a PPP contract established some quite significant protections in the public interest inherently. The U.S. Treasury made some significant effort to study and evaluate these at one point. Their initial experience was that large amounts of the benefit of PPP came from reductions in change orders, as a previous witness mentioned, and the process of writing the PPP contracts required much better project definition than the traditional design bid-build model.

Also, equity investors in the project, who typically include the construction and operating companies, stand to lose all of their investment and are strongly incentivized to remedy problems. Similarly, debt provided to the project has only one form of security, that is, the PPP contract, and typically they hold 80 to 90 percent of the deal, so they are very strongly incentivized to police that contract and reflect any of those terms in the main contract in their subcontracts and do the government's job for it.

A study by the U.K. Treasury in 2003 found these protections resulted in something like 89 percent of projects being delivered on time, contrasting with previous research, which has shown that 70 percent of all non-PPP projects were delivered late. So that is quite a significant difference.

Another frequently quoted example is the bankruptcy of U.K. PPP construction firm Jarvis in 2005. All of its deals were completed at no additional costs to the public sector, and, while there were some delays, that was quite a result. And the other famous or infamous example is the Eurotunnel, which did not come back on to either country's balance sheet.

The problem of excessive returns has been addressed by revenue share triggers, which trigger either high levels of return or high levels of absolute revenue, or by, as just mentioned, termination of the concession when a cumulative return reaches a predefined target level. And that was Delford Crossing on the beltway around London. In most cases, however, toll or fare restrictions are the main focus, and the market is sort of the key focus there.

Also, the majority of international projects are availability payment deals, or shadow toll deals, which are inherently capped. And

that also speaks to why they are generally around 30 years, rather than 50 or 75 years, because you are just getting a straight payment from the government.

Quite often, these include additional incentive payments to address public sector policy objectives such as safety payments for reductions in accidents—and that is the case in Norway, Portugal, and some of the U.K. deals—also, there have been terms that have been put into PPP contracts to reflect refinancing and make sure that the benefits of refinancing have been shared with the government side. And, again, that has mainly been on availability deals, but that is where the government is obviously paying the up-front payment, so it has a right to the refinancing benefit. And also several jurisdictions—and I think this was touched on by a previous witness—undertake value for money analysis and compare their PPP project with an equivalent conventional method of procurement, either called the public sector comparison or a shadow bid, so they justify the difference between PPP and the traditional way of doing it.

Another thing which I think has been a reoccurring theme that lots of people have touched on is sharing best practice. Several countries have set up public entities to promote sharing best practice. An example is Partnerships BC in British Columbia, partners between Victoria and Australia. These authorities either do efforts to standardized contracts, reduce bid costs, or to share knowledge and to advise people procuring projects to make sure that the private sector does not have the advantage of better information.

In conclusion, it should be noted that many of these protections can increase risks, costs, and complexity of the project and drive down the overall value coming from the private sector. Thus, it is a tradeoff between the cheapest price and the risk to the public sector.

I look forward to your questions.

Mr. DEFAZIO. Thank you, Mr. Sawers.

Mr. Poole.

Mr. POOLE. Thank you, Mr. Chairman, Mr. Duncan. I appreciate the opportunity to speak today. I am Robert Poole, Director of Transportation Studies at Reason Foundation. I have been researching PPP toll roads actually since the late 1980's, starting with California's pilot program for toll road concessions.

The past two years, as the previous speakers have just said, the global capital markets had discovered the U.S. highway sector. This comes about at an opportune time, just as we are really realizing the magnitude of the gap between the needs for highway investment and what available funding sources will produce. And so, to help close that gap, States are turning increasingly to tolling and PPPs.

The newest form is the long-term concession, which is going to be the focus of my remarks. In exchange for a long-term contractual agreement the toll road company will design, finance, build, operate, market and rebuild a new or existing toll road, and it is the same basic concept, the same basic agreement form whether it is an existing road that is being leased or a new one being built, although there are obviously differences in risks involved.

This idea actually goes back to the 18th and 19th Centuries when private companies under State franchises built toll roads, turnpikes in Europe, in England particularly, and in the United States. And it was revived in a modern form in the 1990's in Virginia and California, but it has really taken off, as I said, in the past two years between leases of some existing toll roads and something like $25 billion worth of private sector projects in various stages of negotiation for new toll road capacity in about six States. This model has over 40 years experience in Europe and nearly 20 years of use in Australia, and that is why companies from overseas have been among the pioneers of bringing the ideas to America.

Now some will argue that we don't really need this concept of long-term toll concessions because State toll agencies can do all the things that we need if we want toll roads, but my research suggests there are six advantages that the private sector concessions model brings.

Number one, access to new sources of capital. Toll road companies can tap pension funds and other long-term investors who don't buy tax exempt toll revenue bonds. It is a different pool of capital and a potentially much larger one. S and P estimates that up to $150 billion was raised just last year to invest in infrastructure projects.

Number two, larger sums for toll projects. I am familiar with lots of studies, feasibility studies for toll roads, and many toll road projects don't pencil out using conventional toll finance with 30 year revenue bonds, but some of the same projects will work out under 50 or 60 year concession agreements because of the differences in the financing model. The long term really makes a big difference.

Number three is shifting risk from taxpayers to investors, and previous witnesses have mentioned that. Large transportation projects worldwide are notorious for cost overruns and for having over-optimistic forecasts of traffic and revenue. In concession agreements, in exchange for the long term, the private sector will accept and take on construction risk and traffic and revenue risk. These are huge advantages.

Number four has not been mentioned so far, multi-State potential. In the goods movement area where we are doing a lot of work, a lot of important projects are multi-State projects from a shipping origin to a distribution point in other States. State toll agencies can't operate across State lines, but private companies under concession agreements can and are particularly well suited to this.

Number five is a more businesslike approach. We do have some businesslike toll agencies, but many of them are very bureaucratic and not really operating as businesses with customer service as their number one consideration.

The sixth point that I think is very, very important is major innovations. Toll road companies are more likely to think outside the box and come up with innovative approaches to solving difficult problems, for example, traffic congestion. It was a private company in California under California's original concession program that came up with variable pricing as a means of managing traffic flows. This is what has made HOT lanes possible in America. No

public agency was willing to take the risk of introducing variable tolling. The private sector did.

In France, a private toll company solved a 30 year impasse over a missing link on the Paris ring road by building it as a tunnel underneath Versailles instead of trying to cut the town in two.

Now because these concessions are very new, there are a lot of misconceptions, and I have addressed them at some length in my written testimony.

None of these deals involve selling roads. They are all leases. They are all governed by the concession agreements. I have actually read the Chicago and Indiana concession agreements hundreds of pages long, and they really do have a lot of important provisions for protecting the public interest.

It is clear, foreign companies have been in the lead so far because they have the expertise. They have the track record. We don't have a private sector toll road industry in the United States although we are starting to get there. We are starting to see joint ventures between U.S. and global companies. So I am confident that we will have a domestic industry probably within the next five years. There is also a lot of U.S. capital being raised today to invest in these kinds of projects.

Eminent domain: this power is never delegated to the private sector. It is always one of the things that the public sector uses on behalf of a PPP project.

Uncontrolled tolls: all the concession agreements provide some controls over either the rate of annual increase or the rate of return that can be earned in a project.

Up front payments, that obviously has been discussed. There is a big tradeoff between how much money a State will get up front versus sharing revenues over the life of the project. I frankly am urging, I am recommending to State DOTs that they go for the revenue sharing option. I think that is both better for public policy and will be a more sustainable model long term. It also gives the public sector partner a real stake in the success of the project which I think is an important long-term consideration.

Finally, the question, could a public toll agency raise just as much money? Frankly, I doubt it. Nobody has figured out how a public agency can give investors 50 years of certainty that there can be annual increases of toll rates. Until somebody figures that out, the capital markets will not raise the same amount of money for a public sector agency as they will for a private concession.

To sum up, I think it is actually very fortunate for America's highway users that the capital markets including pension funds have discovered the U.S. highway market just as we realize how enormous the gap between needs and revenues is. So I think it is going to take, as we know, hundreds of billions of dollars to rebuild the Interstates, to expand capacity where needed. But we now have a new source for a considerable chunk of that investment. The challenge, of course, is to develop the right public policy framework to be sure the public interest is protected along the way.

Thanks very much, and I look forward to your questions.

Mr. DEFAZIO. Thank you.

I first recognize the gentleman from Tennessee.

Mr. DUNCAN. Well, thank you, Mr. Chairman. I have a series of appointments, and I appreciate your letting me go first.

For the record, I need to ask unanimous consent that the record be held open for 30 days for the submission of written statements or follow-up questions to the witnesses. I have had that request from some on our side.

Mr. DEFAZIO. Without objection.

Mr. DUNCAN. Now I have known of Mr. Poole's work for several years, and he has done a lot of good work. I especially like the revenue sharing suggestion, Mr. Poole, keeping the public sector involved instead of taking all the money up front.

Mr. Enright had, I thought, some pretty interesting testimony, and I underlined these sentences. He said, the combination of credit discipline imposed by the lending community and the high cost of equity has assured that the valuation utilized by these private buyers is no greater than the amount of dollars that could have been generated by the public agencies undertaking the monetization financing on their own. As a matter of fact, the cost of capital in today's markets for public financing is only 60 to 70 percent of the cost of a private monetization, and therefore can either deliver greater delivery or require significantly lower toll increases.

What do you think about those two sentences?

Mr. POOLE. Well, I think on paper you can make a comparison of that sort and show mathematically that you could get equivalent amounts of money and also that some ways of defining the average cost of capital, the public sector will clearly come out lower.

The question is: Could you actually realize that in practice? In my written testimony I say a little bit more than I said in the oral. I think what the markets are reacting to in these concession agreements is the legal certainty of being able to raise tolls every year over a long-term period.

With the public sector, the history of tolling by public sector agencies is that it will go for a long, long time with flat rate tolls even though inflation keeps rising and the costs of running things and maintaining things and repairing things keeps going up, but their revenues don't. Then they get to a crisis point and have to do a big toll increase that is very painful to the users.

I think there is a very interesting tradeoff and probably better for the users to have steady annual predictable inflation-related increases in the toll rates, but in turn, that predictability is indeed what seems to be driving the higher valuations that the private sector deals are getting.

I don't think, I cannot imagine a way to commit future legislators, legislatures and governors over a 50 year period to make sure that tolls can be increased by a public agency. I just don't know a way to do that. So that is why I think you are always in practice going to see a big difference in what a private concession deal can raise versus what a public toll agency can raise.

Mr. DUNCAN. Anything you want to add, Mr. Enright?

Mr. ENRIGHT. I would strongly disagree with Mr. Poole's reasoning there. I have been in the public finance business for over 30 years, and I did not undertake those statements without doing significant analysis and also talking with many bankers at large banks as to their view of this issue.

There is no question that the capital is available at lower cost by doing a public deal. As a matter of fact, in doing normal toll road financings, there is an expectation that they have to meet an ongoing requirement to provide revenue to pay the debt service. Nothing would be different if you did a monetization deal.

The only difference is that the proceeds would not be going directly into that roadway. They would be going for what other, whatever public purpose they are going for. But there is no question that that can be done in the capital markets, and I have researched it quite thoroughly.

Mr. DUNCAN. All right. Ms. Hedlund, the staff tells me that there has been a lot of negative publicity about the Indiana deal and the Chicago Skyway. Why do you think that is and what lessons do you think that they have learned about what they have gotten into or what they have done?

Ms. HEDLUND. Well, let me first say that I didn't work on either of those transactions, so everything I know about them is pretty much what I have read in the newspaper.

Mr. DUNCAN. Right.

Ms. HEDLUND. I don't think the Chicago deal has gotten a lot of negative publicity in Chicago. It is an unusual transaction. It was not a core asset of the City. The City had been trying to get rid of it for years.

Mr. DUNCAN. I did see George Will wrote a column last week, criticizing the Chicago deal. Did you see that?

Ms. HEDLUND. Yes, I did. Yes, I did, but the value in the Chicago Skyway is something that arose only recently when a couple of casinos were built at the south end of the lake. That is a road that was built to take southsiders to the steel mills. The steel mills aren't there anymore. It now takes people to casinos.

You know it was the first deal. It was certainly the one that got a tremendous amount of attraction, particularly because it drew a bid that was well in excess of even what Goldman Sachs, who was advising the City, expected.

Indiana, I know has been very, very controversial, and I can assure that I am certain the other governors that are looking at similar kinds of monetization are looking at that transaction and seeing if there are ways of improving on it.

Mr. DUNCAN. I am sure you are familiar with the term, shadow tolling?

Ms. HEDLUND. Yes.

Mr. DUNCAN. Is that something that is starting to be used in place or what can you tell us about it?

Ms. HEDLUND. The concept is used in Great Britain. There was a similar transaction done in Massachusetts on Highway 203 that was structured around a long-term lease payment, and the State assured the contractors that they would make certain payments to them over a period of time. The Miami Port Tunnel which is in the middle of a procurement has availability payments. So it is something that is being examined.

You do have to have a stream of revenues. It may be a public stream of revenues, but you have to have some kind of stream of revenues to compensate the private party for providing the availability of that project over the long term.

Mr. DUNCAN. Mr. Poole, you mentioned that Standard and Poor's said that $150 billion or almost $150 billion in private capital was raised for infrastructure projects last year alone. How much of that was in the U.S.? Something else, is that a big jump over, say, five years ago?

Mr. POOLE. I don't know for sure the answer to either of those questions, Mr. Duncan. I suspect that a significant fraction of that was in the U.S. I know Goldman Sachs just announced they have raised $6.5 billion.

Mr. DUNCAN. You said that.

Mr. POOLE. I believe that was almost all in the United States. Carlyle Group has a fund that I think is almost all U.S. money. I think Merrill Lynch has a fund.

The trend in the last few years, I mean really, literally in the last year, is for major new U.S. money, capital, to be raised in these kinds of investment funds because of the overseas funds—the Australian pension funds discovering that there is a market here for toll roads and that we have a secure legal framework as opposed to lots of third world places where the deal might be overturned after you have built the road and taken away from you.

The U.S. is a very, potentially, very, very attractive market, huge needs, stable rule of law and a willingness of people to do some large scale projects. So I think we are going to see a big trend, a further trend toward U.S. capital going to this.

As I mentioned in the written testimony, I predict within five years, we will see purely U.S. toll road companies if this trend continues competing with the Macquaries and the Cintras from overseas. We are already seeing a lot of joint ventures, U.S. and foreign companies trading on the U.S. firm's knowledge of the local market, the overseas company's actual hands-on experience running, owning and operating toll roads for 15, 20 years and so forth. It is a market very much that is in transition to a much more domestic one.

Mr. DUNCAN. But you see a lot of interest developing, though.

Mr. POOLE. Very definitely, I mean I speak at conferences every month, and increasingly there are conferences in New York with investor type people. I think the movement of U.S. pension funds, as Tyler Duvall mentioned, into this field is a sea change. It is a huge, huge development, I mean if there are enough projects. I don't think there is going to be any question there will be enough funding to do them if they lend themselves to this sort of funding.

Mr. DUNCAN. I apologize. I have been told two different ways to pronounce your name.

Mr. SAWERS. Sawers.

Mr. DUNCAN. Let me ask you this. What is the European experience?

I am told by the staff that there are several major highway projects in Europe or different places around the world where they have started out as a public-private partnership, but they have reverted back to total public ownership or something. Is this something? Is this growing in Europe?

Mr. SAWERS. No. This is very much definitely spreading through the European countries. It kind of started in France and Spain and the U.K. as the three core countries that started this. Some of them

are public-private partnerships because they had operating companies, but they have actually gone increasingly towards more of the PPP model.

In terms of reversion, there have been a couple of toll roads that have reverted to the public ownership, but they have been because of expiry of contracts. In Spain, actually they have been going for 30 years. So several of them were returned to the public side and actually relet with additional investment.

Mr. DUNCAN. They came to public ownership, but then they started a new public-private partnership. Is that what you are saying?

Mr. SAWERS. That is what I am saying. The only country that has had particular trouble is Portugal which had this shadow toll system, and they couldn't afford to pay their shadow tolls because their budgetary issues changed and the government changes. Actually, they were seeking to convert their shadow tolls to real tolls which is obviously riskier.

Mr. DUNCAN. Well, I appreciate all your testimony. I can tell you there is a lot of interest in this. We have a difficult time when our hearings get interrupted by four votes, but nobody can control that. I thank each of you for being here, and I turn it back to the Chairman.

Mr. DEFAZIO. I thank the gentleman from Tennessee for his thoughtful questions and understand he has other commitments and appreciate the time he invested today. We will have more opportunities to invest time.

Ms. Hedlund, if I could refer to something in your testimony that I find somewhat disturbing, and I think part of what has occurred in Indiana and elsewhere is that if you follow the model legislation proposed by the Administration, States would attempt to get around public disclosure, freedom of information and other things and basically declare these agreements proprietary at the outset.

In your testimony, you say, following actual execution of the contract, almost all agencies release to the public the contracts themselves—wow—the proposals and relevant information, excepting only proprietary data such as financial statements of private companies.

Isn't that a little late for the public when a governor has just given an asset away in the case of Mr. Daniels for 75 years?

The public gets to evaluate it after it is executed. What good does that do since it is irrevocable? Wouldn't we want to do that beforehand, before it is actually executed?

Ms. HEDLUND. With respect to Indiana, I believe he did put the entire contract in front of the legislature. I do know in the case of Chicago, the contract was printed in the proceedings of the city council for all of them to look at well in advance of the time they took the vote.

Mr. DEFAZIO. Then why would you say this? Why wouldn't you say that in fact most agencies actually release all the details and they are approved and vetted in public?

I have been approached by analysts who say, well, now that I have analyzed Indiana, given the constraints in it, it actually was undersold. That wasn't anywhere near the price you should have gotten with the non-competes and all the other restrictions in it,

since it wasn't reviewed publicly and people didn't have an opportunity to comment on it other than the legislature which was bullied into it very quickly.

Why would you say this? I am just puzzled.

Ms. HEDLUND. I may have not expressed it correctly, and I was really trying to get at a different point. With the old traditional design-bid-build method of procurement, the State puts out the RFP, puts out the entire design, the bids come in and they are made public immediately upon the bids coming in.

You have a more complicated situation with a public-private partnership, and the evaluation process takes a longer period of time. I am talking about a competitive procurement here. We can talk about negotiated procurements separately.

But in a competitive procurement, it is important that during the evaluation process, that the proposals, not that they be kept from the public—the public has an interest in knowing what those proposals are—they need to keep the proposals private from the other proposers, just to maintain the integrity of the proposal process itself. Those proposals, the RFP, the contracts are all made. In a competitive process, the proposed contract terms are made public before the proposals come in.

Mr. DEFAZIO. OK, well, I think then perhaps we are in more agreement than the phrasing would have led me to believe. I believe the public interest is best served if the public, before an irrevocable 50 or 75 or 99 year contract is entered into, has full opportunity to review it and that others who might be interested, who bring more expertise to the issue, could also have an opportunity to review it so people would be fully aware of what was being entered into.

Ms. HEDLUND. I think my State clients would agree with you 100 percent.

Mr. DEFAZIO. OK, that is good.

Mr. Poole, I think we have some grounds for agreement, that if you are going to do these sorts of things, you should do revenue sharing. I would agree there.

You talk about the markets reacting. I would say the markets are reacting to what they see here as a really sweet deal. In the case of Macquarie, they only put 10 percent into Indiana. Now couldn't the State of Indiana have borrowed under a general obligation bond, $380 million, and then gone out and financed the rest of the project the way Macquarie did because they only put 10 percent in?

Mr. POOLE. Well, it is conceivable that they could have. On the other hand, the team that actually, the Macquarie team, I think it is Macquarie-Cintra that won the bidding, has taken on risks even though it is not the same as initial construction risk. Over 75 years, they are contractually committed to maintain at least level of service C on some segments and level of service D on other segments.

Mr. DEFAZIO. Right, on level of service, as I said earlier and as an economist you would know, that there are two ways to manage demand in case of congestion or level of service. You would say, OK, we are going to expand the roadway.

Mr. POOLE. Which is what the concession agreement requires them to do to maintain those levels of service

Mr. DEFAZIO. Yes. But what if I raise the tolls regularly and I just artificially depress demand, people will be diverted into the 10 mile non-compete area on either side, how do you measure that?

Mr. POOLE. Well, I mean those are tradeoffs definitely.

Mr. DEFAZIO. Yes, those are big tradeoffs.

Mr. POOLE. They are tradeoffs.

Mr. DEFAZIO. Right.

Mr. POOLE. I mean I think the non-compete provisions are modest and reasonable.

Mr. DEFAZIO. Unless you live within 10 miles on either side of that asset.

Mr. POOLE. They allow local, high speed————

Mr. DEFAZIO. The people of Indiana don't seem to think so.

When you say the caps or ceilings, I guess I hope we don't have to argue semantics. Have you seen the evaluation and would you question it? There are two evaluations that strike me.

Mr. POOLE. Right.

Mr. DEFAZIO. One is applying these ceilings or caps, which I would call floors, and hopefully we don't have this much of a semantic disagreement, but we might because I would look at them as floors because is it no less than 2 percent GPD or CPI. Now that sounds to me like a floor. It will never be less than 2 percent.

Next year, the economy tanks. The Bush Administration attacks Iran. Oil goes to $200 a barrel. We see a great depression in this Country. We have negative growth for 10 years, and you get 2 percent a year on your tolls. Now wouldn't you call that a floor, not a ceiling?

Mr. POOLE. No, I wouldn't for the following reason. I actually know people who do toll road————

Mr. DEFAZIO. We have gone through a period of devaluation and adding 2 percent a year to the toll isn't a floor?

Mr. POOLE. They will only charge the 2 percent more if people are willing to pay it. If you have a recession, it is quite————

Mr. DEFAZIO. Right, if people are willing to pay it to access the asset.

Mr. POOLE. In a time of recession, it is quite possible that traffic will fall off.

Mr. DEFAZIO. Yes, but just remember the premise. Oil has gone to $200 a barrel. One of the big factors becomes distance and fuel economy. That is the straightest route, so Macquarie just keeps jacking up the tolls even though the rest of the economy is in a depression. They can do that.

Mr. POOLE. That is not how. That is not what you do in a traffic and revenue study. You have to look at what is the optimum toll to maximize revenue. It is not the highest conceivable.

Mr. DEFAZIO. Right, I know what an economist can argue.

But let us look at it this way. Let us go back to what I assume you have seen. There are two numbers that really stick in my mind. The first is if we applied the ceiling, which I call a floor, to the Holland Tunnel, today's toll could be as high as $165 or $185.13 per car. Obviously, people wouldn't pay that.

Mr. POOLE. That is right.

Mr. DEFAZIO. But they might pay $10.

Mr. POOLE. They might.

Mr. DEFAZIO. Right now it is only $6. So we are not optimizing the asset.

Mr. POOLE. I think a lot of environmentalists would say that would be a very good thing.

Mr. DEFAZIO. Well, I don't happen to agree with that particular sentiment of an environmentalist.

Now if we applied to the Indiana toll road from 1985, the ceiling, which I call a floor, they could charge commercial vehicles $38.19, those poor truck drivers, as opposed to $14.60, and cars $12.16 as opposed to $4.65. Again, it seems to me to leave an awful lot of latitude. How can we call that a ceiling? It is not a ceiling.

Mr. POOLE. Mr. Chairman, we had an actual experiment with that a couple of years ago. The Ohio Turnpike which is the continuation of the Indiana toll road, attempted a large one time toll increase, and their truck traffic diverted in massive numbers to parallel State highways. This was a big problem, understandably so, and so the Ohio Turnpike Administration basically decided this was terrible for them. They were losing money. They were not getting the revenue increase they thought. They actually lowered significantly the truck tolls to win back the trucking traffic.

Mr. DEFAZIO. That is great.

Mr. POOLE. The point is they cannot charge whatever they feel like.

Mr. DEFAZIO. No, they can't, but they can certainly extort a little bit more than they are extorting today with this sort of monopoly situation. It could be more incremental like the frog in the hot water as we turn the heat up to see at what point are they going to jump, again, if you did so as constructed.

If that is true, I guess I would wonder why is Governor Daniels taking some of the money which is supposed to be spent on capital projects and either with that or maybe he is diverting State general revenues. I am not sure which, but he is actually subsidizing the toll, as I understand, for a five year period because they legislated an increase but they didn't want it to hit them all at once because people would be mad. Governor Daniels is already at 19 percent in the polls, and he doesn't want to go to zero. So he says, oh, let us keep the tolls down.

Do you know what this sounds like to me? I am sure you probably supported this too. Energy deregulation in California, I was one of the earliest and most frequent opponents of energy deregulation. California borrowed money to keep the rates down for a short period of time so the frogs wouldn't jump out of the hot water and think this was a really sweet deal before the whole Western United States collapsed on top of the scandal.

I am looking at kind of the same thing here in Indiana. They could raise the toll. They are going to raise the toll, but the state is going to subsidize the toll to keep the toll down in the short term. Do you think that is good public policy?

Mr. POOLE. I think it is normal politics, Mr. Chairman.

Mr. DEFAZIO. Well, that is politics, but I thought we were going to get policy.

Mr. Enright, would you care? I am really puzzled here. You are saying public entities can raise this money. He says they can't. You say they can. Where is the dissonance here?

Mr. ENRIGHT. I don't know Mr. Poole's resume in finance, but I do know I have 30 years and I have talked to bankers at virtually every major U.S. investment bank or commercial bank who participates in this type of financing, and they all agree that the money can be raised.

As to the issue of new pools of capital, it is nice that pension funds are interested in infrastructure assets, and certainly if the public sector wants to pay the cost of taxable financing, they can sell bonds to pension funds. Toll roads already do taxable financing occasionally and do sell to pension funds. So the availability of capital shouldn't drive the public policy decision, in my view.

The capital is available in the tax exempt sector, if the proceeds are used in accordance with tax law, and if not, they are available in the taxable sector to the toll roads as well without equity. They can finance 100 percent financing. They always have financed 100 percent financing.

Mr. Chairman, going back to your example of couldn't the State of Indiana raise general obligation bonds, they wouldn't have even needed to do that. Revenue bonds supported solely by the revenues of a toll road are a highly acceptable and high quality revenue bond in the industry.

Mr. DEFAZIO. But what about what Mr. Poole says, that the investors won't accept the risk because the government might not raise the tolls and choose to default instead? I guess that is what he is saying.

Mr. ENRIGHT. The basis structure of any toll road financing in the U.S. requires the entity that is running the toll road to raise tolls in an amount necessary to meet its loan covenants, typically a debt service coverage ratio of anywhere from 1.2 to 1.5 percent depending upon how they structure their documents.

Mr. DEFAZIO. That is enforceable on a public entity?

Mr. ENRIGHT. Absolutely, it is absolutely enforceable, and the same thing is true for water systems, sewer systems. Anything that is rate-oriented, that is enforceable, parking authorities. They all have rate covenants, and they are required in their documents to raise the rates.

The other point to distinguish from whether the legislature and the governors have to raise the rates, they don't. It is the toll road authority who raises the rates which is, in theory anyway, an independent authority. The problem is that they have been pressured to not raise the rates for the public good.

But if you want to monetize the future revenues, then you have to surrender the freedom to raise the tolls. Whether you do it with public sector or you do it with private sector, whatever administration makes that decision to give up the control of tolls does it on the date the agreement is signed. It is a massive future toll increase for the rate payers, whether it is public or private. You can monetize that future toll increase and get the cash today if you wish.

Mr. DEFAZIO. Mr. Poole, that was, I thought, one of your arguments that I asked the staff to refute and they couldn't, but I think

it has been. Do you agree with Mr. Enright's characterization that there would be a rate covenant and that it could be issued either by a public entity or a private entity?

Mr. POOLE. No. I think that could be done in principle. I think we will have an opportunity to observe over the next few years. Mr. Enright has basically issued a challenge. I think any public sector toll agency is free and their governor is free to try to implement that, and we will see if anybody does. My prediction is that none of them will.

Mr. DEFAZIO. Well, Mr. Daniels has implemented that for 75 years.

Mr. POOLE. Exactly.

Mr. DEFAZIO. Of course, he is at 20 percent in the polls. That is unfortunate, but he did implement it. Got it done.

Mr. POOLE. I think when Governor Rendell implements his, he will not be at 20 percent in the polls. He has bipartisan support in his legislature, and they will include revenue sharing in their deal.

Mr. DEFAZIO. Revenue sharing would certainly be an improvement.

I guess my question, and perhaps Mr. Sawers could address this, but other panel members could. Why wouldn't we adopt something more along the lines of the British model where the terms are generally limited?

They have also gone to this non-tolling version, but let us just leave aside whether you want to call it availability payment or shadow tolling because we don't want to strain people here.

Let us look at the fact that basically their agreements are generally a term of up to about 30 years. Many of these are greenfields. They are not assuming existing assets. Somehow the investors are making money. The control reverts back to the public in 30 years or even less if the equity investment plus profit is made back with unanticipated revenues before then. Is that a fair characterization?

Mr. SAWERS. More or less, but not quite, I think the issue about the 30 year term is where it has been an availability payment, so the government is paying the money. It is basically paying back like a lease payment effectively with a whole bunch of performance tweaks to it for the construction of a greenfield asset.

Brownfields, there have been deals where, for example, a major city, Birmingham, is putting out its road network for highways maintenance, so contracting for a fixed price for highways maintenance for 15, 20 years but including quite a lot of major refurbishment and capital investment. It is that style of deal, but there aren't any toll road deals which are done on 30 years. Toll road deals tend to be longer because there is more risk, and that is the key, the risk.

I would say that is the difference between the project finance market, as we call it, and the municipal market, the risk and who bears the risk. You may say that on an existing O and M deal like Chicago Skyway, there isn't much risk there. Well, yes, that is your view, and therefore you are probably even better off doing your own bonds. But if it was a greenfield deal, you would be transferring a lot of risk to the private sector for that difference.

Mr. DEFAZIO. I think there is room for agreement there, and I have consistently said from the beginning, I can see more likely public purposes and objectives being met by well crafted agreements in the greenfield area as opposed to monetization of existing assets.

I guess my question would be to both Mr. Enright and/or Mr. Poole. It seems to me that in the case of the monetization of, say, the Indiana Toll Road, that there must be a profit involved. There is. Obviously, there are tax advantages. That has to do with the term. There is only 10 percent equity in it. That is true. We have already established the State could have done the same thing. They could have done it with a GO bond which Goldman Sachs says and you are saying. They could do it without a GO bond with the rate covenants.

I guess the question is: What is the total cost over here versus what I would look at as the cost of the State in whatever tax relief they are giving?

Has anyone calculated what the public is foregoing, the opportunity costs, the revenues, the taxes foregone and all that versus had they done this themselves, operated it efficiently and used the profits or kept the tolls down one way or the other as they chose? Has anyone done that kind of analysis, total cost analysis over the term and/or profit?

Yes, go ahead.

Mr. ENRIGHT. We have done that analysis. The difference that occurs is in order to finance the asset, the asset acquisition if you will in the case of the Chicago-Indiana deal, again they have to live within the discipline of the credit community and that discipline will allow them to only indicate so much they can finance in the deal, regardless of the pure net present value of expected cash flows. They are going to be limited by that.

After the Chicago deal, which actually did a lot of things in their refinancing structure that people thought weren't even possible, the bond rating agencies changed the rules and tightened up a lot of the requirements, so you can't have an assumption of galloping high toll increases forever and traffic increases forever to finance your deal.

The net realizable value of the deal is significantly less than the actual present value of the cash flows over time. That difference, that delta between what you get up front and what the actual cash flows are going to be is a large amount. If it is owned by the public sector, you capture all of that. You get what we call the public ownership dividend by capturing that and getting all the cash flows. Certainly revenue sharing is a way to get them, but you have now given up part of the cash flows you could otherwise capture. On existing asset deals, that just doesn't seem to make sense.

Mr. DEFAZIO. In a revenue sharing, you would capture part of that premium back but obviously not all of it or there wouldn't be a profit motivation.

Mr. ENRIGHT. Correct. On to be built deals, on what are called greenfield deals, I mean yes, OK, there is risk involved—there is no question about that—but perhaps the public sector doesn't want to take that risk although traditionally in the U.S., they have been willing to. There have been a few failures on toll roads over the

years, but pretty few. They can do that. They can share that risk if they want.

But on existing asset deals, there are pretty well established traffic flows. You kind of know what you can do in toll increases. There could be limits practically. But in the real world, do you care whether you get half the traffic at double the toll or the expected traffic at the toll? You don't care. It is revenue.

Mr. DEFAZIO. Right.

Mr. ENRIGHT. I think the more you increase a toll, the more valuable your road is.

Mr. DEFAZIO. If you look at the Macquarie Infrastructure Group disclosure which is very candid and well written—it is a good company—over the long term, revenue growth is expected to be substantially driven by toll growth rather than traffic growth.

Mr. ENRIGHT. Our analysis would indicate that to be true.

Mr. DEFAZIO. Which means to some extent, since we all know that our traffic projections according to the Federal Government are like this, we must be driving some of that traffic somewhere else because of the tolls.

Mr. ENRIGHT. In the Chicago case, it would drive it on to roads not the responsibility of the City of Chicago. So the State of Illinois would have to pick up the tab for that.

Mr. DEFAZIO. It also says no significant cost savings are envisioned, so that doesn't go to the argument that they are so much more efficient in the private sector.

Mr. Poole, would you care to comment on what he just said?

Mr. POOLE. I think, again, there clearly are tradeoffs involved. There is risk in a 75 year deal even with an existing facility. There are risks involved in adding the necessary capacity to meet the level of service requirements which are spelled out in the concession agreement. So you are not getting nothing in exchange for the private sector taking that risk and making the profits. You are getting something because you are transferring the risk of future expansions, changes in technology, changes in business conditions. One of the criticisms of the long term is don't know if people are even going to be driving cars in 75 years. They are taking that risk.

Mr. DEFAZIO. No, absolutely. I understand that, but again we would say there is considerably less risk.

I have been told by the staff that we have to clear out for another hearing which I am sure is equally interesting and substantive.

One thing you said, Mr. Poole, I do want to say I hope that Governor Rendell is entering into this carefully. As you said bipartisan, bipartisan doesn't matter. It was unanimously adopted that they would have energy deregulation in California, unanimously by the legislature. Of course, you can talk to ex-Governor Davis about that and others. Bipartisanship is no indication of the wisdom or the protection of the public interest in a particular deal.

My understanding with Governor Rendell is that he is saying he doesn't raise the gas tax so he would rather have an invisible tax which is a toll and would rather lock it in with a contract over a long period of time, and then he can say, well, gee, maybe I will do what Mitch Daniels did until I am out of office. He will subsidize the tolls. Then when he gets out of office, he will say, well, gee, who could have known?

In any case, I think these are incredibly complicated things that need to be approached deliberately. I don't want to see them abused because I think it is a useful tool. It is not going to solve our infrastructure problems, but if we get some bad deals, a few more Indianas, public sentiment is going to demand the Federal Government step in and put an end to this stuff. They have got to be approached carefully.

I appreciate the dialogue we had here today. I thank the witnesses for their generous granting of time.

As was stated earlier, the record will be held open for 30 days. Thank you.

[Whereupon, at 1:40 p.m., the subcommittee was adjourned.]

Testimony on Protecting the Public Interest in Public Private Partnerships

to the

Subcommittee on Highways and Transit

of the

House Committee on Transportation and Infrastructure

by

Frank J. Busalacchi

Secretary, Wisconsin Department of Transportation

Tuesday, February 13, 2007

Frank J. Busalacchi, Secretary
Wisconsin Department of Transportation
4802 Sheboygan Avenue
P.O. Box 7910
Madison, Wisconsin 53707
608/266-1114

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Frank J. Busalacchi
Secretary, Wisconsin Department of Transportation

Mr. Chairman and members of the Committee, my name is Frank Busalacchi and I am the Secretary of the Wisconsin Department of Transportation. I am honored to have this opportunity to comment on how the public interest should be addressed as state governments look at Public Private Partnerships – or P3s – as one of several options to augment their transportation revenues.

I am also a member of the National Surface Transportation Policy and Revenue Study Commission – the National Commission. The National Commission is working to construct a new 50-year vision for our nation's transportation system. We are in the midst of our deliberations and my comments do not represent the views of the Commission. Every Commissioner is working to keep an open mind on all issues.

State DOTs are all stretched to find adequate revenues to fund their projects. The daily news stories cover the projects that each and every state envisions but lacks the funding to build. In Wisconsin, a legislative committee estimates our unmet transportation needs to be in the range of $544 million for highways alone. If we factor in the needs for transit, intercity rail and multi-state freight improvements, the figures are just enormous.

This nation's Interstate System is at the end of its useful life. It cannot be repaired; it must be reconstructed and, in some areas, expanded to accommodate increased traffic. State governments must find funding.

In the 1950s, the federal government envisioned a national transportation system and funded it. States, in turn, constructed a first-class system. If the federal government had not paid the lion's

share of construction costs for the system, it would not have been built. States cannot create or fulfill that kind of vision on their own; nor can the private sector.

The federal government should continue to pay its share of at least 45 percent of the nation's highway system. At National Commission hearings, nearly every witness tells us the federal government's share should increase. I don't think P3s are a better value for the taxpayer and they won't fund an integrated national system. States are turning to the private sector because they do not want to ask taxpayers to pay more. The states sense the federal government may step away from its responsibility.

Some suggest that P3s could replace the federal responsibility. The purpose of this hearing is to explore how to protect the public sector interest in these deals should Congress agree with the promises of those who promote P3s. P3s come in many forms; my focus today is on the deals where a private sector organization, for all intents and purposes, controls a highway segment. The public sector negotiates a lease term and other conditions through a concession agreement. In turn, the private sector partner is responsible for operating the roadway, is held to certain performance standards, and collects tolls and other payments to gain a return on its investment.

The public interest is different from the private interest and, in this case, it will be extremely difficult to assure a win-win solution. The P3 model comes up short for Wisconsin. Wisconsin DOT partners with the private sector to design and construct its highways. But the public sector is held accountable for setting priorities, financing, managing, and providing oversight of the highways and other public assets. We have two fundamental decisions to make on transportation policy: First, can we responsibly delegate some or all of that accountability to the private sector? Second, if we can, how do we integrate the needs of the private sector into what has traditionally been a public sector system?

Some argue that the P3 model is an effort to harness the power of the market for the good of the public. But we come to the table with different interests, which need to be acknowledged and aligned for a project to succeed. Like any transaction, we need to ask whether we have enough information to get the best possible deal for the public. The private sector argues that we do. From what I have seen, I believe we do not.

The private sector's legal responsibility to its shareholders is to make money – profit is their purpose. The public sector's responsibility is to ensure that we make wise choices with

our citizens' resources: using them to build and maintain a system that supports regional and national economies, meets equity goals, has transparent financing, and supports other national efforts in the public interest. To do all of these things, we must negotiate a contract that aligns our stewardship responsibilities with the private sector's profit motives. This requires a reasonable amount of knowledge about the future, what is known and unknown, the range of possibilities.

Should states be allowed to enter into long-term leases of the Interstate or National Highways that sell off – or lease for several generations – a part of our national system to a private entity? Is this in our national interest? Faced with uncertainty about future needs and goals, the states will try to spell out every detail of the partnership. But there is too much that is unknown about demographic trends, technological development, pollution concerns, equity needs, future congestion, and safety innovations. No contract, no matter how effective, can eliminate risk. We do not know enough to price or manage such long-term risks.

Harnessing the profit motive to serve the public good is a worthy goal – one that would be worth supporting if we knew enough to ensure that profit would come from superior efficiencies in our national system. But in these contracts, we need to assure that profits are not coming from other sources, including:

- Cash flows generated by infrastructure investments made by government;
- Tolls, in excess of cost, that would otherwise be available to the government as revenue;
- Tax breaks to equity investors that reduce federal, state and local government revenue;
- Government guarantees of toll revenue streams;
- Deals that can be done because of government powers like eminent domain.

The public has significant concerns with P3 deals. The public sector needs better tools to evaluate the deals and share that evaluation with the public. It's not clear the deal in Indiana would happen if it were being considered today. Last news report I saw, half the citizens polled in New Jersey think the P3 approach to the Turnpike is not in their best interest. Why wouldn't we listen and consider the strong public reaction to these deals?

An underpinning of transportation project delivery is the public hearing process. Ideally, we would have perfect information to consider the long- and short-term costs and benefits associated with private and public sector approaches to projects that we could share with the public. Some countries have used public-private sector comparators to make these decisions.

Comparators can help public officials think through issues. We need to show the public what they will pay with the gas tax compared to what they will pay with private sector tolling. With this information, we could all make better decisions.

P3s will likely not generate a predictable revenue stream that can replace the current federal share of the program. The federal government can move national transportation policy in ways that states cannot. At least 45 percent of the revenues for our nation's system should continue to come from the federal government. With a renewed federal financial commitment to transportation, fewer states would need to consider P3s.

Why is federal funding in jeopardy? The federal gas tax provides most of the revenue stream for states' transportation grants. Congress has not increased the gas tax since 1991 and inflation has seriously eroded its purchasing power. At the same time, states are delivering more complex and expensive projects that must address all the human and environmental issues associated with a highway project.

SAFETEA-LU opened the door to tax incentives and tolling pilots. Some argue innovative finance should be expanded to offer the private sector a greater role. I have not seen any information that convinces me that P3s will replace the current federal revenue source. So is this really a discussion of whether the federal government's policy should be to hand transportation over to the states by slowly allowing federal gas tax revenues to dry up? I hope not. If we choose the path of continuing to reduce federal funds, I believe we will no longer have a national transportation system. Each state will act in its own interest.

There will be considerable problems with integrating private sector financing with public sector policy goals. Congress will need to consider many issues as they evaluate the P3 model.

- Will states that do not adopt tolling be left behind with no federal partner? Tolling only works when there is adequate VMT[1] on a roadway and there are no convenient, non-tolled highway routes that motorists can easily access. We have a large system of highways in our nation. Some states will not support tolls. Roads cannot be allowed to deteriorate if P3s are unacceptable to the citizens of some states.

[1] Vehicle Miles Traveled

- Will federal policy penalize states that do not toll their systems? Already, many Federal Highway Administration (FHWA) discretionary programs include private sector investment as criteria for project selection.
- How will private sector partners be integrated into the current planning process for highway projects? Federal transportation authorization bills have created an interconnected system of planning for projects that includes state and local governments and other organizations. How will planning for our transportation system work in this new world of unsolicited bids? FHWA has employed a special experimental program, SEP-15, to deal with P3 questions related to federal requirements. This committee may wish to learn more about the SEP-15 program.
- Does Congress view federal tax expenditures for private sector projects as preferable to federal revenue increases for public sector projects? Most P3 deals have significant tax-shield benefits. Should federal tax expenditure benefits be more clearly stipulated in these deals so that the public can more easily consider whether a P3 or another revenue alternative makes better sense from the public's perspective?

US DOT's Model Legislation

The committee asked that I comment on US DOT's model legislation. The legislation is designed to give states the authority to enter into P3 agreements. Twenty-one states and Puerto Rico already have some legal ability to use P3s.

The intent of the model legislation is to establish a process for lawfully creating P3s. Based on our review, the legislation imposes no restrictions and creates no public protections. The ability to address and protect the public interest in P3 deals depends entirely on the skill with which states and municipalities negotiate contractual agreements.

The model legislation protects proprietary information contained in documents submitted by private entities submitting bids. These provisions conflict with strongly held Wisconsin values about openness and competition. These values are reflected in our state's open records and procurement laws that ensure transparency and encourage a robust and competitive bidding process.

The model legislation requires state DOTs to review unsolicited proposals within a certain timeframe. This provision puts investment consortiums in the position of bidding on any state highway asset, with states required to respond to all bids, solicited or unsolicited.

The P3 bidders are highly sophisticated consortiums, represented by large banks or investment firms. States will need advisors who are as well trained and experienced. States and municipalities are experienced in planning, designing and constructing projects; their strengths do not lie in the realm of high finance or long-term investment contracting. For states to negotiate on a level playing field, their P3 advisor budgets will necessarily become a significant sunk cost. Another concern is conflicts of interest with P3 advisors; P3 advisors should not advise states and those who bid on the projects.

Finally, the model legislation recommends state and/or local exemptions from property and other taxes. In addition to states and local governments losing potential toll revenues that could be invested in other projects, they are encouraged to give up other revenues.

This committee will make critical choices that determine the outcome of this debate. While I know your Committee is interested in what state and local governments are doing, it is the federal questions that are the focus of your work. Ultimately, you will consider the recommendations of the National Commission and you will put together the policy direction for the next authorization bill. That bill may signal things to come.

I do not believe P3s are ready for prime time. These are only some of the P3 issues that deserve debate. In a supplement to this testimony, my staff has pulled together a list of policy questions that provides a starting point for the debate. My colleagues in state and local government need to be part of this national debate. I know that some of them will disagree with the ideas I have shared with this Committee. In my view, that is good. We have not yet had this debate from a national, system-wide perspective, and we need to.

I ask this Committee to engage in the P3 debate. **You are in the unique position to build the public record**, to detail what has worked well with the P3 deals, and to outline the key concerns that should be addressed at different levels of government. I fear that our P3 policies have evolved with little attention to their impacts. To simply say each state can do what it wants with the Interstate segments that lie within its borders is to bring into question the purpose of any federal role in transportation.

I have looked at the Clay Commission's report, calling for construction of the Interstate highway network. One of the most courageous elements of the 1950s highway legislation is that

it created a system that was accompanied by a federal commitment of federal funds – saying, in effect: This national system is in the best interest of the country and the federal government will pay for it, in partnership with states. That legislation was right for the time.

Today the role of the national transportation system is even more critical. Our businesses compete in global markets. Our nation needs an integrated freight transportation system. Our national security depends on rapid responses whether a crisis comes from outside or within our borders. We cannot risk having parts of the system fail. We cannot have a national system without a national vision and stable federal revenue stream. We must now have the policy debate that will help all of us – together – create the right transportation policy and financing for the next 50 years. Thank you for inviting me to testify today. I look forward to the policy discussions that lay ahead.

Supplement
To the Testimony of
Frank J. Busalacchi, Secretary Wisconsin Department of Transportation
Public Policy Issues Associated with Public Private Partnerships
Questions for Study

Any analysis of PPP models should address issues and questions associated with the appropriate use of PPPs and how to assure the public's interest in the delivery of services and management of the infrastructure. The following questions begin to outline some of the issues that should be addressed before determining how PPPs can play a role in the nation's transportation system:

1. Are PPP agreements flexible enough to adapt to the changing objectives of different elected governments and the traveling public over the duration of the PPP agreement?

a. Transportation infrastructure is a valuable public asset. Should state governments establish guidelines for initial and long-term returns to private investors for their participation in a PPP to assure that the public's interest is protected? How would the public sector partner assess what a prudent long-term return would be for investments of 20, 30, 50, 75, or 100 years?

b. Has there been competition in the bidding process with the U.S. PPP projects? What role have unsolicited bids played in the evolution of PPP deals in the U.S.? How can state governments be protected from private partner conflicts of interest?

c. State governments typically work to improve the business climate within their borders. Should state governments be encouraged or discouraged from considering the impact of PPPs on competition among contractors bidding for transportation projects?

d. In long-term concession agreements, what protections has the private sector incorporated to assure they are protected from the actions of future legislative bodies that may receive political pressure to reduce tolls that are perceived as too high?[2]

e. What grounds are sufficient for terminating a PPP agreement? What has been the experience thus far in contracts negotiated in the U.S.? Should there be overarching guidance for states on issues to address in the concession agreements?

2. Have policy makers adequately assessed the benefits of PPPs to date, specifically the contract elements that have been effective in protecting the public sector interest?

a. Could state governments ever allow a private sector partner to face bankruptcy? Would the state have recourse to the assets of its private partner or a parent company of the partner, or should the state serve as an "investor" of last resort for an inefficient or undercapitalized PPP?

[2] The change from Conservative to Liberal rule in Ontario resulted in many efforts to rescind or change the lease. The Indiana Toll Road lease specifically provides the concessionaire "quiet possession and enjoyment" of the toll road.

b. Should state governments play a role in the corporate governance of a private partner after a PPP agreement has been signed? Is this realistic, and from the public's perspective, is this desirable?

c. How can the state, acting in the public's interest, be sure it has not under-priced its assets prior to entering into a concession with a private partner? What actions have states taken to assure the accurate valuation of their assets?

d. Concession agreements reached in the U.S. have been longer (50 + years) than those typically seen in Europe and Asia (20 to 30 years). Is it prudent to extend a contract out 50, 75 or 100 years in order to obtain a large amount of cash upfront? Would it be better to issue several contracts for a shorter length of time and, possibly, engage different entities as partners? Are there other reasons for the issuance of longer contracts in the U.S.?

e. What problems can state governments expect to encounter when interpreting the differences in costs between a PPP project and a wholly government-sponsored project? Have states analyzed the positives and negatives associated with a state-administered toll facility and a privately leased toll facility?[3] Has any methodology been used in the concession evaluations to date?

f. Are PPPs fiscally responsible when taking into consideration all factors such as state and federal tax treatment, lump-sum payments, and the reassignment of long-term revenue streams?

g. How does the public sector assure that contracts between the public and private sectors are adequately exposed to government sunshine laws and at the same time respecting the private sector's need for shielding proprietary information?

3. What considerations should be given to the intergovernmental relationship when addressing policy associated with the use of the PPP approach to financing our transportation system?

a. If state governments are negotiating independently with the private sector to design, build, rehabilitate, and operate separate pieces of a national highway system, how will the separate pieces of the system be integrated to comport with federal highway requirements and overarching national system goals? What about regional and local goals? Should MPOs or affected local governments are part of the PPP negotiations?

b. From a national perspective, will potential concessionaires "cherry-pick" facilities with great profit opportunity leaving other less traveled facilities in more remote areas of the country to rely only upon federal payments to improve their systems?

c. There is a dispute between the private sector concessionaire and local volunteer EMS providers who seek to charge the concessionaire for responding to crashes and other emergencies on the toll road. How will emergency services be paid for on leased toll ways?

[3] Methodologies include: British National Audit Office report on: "A Framework for Evaluating the Implementation of Private Finance Initiative projects: Volumes 1 and 2", May 2006 and Services Industries Branch, Industry Canada, "The Public Sector Comparator: A Canadian Best Practice Guide", May 2003.

d. Should the federal government lay out requirements for state governments to address in their PPP projects, or should the federal government take a laissez faire attitude and leave complete discretion to the state governments?

e. Should private sector partners and public-privates sector deals be given preferential treatment by US DOT, both in process and financing areas?

f. Should there be federal incentives to states to look at PPP options for project financing? Some have suggested that projects over $50 million should consider the PPP option. In addition, it has been suggested that states be allowed to argue a *de minimus* federal financial involvement in a project to avoid federal requirements that attach to traditionally financed federal-aid highway projects.

g. What branch of government should bear responsibility for authorizing PPP agreements with a private partner or terminating a PPP agreement? If the facility is part of the "national interest," should that affect the ability of states to enter into these agreements?

4. Should state governments develop and retain the in-house expertise necessary to monitor, inspect and evaluate private partner performance? Or is contracting for analysis of private partner performance preferable to using in-house resources?

a. What has been the experience of state and local governments negotiating these deals? Have some states relied on contracted experts while others have relied on in-house advice? Has this made any difference in the quality of the contracts?

b. When using contracted experts, how can conflicts of interest be avoided? Should firms that provide investment and expertise on these deals be able to bid on projects?

c. What has been the experience of states with administrative costs – including legal, financial, management and other advisors and consultant fees – associated with their PPP projects? How much should states expect to pay for all the studies and financing expertise that are associated with a PPP project?

5. What interests of state government and the traveling public are served by granting so-called "non-compete" clauses to private sector partners as part of a DBFO agreement?

a. What are the potential positive and negative impacts, to the public sector, of non-compete agreements in concession agreements? How have non-compete clauses been established in U.S. PPP agreements?

b. Have non-compete clauses been a standard part of PPP contracts in other countries? If yes, is there longer-term experience with their impact on future transportation decision-making?

Principles

Once the analysis of the issues above is completed, the Commission could develop a simple set of principles for their use in discussing and evaluating potential Public-Private Partnership (PPP) models. The principles could include:

- The principle of **equity** could require that PPP project financing (tolls) reflect the proportion of a traveler's use of, impact on, and benefit from a transportation facility, while not placing a more regressive financial impact on users than traditional forms of transportation finance.

- The principle of **efficiency** could require that PPP arrangements deliver lower costs with less bureaucracy than traditional transportation arrangements.

- The principle of **adequacy** could require that PPP arrangements have sufficient revenue, financial reserves and contract flexibility to meet the reasonable, predictable, short and long-term needs of the traveling public.

- The principle of **transparency** could require that all PPP arrangements, including contract language and provisions, be simple, straightforward, and open to public scrutiny, monitoring and evaluation. In addition, transparency would address the extent to which the elements of a PPP contract could be shared with elected officials and the public.

- Another relevant principle could be a demonstrable level of **public acceptability** for a particular PPP arrangement.

- The principle of **system integration** promotes the evaluation of how the PPP approach to financing infrastructure addresses the goals and needs of an integrated national transportation system

Statement of Tyler D. Duvall
Assistant Secretary for Transportation Policy
U.S. Department of Transportation

Before the

Committee on Transportation and Infrastructure
Subcommittee on Highways and Transit
U.S. House of Representatives
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Public-Private Partnerships

Chairman DeFazio, Ranking Member Duncan, and Members of the Subcommittee:

I greatly appreciate the opportunity to appear before you today to talk about one of the most important trends in transportation, Public-Private Partnerships. Under the leadership of Secretary Peters and Secretary Mineta before her, the U.S. Department of Transportation (USDOT) has made the expansion of public-private partnership a key component in the Department's on-going initiatives to reduce the high and growing costs of congestion and improve transportation system performance.

The combined public and private sector interest in forming various transportation-infrastructure-related partnerships is growing every year. Based on a recent internal Federal Highway Administration survey, the majority of States are either participating in —or exploring the creation of — a public-private program. Currently, 23 States have some form of legislation that authorizes public-private partnerships in transportation. The 2005 Safe, Accountable, Flexible, Efficient Transportation Equity Act – a Legacy for Users (SAFETEA-LU) also took important steps to further encourage development of public-private partnerships by expanding state tolling flexibilities, allowing up to $15 billion in private activity bonds to be issued outside state volume caps for highways and intermodal freight facilities, and directing USDOT to streamline design-build regulations.

While the private sector is keenly interested in investing in a broad range of infrastructure systems in the U.S., my testimony will focus on highways and public transportation facilities with an emphasis on four areas: 1) why have public-private partnerships become an attractive financing option; 2) what are the various forms that public private partnerships can take; 3) what are the public policy implications; and 4) the Federal government's role.

WHY HAVE PUBLIC-PRIVATE PARTNERSHIPS BECOME AN ATTRACTIVE FINANCING OPTION?

The Demand for Private Sector Finance

As with any major economic trend, there are a variety of factors that have come together at the same time to propel us to this point. The willingness of public authorities to go beyond the traditional government approach to providing highways and public transportation systems has been driven largely by four distinct, but related trends: 1) growing resource scarcity; 2)

declining system performance; 3) emergence of contract mechanisms to reduce government risk; and 4) growing public acceptability of direct user fees.

Growing Resource Scarcity

Governments today (Federal, State, and local) are experiencing financial difficulty in keeping up with the demand for transportation investment. Transportation-related taxes are being increasingly absorbed by rising costs and the need to dedicate ever more resources to system preservation and maintenance.

Over time, the growth in gasoline consumption has been and will continue to be limited by increases in fuel economy for cars. In this year's State of the Union address, the President called for reducing gasoline consumption by an additional twenty percent in the next ten years by expanding alternative fuel production and increasing the average fuel economy of new cars and light trucks. In addition, vehicle miles traveled trends in the U.S. appear to have flattened out in recent years after tracking closely

Political resistance to fuel tax increases has grown at both the state and federal levels. Results of a recent survey by Washington State's DOT indicate 58 percent prefer the collection of tolls to fund future transportation improvements. Only 26 percent would rather see an increase in the gasoline tax.

At the same time, the costs of highway construction and rehabilitation have been growing faster than prices generally. As construction activity has taken off in China and India, competition for scarce construction materials has caused materials costs to explode, rising 8.5 percent in 2004 and 12.6 percent in 2005. Overall, construction costs since 1998 have risen 35 percent, more than twice as much as the GDP deflator.

Construction costs are particularly high in urban areas where congestion is most severe. Even without land acquisition costs, building a lane-mile of uncomplicated new highway in an urban area now costs about $11.2 million – adding land acquisition brings it to $15 million. But often there are complications that add to the costs, such as tunneling and overpasses, and these can push the cost of building a lane-mile of new highway to anywhere between $40 million and $300 million. Environmental mitigation is also a growing portion of project costs, amounting to between 5 and 27 percent of project costs.

Declining System Performance

Deteriorating performance in the Nation's surface transportation infrastructure is acute and widespread, and it affects both passenger travel and freight movement. For many years, the U.S. enjoyed substantial amounts of excess capacity along many sections of our transportation systems. Quite clearly, that era is over. In the past 20 years, hours of delay and wasted fuel have each increased by more than four times. The cost of wasted time and fuel for travelers in 2003 was over $60 billion, about 5 times the level in 1982. If we add the extra time people must allow in planning for congestion delay and the lost productivity associated with it, the annual costs rise to roughly $170 billion. These costs have been growing at about 8 percent per year – almost triple the rate of growth of the economy. The extent, duration, and intensity of delay associated with these costs have all skyrocketed over the past two decades.

For example, between 1982 and 2003 U.S. highway congestion:

- Increased from affecting 33 percent of travel in 1982 to 67 percent of travel in 2003;
- Increased in duration from 4.5 hours per day in 1982 to 7 hours per day in 2003; and
- Tripled the delay for the average rush hour driver's trip from 13 percent of normal trip time in 1982 to 37 percent in 2003.

For the trucking industry, the increases in delay time, wasted fuel, and other increased operating costs that congestion imposes costs them about $10.7 billion annually. The cost to shippers of delays in deliveries of shipments has been estimated at another $9.4 billion, so the total costs to truckers and their customers is about $20 billion per year. Productivity losses and costs of unreliability are in addition to those costs.

Emergence of Contract Mechanisms to Reduce Government Risk

Over the past decade, states and the private sector have gained valuable experience with new contractual mechanisms, including various types of design-build contracts, long-term management contracts and concession arrangements. These new contractual structures allow the government to efficiently manage the various risks associated with infrastructure development and operation without compromising other policy objectives. Because of these successful experiences, state legislators have given state transportation authorities broader leeway to experiment with ever more sophisticated arrangements.

Growing Public Acceptability of Direct User Fees

The introduction of the first motor vehicle fuel tax in the U.S. was in Oregon in 1918, however, that was not the preferred option. As transportation expert Martin Wachs, now with the Rand Corporation wrote in 2003 for the Report of the Committee for the International Symposium on Road Pricing, "The legislature had preferred a toll-based system of finance, but at the time it was rejected because of the cost of constructing toll booths and collecting tolls. So a practical limitation, rather than a policy-based one, dictated the starting point for our system of paying for road infrastructure." Similarly, when President Eisenhower created the Interstate Highway System in 1956, he had originally preferred a toll-based system, but reluctantly agreed to go along with the recommendation of the Clay Commission to use fuel taxes as the financing mechanism instead.

By the 1960s, some visionaries were already anticipating a time when administrative costs would no longer force us to rely only on indirect charges such as the fuel tax. In 1963 the economist William Vickrey, who later won the Nobel Prize, wrote:

> "Talk of direct and specific charges for roadway use conjures up visions of a clutter of toll booths, an army of toll collectors, and traffic endlessly tangled up in queues. . . . However, with a little ingenuity, it is possible to devise methods of charging for the use of city streets that are relatively inexpensive, produce no interference with the free flow

> of traffic, and are capable of adjusting the charge in close conformity with variations in costs and traffic conditions. My own fairly elaborate scheme involves equipping all cars with an electronic identifier which hopefully can be produced on a large-scale basis for about $20 each. These blocks would be scanned by roadside equipment at a fairly dense network of cordon points, making a record of the identity of the car; these records would then be taken to a central processing point once a month and the records assembled on electronic digital computers and bills sent out. . . . Cameras can be arranged at some locations to take pictures of cars not producing a valid response signal."[1]

Twenty-five years before E-ZPass, and 40 years before the London and Stockholm congestion pricing systems, Vickrey had anticipated exactly how congestion charging would be carried out and enforced. Needless to say, with technology reducing the costs of electronic toll collection to a fraction of what it would have been in the 1960's, administrative feasibility is no longer a problem.

Public opinion has also turned around. The American Automobile Association recently published a national opinion poll that found that 52 percent of respondents favored tolls as a revenue source for expanded highway investment, while only 21 percent favored an increase in fuel taxes. A survey by the Colorado DOT found 66 percent in favor of tolls as a way of financing new highway capacity, while only 16 percent favored fuel taxes. A 2005 Washington Post survey for the D.C. area similarly found 60 percent in favor of tolls, compared with 30 percent in favor of fuel taxes. A 2004 poll by the Minneapolis Star Tribune found 69 percent in favor of express toll lanes, but only 23 percent in favor of increases in fuel taxes. A 2006 poll for the Richmond-Times Dispatch found that 59 opposed an increase in fuel taxes, while tolls were supported by a 49-45 margin.

Although indirect taxes on gasoline, diesel, general sales, motor vehicles, property and income still dominate the transportation revenue landscape, it is important to observe the trends closely. From 2000 to 2004, toll revenues grew 21.1% in the U.S. compared to 2.5% and 0.1% for fuel and vehicle taxes, respectively. The majority of new highway projects over $500 million that are currently in the development phase in the U.S. will be toll roads. In many cases, they will be toll roads constructed using some form of public-private partnership and whose prices will vary based on congestion levels.

The Supply of Private Sector Finance

From a supply standpoint, the surge in private sector interest in investing in U.S. highways and public transportation systems is driven by four entirely different factors: 1) investment returns at rates higher than long-term government debt with risks lower than real estate; 2) confidence in the stability and predictability of U.S. legal systems; 3) a belief that the U.S. economy will continue to grow as quickly as any industrialized economy in the world; and 4) increased facility operating and management expertise.

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[1] William S. Vickrey, "Pricing and Resource Allocation in Transportation and Public Utilities: Pricing in Urban and Suburban Transport," *American Economic Review*, v. 53, no. 2 (May 1963), pp. 457-459.

Investment Returns

In order to fully understand current infrastructure trends both in the U.S. and around the globe, one must have some appreciation for the current forces at work in international capital markets. With long-term interest rates continuing to hover near record lows, a substantial amount of savings has been organized to invest in low to medium risk assets with low to medium returns.

As then Federal Reserve Governor Ben Bernanke said in April 2005,

> "One well-understood source of the saving glut is the strong saving motive of rich countries with aging populations, which must make provision for an impending sharp increase in the number of retirees relative to the number of workers. With slowly growing or declining workforces, as well as high capital-labor ratios, many advanced economies outside the United States also face an apparent dearth of domestic investment opportunities. As a consequence of high desired saving and the low prospective returns to domestic investment, the mature industrial economies as a group seek to run current account surpluses and thus to lend abroad."

Many of the same forces that have driven international managers of large pools of savings to seek new investment opportunities are now driving U.S. fund managers to do the same. The California Public Employees' Retirement System, for example, is now the majority investor in a major intermodal transportation facility developer. More than 50 percent of the investors in Macquarie Infrastructure Partners, a recently formed infrastructure fund, are Americans, including substantial commitments from the retirement funds of several labor unions. Various other financial services firms in the U.S. have reported the speedy formation of large investment funds with an infrastructure focus. Private-sector infrastructure investments globally have grown from $52 billion in 2000 to $145 billion in 2006.

Confidence in U.S. Legal System, Economy, and Demographics

Growing interest in U.S. infrastructure reflects not only a large pool of long-term lenders, but also great confidence in the U.S. legal system. Public-private partnerships have been commonplace in the developing world for many years, but the recent emergence of infrastructure investment funds in the developed world that allow the diversification of infrastructure investment portfolios has greatly reduced investment risk. As a result, investors are willing to tolerate significantly lower returns, which lower the costs born by the public sector in connection with the execution of a public-private agreement.

Given the scope of our infrastructure networks, our demographic advantage over most of the industrialized world, and our economic growth potential, there is little question that a substantial wave of investment in U.S. infrastructure across multiple sectors is possible. A 2004 survey by the Global Business Council ranked the United States as the second leading destination country for foreign direct investment.

Increased Expertise

At the same time that macroeconomic and external forces are driving private investors to the U.S. transportation system, private toll road operators have gained valuable operating

experience in the U.S. and around the world. Several European firms each operate more than 2,000 miles of toll roads. France, Spain, Portugal, Italy and Australia have all moved extensively to private operators to run large parts of their national motorways. Through efficient capital investments and a strong focus on throughput and operational performance, these companies generate higher operating margins than their public sector counterparts. This trend is a throwback to the 19th century in which over 2,000 private companies operated toll roads in the U.S.

WHAT FORMS DO PUBLIC-PRIVATE PARTNERSHIP TAKE?

There has been a great deal of discussion and interest in the lease transactions that took place in Chicago and Indiana, but it is important to bear in mind that the opportunities for public-private partnerships extend well beyond long-term lease agreements. The basic opportunity for the public sector is to allocate various project risks to private sector entities that may be in a better position to efficiently manage and reduce those risks. Those include design risk, financial risk, construction risk, operations and maintenance risk, and revenue collection risk, among others. The ability to shift these various risks to private investors increases the public sector's ability to manage a large number of projects, while also reducing strains on government budgets and the taxpayer.

No two projects are identical and, as a result, the scope of risk transfer can vary substantially from transaction to transaction. At one end of the risk transfer spectrum is the basic design-build contract, whereby the public agency transfers various cost and design risks to the private sector, but retains virtually all other risks. At the other end of the risk transfer spectrum are contracts to build/re-build, own, and operate. In these agreements, the public sector can insist on various performance requirements and rate schedules, but provides the private sector with broad discretion to operate and invest in the facility in the most cost-effective manner.

In the middle of this spectrum are variations on these contracts, including contracts to build, operate, and transfer, as well as long-term concession/franchise agreements. In both of these arrangements, the private sector bears virtually all the operating and maintenance risk. In the concession arrangement, the private sector also bears financing and revenue risk for the term of the contract.

While relatively new to the United States, particularly in the post-interstate highway era, these various arrangements have become commonplace around the world. According to a 2005 Federal Highway Administration synthesis that relied on information from Public Works Financing, there were 1,121 public-private infrastructure partnerships completed around the world between 1985 and 2004. Eighty percent of these projects were in the transport sector, representing a value in excess of $360 billion.

In a recently released design-build study, FHWA found that, among responding agencies that had design-build programs, more than a quarter of total project costs were incurred in connection with design-build contracts. For large-scale highway projects, particularly bridges and tunnels, design-build has become a standardized procurement technique in many states. Some of the most comprehensive analysis of the benefits of public-private partnerships has

been conducted by the United Kingdom's Treasury department. Among other findings, the UK found that 88 percent of ppp projects were delivered on time or early, and with no cost overruns on construction born by the public sector while non-ppp projects were delivered late 70 percent of the time and over budget 73 percent of the time.

Intermodal freight facilities are an emerging area of public-private partnership interest. The Alameda Corridor project in Southern California was one of the earliest examples of a successful public-private partnership. With the passage of the intermodal freight transfer private activity bond provision in SAFETEA-LU, USDOT is expecting several large intermodal facility developments to proceed as public-private partnerships in the next two years. While such projects often have a freight transportation focus, they often have spillover benefits for passenger transportation as well.

As the country's public-private partnership experiences grow, we can expect that our public transportation systems will increasingly explore creative partnerships with the private sector. The majority of empirical studies in both the U.S. and abroad find that the private operation of public transportation lowers costs, increases operational efficiency, produces a more efficient allocation of resources, and enhances innovation in comparison with the public sector.[2]

According to a comprehensive analysis of data from all major UK bus companies, private firms are technically and organizationally more efficient than public companies.[3] Evidence indicates that bus deregulation in the UK decreased operating costs by 30 percent, largely due to productivity and efficiency improvements.[4] Similarly, in Sweden, competitive tendering led to cost savings of 8 -15 percent.[5] In Greece, controlled competition led to 40 percent reduction in total costs and a 15 percent increase in ridership and productivity; and in Spain private firms provided public transportation at a cost 42 percent lower than that of public providers.[6]

Although public transportation agencies in the U.S. have far less experience with private involvement in recent decades than their European counterparts, these agencies have experienced similar reductions in cost through private sector involvement. In Indianapolis, for example, cost efficiency increased by 15 percent over a five-year period after its transit agency contracted all bus routes to private operators.[7] Researchers indicate that U.S. public

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[2] Matthew G. Karlaftis, Ph.D., *Privatisation and Regulation of Urban Transit Systems—Privatization, Regulation and Competition: A Thirty-year Retrospective on Transit Efficiency*, European Conference of Ministers of Transport Joint OECD/ECMT Transport Research Centre, at 35 (January 30, 2007).

[3] J. Cowie and D. Asenova, *Organizational Form, Scale Effects and Efficiency in the British Bus Industry*, Transportation, 26, 231-248 (1999).

[4] A. Nolan, *Urban Bus Deregulation: A Review of the UK Experience*, Published Commissioned Research Report, Dublin Corporation, Trinity College, Dublin, Ireland (1999).

[5] B. Anderson, *Factors Affecting European Privatization and Deregulation Policies in Local Public Transport: The Evidence from Scandinavia*, Transportation Research A, 26A (2), 179-191 (1992).

[6] G. De Rus and G. Nombela, *Privatization of Urban Bus Services in Spain*, Journal of Transport Economics and Policy, 31(1), 115-129 (1997)

[7] M.G. Karlaftis, J.S. Wasson and E.S. Steadham, *Impacts of Privatization on the Performance of Urban Transit Systems* Transportation Quarterly, 51(3), 67-79 (1997).

transportation agencies with competitive contracting regimes experience cost savings between 5.5 and 14 percent.[8]

A small but growing number of Federally-supported public transportation projects have experienced reduced costs, shortened project delivery, improved project quality, or enhanced revenues by transferring risks and responsibilities to private partners. The Federal Transit Administration hopes to demonstrate the advantages of PPPs for new fixed guideway capital projects through its newly created Public-Private Partnership Pilot Program, which was formally established on January 19, 2007.[9]

Although no transaction has taken place to date, the Department also expects that creative arrangements involving multiple facilities, including highway and public transportation systems will emerge. Multiple facility transactions would permit the pooling of low and high risk facilities, as well as revenue positive and revenue negative facilities.

PUBLIC POLICY ISSUES

Any analysis of the policy merits or pitfalls of public-private transportation partnerships is only appropriately discussed in comparison with the predominant approach of sole government provision. In other words, the burden on proponents of the public-private model is to articulate how such a model improves on our current policy framework. In that regard, I believe there are five critical (and related) policy failures that have emerged.

First and foremost, as discussed earlier, we are suffering an intolerable decline in system performance in the form of travel delays and unreliability. Sadly, we are far too tolerant of this obvious deterioration, choosing to assume that there are few, if any, solutions. Transportation system decline poses a threat to our continued economic prosperity, to our quality of life, and to our environment. An increased private sector role can help reverse these trends. Because congestion is an internal cost to a private operator, there are powerful incentives for the private entity to take aggressive steps to reduce it. A decline in vehicle throughput caused by congestion or an inability to effectively operate and manage a facility will reduce revenues and encourage customers to seek alternate routes.

Second, current planning and project selection processes are not adequately investing in projects that generate high returns. According to Clifford Winston from the Brookings Institution, "It would be expected that as the road system matures, the payoff from investments would decline, but inefficient highway policies also appear to have significantly reduced the rate of return from highway infrastructure investments. Shirley and Winston found that during the 1970's annual returns exceeded 15 percent, but that returns have fallen to less than 5 percent during the 1980's and 1990's." FHWA is working with states to develop mechanisms to analyze the economic costs and benefits of major investments; however, substantial work remains. Because private investors have little interest in investing in low return projects, resources are far more likely to flow where they are most critical. Most often, these will be

[8] Matthew G. Karlaftis, *Privatisation and Regulation of Urban Transit Systems—Privatization, Regulation and Competition: A Thirty-year Retrospective on Transit Efficiency*, European Conference of Ministers of Transport Joint OECD/ECMT Transport Research Centre, at 25 (January 30, 2007).
[9] 72 Federal Register 2583.

major congestion relief projects in some of our largest metropolitan areas. In turn, this frees up public resources to invest in socially desirable transportation projects that would not rate highly on purely economic grounds.

Third, due to various budget and political constraints, highway capitalization has been sub-optimal. The majority of pavements in the U.S. interstate and primary systems were designed on the basis of a 20-25 year initial service life. The original design life of many of these assets is now over, and a growing percentage of Federal and state resources are being directed to preservation and maintenance activities. Current materials and technologies are widely available in the U.S. and around the world for much longer lasting pavement. Improved management practices, using timely preservation actions, can also significantly extend the life of existing infrastructure. In addition to providing substantial amounts of new investment resources, a long-term contract with the private sector can reverse some of the incentive challenges inherent in the current approach to government budgeting. As with congestion, an under-capitalized asset is an internal cost to a private concessionaire and its lenders. Over time, the operating and maintenance costs of such an asset will grow at rates far faster than would have been the case with a larger up-front investment. Equally important, more efficient investment schedules will lower the costs to users.

Fourth, as with any asset or service provided solely by government agencies, the current policy framework provides weak incentives for innovation and competition. Because the rewards of a given advancement – for example, in extended life pavements or more sophisticated traveler information systems – accrue broadly and not to specific creative individual firms or individuals, the current approach is unlikely to deliver the pace of breakthroughs that we are seeing in other critical infrastructure sectors like telecommunications and energy. Public-private partnerships can greatly improve the incentives to innovate, as well as the level of competition in the highway and public transportation sectors.

Finally, accountability to customers in transportation lags other infrastructure sectors. The current policy framework largely disconnects highway users from the ownership, operation and management of highway assets despite the fact that users depend on these facilities and indirectly finance their existence. This disconnect weakens the facility owner's incentive to provide superior customer service, as well as reduces opportunities for customers to voice complaints. Because the health of transit systems is in part dependent on satisfied customers, customer interaction tends to be much more frequent and sustained than can be observed with highway systems.

Public Policy Risks

Despite the clear opportunities that PPPs present to address some of the most pressing policy failures, it is also critical that public authorities, policymakers, and elected officials protect the public interest by fully understanding and analyzing the risks to the general taxpayer and transportation system user that can arise in connection with these transactions. The most important risks are: monopoly pricing risk, corruption risk, thin market risk, system distortion risk, financial risk, and inexperience risk.

Monopoly Pricing Risk

To the extent that the government views the leasing of existing transportation assets as a potential income source, there is an inherent tension that must be addressed. Contractual terms that provide substantial degrees of pricing power and protection from competition can substantially increase the discounted present value of the revenue stream associated with the asset. Obviously, there are other critical assumptions that go into asset valuations, such as traffic growth projections, the ability to control costs, and the cost of long term borrowing. However, there is little question that pricing flexibility in a potentially constrained market will be a major driver of facility value.

As a result, it is important that public agencies analyze closely the potential for prices that do not bear a close relationship to costs plus some reasonable return commensurate with the level of risk being assumed. Around the world, we have witnessed a trend in utility infrastructure toward price cap regulations that provide the regulated entity the authority to increase prices at a rate not to exceed the consumer price index plus or minus some X factor related to productivity improvements and changes in costs.

Another form of economic regulation is rate of return regulation. Rate of return regulation was the traditional form of economic regulation in the U.S. for many years. It has increasingly fallen out of favor because it provides perverse cost incentives and encourages overcapitalization. Given the complexity of these matters, it is important that public sector officials without regulatory experience gain a better understanding of the various penalties and incentives that are unlocked in connection with any economic regulatory decision.

A related issue is the treatment of competing facilities in the concession agreement. Contract provisions that limit the prospect of competition will increase the up front lease value of a highway, but may run counter to the public interest if such a provision is not commensurate with the private sector's risk. The emerging trend in this area appears to be the inclusion of either a limited provision or no protection at all. As with economic regulations, public sector officials must fully understand the implications of the various forms that these provisions can take prior to entering into any agreement.

Despite the monopoly risks, economists ask the more salient question: how do inefficiencies in a privatization compare to the inefficiencies of sole government provision? As Nobel Prize winning economist Gary Becker wrote recently on his internet site, in the context of a discussion about highways:

> "Still, I generally strongly support privatization, even when privatized companies have monopoly power in setting prices and other conditions of the sale. The reason is that other companies are more likely to find ways to compete against private monopolies than against government ones. A very important part of this argument is that technological progress is faster with private monopolies than with public monopolies. For example, ATT was a private regulated monopoly before the breakup of the Bells in the early 1980's into competing entities. The breakup was desirable, but still ATT was much more efficient than were the government run companies that dominated the telephone industry in the rest of the world."

Facility characteristics differ greatly across the country, and a uniform pricing policy at the national level is not appropriate. The Department hopes to conduct research into this economic regulatory question so that we can provide helpful guidance to State and local governments considering these transactions.

Corruption Risk

In any public-private contractual arrangement, there is always a risk of corruption, and the risks must be particularly managed when the agreement is for a large amount of money and for a lengthy period of time. An open and transparent process is the single most effective means to combat corruption. It is important that clear selection criteria are established, and that the qualifications of the various competitors are fully disclosed. Rarely, even with such transparency, an inappropriate concession award may be made. In these cases, public authorities should protect themselves and their constituents with provisions that allow a contract award to be cancelled if it can be proven that the award was corruptly made.

Thin Market Risk

In the past, the number of investors capable of bidding on major infrastructure projects was limited, and this raised the risk that the market for investors in such projects was so thin that the public authority could not be assured that fair value for the public was being received. In a thin market, and with a public agency focused on short-term returns, an agency might fail to receive returns commensurate with the long-term value of an asset. To a large extent, this risk has now receded, as the capital funding available to invest in such projects has multiplied several-fold over the past few years. With multiple U.S. investment firms entering this market, and foreign investment funds expanding their capacity, the risk that a thin market will fail to provide fair market value to the public is lessening year by year.

System Distortion Risk

The national highway system is a well-developed network, and we want to ensure that the system continues to work efficiently even when some parts of the system have been privatized. Of course, we already have substantial experience with operating a system that has multiple owners – the current national highway system is owned by 50 different states and numerous other highway, bridge, and tunnel authorities. For the most part, this multiple ownership of the system has not been a problem, and we do not expect that private ownership of part of the system would present an operational problem. Private owners have a financial incentive to maintain their facilities to a high standard and to ensure that construction activities, inclement weather, and other potential service disruptions do not interfere with continuous operations. The fact that part of the system is subject to tolls and part is not is an issue that has been with us for many years. This creates a distortion primarily when the prices charged do not reflect the real value of the facility to the user (as when prices do not reflect levels of congestion). Public authorities should ensure that the pricing structure established by private operators reflects congestion and other characteristics affecting the value that the user receives, so that traffic is not inappropriately diverted from one part of the system to another.

Financial Bailout Risk

Public authorities that use private sector finance will want to ensure that, if a private sector project encounters financial difficulties, the operations of the project will not be interrupted and that unforeseen financial liability does not transfer to the public sector. The public partner will also want to ensure that control of operations on the facility will not be tied up in bankruptcy proceedings. We have extensive experience in private sector ownership of essential facilities, such as railroads and power plants, so these issues are not novel and the means to ensure uninterrupted service are well-established.

Inexperience Risk

Finally, given the novelty of some of these concepts, there is risk that public agencies will lack the capability to successfully administer public-private programs in the public's interest. An inexperienced public agency, for example, might underestimate the value of an asset and lease it for too little. As a result, it will often be necessary for these agencies to procure legal and financial expertise to assist them. As experience grows across the country, the sharing of best practices and lessons learned from state to state will also grow, thereby helping to minimize some of these risks. In addition, it will be necessary for States to acquire different types of in-house skills.

WHAT IS THE FEDERAL ROLE?

The approach to federalism that we have historically adopted in highways and transit delegates most of the responsibilities to the states. The federal government sets certain kinds of performance standards for highway and transit facilities, but leaves most of the decisionmaking to the states and their agencies. We see no reason to alter that fundamental division of responsibility. The federal government must focus more closely on ensuring that national transportation objectives are being achieved. This includes ensuring that freight and passenger traffic can flow easily across state and international boundaries, and that the national connectivity of the highway system is maintained. We believe that public-private partnerships, by bringing more market-oriented perspectives into transportation planning, will help to ensure that both private and public transportation dollars are allocated more efficiently. And our top priority, as always, is safety. As an integral part of the roadway network, it is essential that privately financed and operated highways be a full partner in the goal of improving safety, through being engaged as part of the Strategic Highway Safety Planning process being led by State DOTs and other means.

In general, the advent of privately operated highway and transit infrastructure does not alter that division of responsibilities. Privately operated highways that are part of the Interstate system must still meet Interstate standards set by the Federal Highway Administration. Buses used in a privately operated transit system must still meet federally established standards for access by people with disabilities. Privately operated highways will still be subject to patrol by state police forces. Highways built with private sector financing should still be included on state transportation plans.

The fact that public financing is not at risk in a privately financed project will alter the nature of the planning process somewhat, because the public partner does not need to do the same kind of assessment of costs and benefits that it would do if it were committing its own funds to the project. It still needs to ensure that the project will be, on balance, beneficial to the public, including effects on land use and the environment, but this analysis will be somewhat simplified as compared with the analysis required for a publicly financed project.

In general, we believe that the planning and regulatory framework in place now is sufficient to protect the public interest as it is affected by public-private partnerships. But we welcome review by advocates of various kinds of public sector concerns, and we will all need to be sensitive to cases in which important public sector concerns may not be adequately protected. As those cases come to light, we can make adjustments in our regulatory and planning processes to take account of them.

I appreciate your attention to my testimony, and I would be happy to answer any questions that you may have.

Questions for DOT Assistant Secretary Tyler Duvall
Highways and Transit Subcommittee Hearing
By Rep. Grace F. Napolitano
February 13, 2007

1) *Question regarding State DOT comments on Public-Private Partnerships*

- What outreach has the U.S. DOT done to states on how to use public-private partnerships to enhance their transportation projects?
- What has been the response of States to your proposals to invest in public-private partnerships?

Answer: The U.S. Department of Transportation (DOT) has undertaken and supported a wide range of outreach activities on public-private partnerships (PPPs) in response to requests from States. These activities include presenting a series of workshops around the country (WA/OR, MN, TX, FL, CA, NC, MO/IL) attended by over 800 people; organizing technical visits for States interested in learning about PPPs to States that have developed programs; speaking at numerous conferences and workshops hosted by and at the invitation of State departments of transportation; co-sponsoring a number of national conferences with other public agencies and the private sector; and providing technical assistance, upon request, on the application of the PPP concept to a State's program or a specific project or enabling legislation. For example, in the recent past, the Department has provided technical assistance on projects in response to requests from Minnesota, Wisconsin, Missouri, Texas, Virginia, and others. The Department also has provided technical information and support to State legislators, State legislative staff, and State department of transportation representatives on enabling legislation in such States as New Jersey, Pennsylvania, Illinois, and Nevada.

Additionally, FHWA has developed a number of resources to address the questions raised by States in this area, including: the PPP website (http://www.fhwa.dot.gov/ppp); various reports, such as the PPP Report to Congress; a PPP manual; a PPP guide book, which will be released soon; model PPP legislation; international and domestic case studies; and a web-based PPP tool kit, which will be released soon.

States have been very receptive to the concept of PPPs. In fact, many of these activities were undertaken at the request of the States. DOT continues to try to meet the growing and varied information demands of the States in this area.

2) *Questions regarding non-compete clauses*

- Non-compete clauses in public-private partnerships have stifled alternative public infrastructure projects. How does DOT plan to address the monopoly that non-compete clauses create?
- How should states deal with the desire from the private sector to have non-compete clauses?

Answer: Whether to include a non-compete clause in a public-private partnership agreement is a decision for State and local government. In general, States decide this on

a case-by-case basis, although some States, such as Alabama and North Carolina, prohibit non-compete clauses in their PPP legislation.

From an economic perspective, there may not be much need for non-compete clauses. If a corridor is projected to generate a -level of traffic low enough that a private sector investor would want a non-compete clause, it is not likely that the public authority would want to move forward with the project, since the low traffic projections indicate there is not a strong need for the facility. If a facility is projected to generate levels of traffic sufficient enough to support the project financially, the public authority will likely want to move forward with the project, since the higher projected levels of traffic indicate that there is sufficient demand for the facility.

States should be aware that contract provisions that limit competition will increase the up-front lease value of a highway, but may run counter to the public interest, if such a provision is not commensurate with the private sector's risk. The emerging trend seems to be inclusion of a limited provision or no provision at all. Public sector officials need to fully understand the implications of various forms that these provisions can take before entering into any agreement.

3) *Questions regarding public-private partnerships*

- Do public-private partnerships consider the environmental impact of their projects? How do they address environmental concerns of a community?

Answer: Public-private partnerships involving federal funding or approvals fully comply with the National Environmental Policy Act (NEPA) in much the same way as federally funded or approved projects implemented solely by State and local transportation agencies. In most cases to date, the public-private partnership has not been finalized until FHWA and the State DOT have completed a full environmental review under NEPA for the project that would be subject to the agreement. This includes public involvement as specified in FHWA-approved, State DOT public involvement procedures and appropriate interagency coordination on environmental issues of concern.

There is a trend toward public-private partnerships forming prior to the conclusion of the NEPA process. In these cases, the private partner's role will be to offer objective technical advice to the public agency members of the project development team that is responsible for completing the NEPA process. In cases where the project advanced by the public-private partnership does not require Federal funding or other Federal approvals, then the NEPA process would not apply, since it only applies to Federal actions. In these cases, state environmental statutes would apply. However, in air quality nonattainment and maintenance areas, the transportation conformity analysis must include emissions from a regionally significant project, i.e., a facility which serves regional transportation needs, regardless of the funding source.

4) *Questions regarding workers salaries and benefits*

- Public-private partnerships have been lauded by some for increasing efficiency and lowering costs in the transportation industry. Additionally, many have

criticized public-private partnerships as providing economic efficiency as a result of cutting workers' salaries and benefits. How can we make sure that public-private partnerships do not decrease the wages and benefits of transportation workers?

Answer: Public-private partnerships that use Federal-aid highway funds will be subject to Federal requirements. Section 113 of Title 23, United States Code, requires the Secretary to take such action as may be necessary to ensure that all laborers and mechanics employed by contractors or subcontractors on the construction work performed on Federal-aid highway projects are paid wages in accordance with the Davis-Bacon Act. All laborers and mechanics who are employed on a Federal-aid highway project, regardless of whether the project is a public-private partnership or one that is undertaken solely by a State transportation department, must be paid prevailing minimum wages in accordance with the Davis-Bacon Act.

Public-private partnerships that do not use Federal funds will not be subject to Federal requirements. However, State labor requirements may apply to the project being undertaken as public-private partnership, even if the project is not subject to Federal requirements.

5) *Question regarding foreign involvement in transportation projects*

- How do public-private partnerships address Buy America provisions in transportation projects? Are buy America requirements undermined by public-private partnerships?
- What percentage of public-private partnerships have foreign financing?
- What is your position on foreign financing of public-private partnerships? Do you think it is useful? Do you have any concerns? Should there be limits to foreign involvement in domestic transportation infrastructure projects?

Answer: Public-private partnerships that use Federal-aid highway funds are subject to Federal requirements. Section 313 of Title 23, United States Code ("Buy America"), requires that all steel, iron, and manufactured products permanently incorporated into a Federal-aid highway project be produced in the United States. This requirement applies whenever Federal funds are obligated to any highway project, regardless of whether the project is a public-private partnership. Moreover, section 313 prescribes penalties, including suspension and debarment, for intentional violations of law related to the mislabeling or misrepresentation of products as made in the United States. Therefore, the Buy America requirements are not undermined by public-private partnership projects that use Federal-aid highway funds.

With regard to foreign financing of public-private partnerships, there is no comprehensive data base on the financing of the complete spectrum of public-private partnerships from design-build contracts to build/rebuild, own, and operate. In general, design-build projects are largely financed domestically, while the limited number of long-term concessions to date have used foreign equity and debt capital. It is important to remember that foreign firms may have U.S. investors and may use U.S. infrastructure

funds . For example, more the half of the investors in Macquarie Infrastructure Partners, a recently formed infrastructure fund, are Americans, including substantial investments from the pension funds of several labor unions. Finally, a number of U.S. firms have started, or are in the process of starting, infrastructure investment funds. Therefore, the domestic share of transportation infrastructure investment could increase in the future.

The United States has traditionally welcomed foreign direct investment, including investments in transportation infrastructure, and provided foreign investors fair, equitable, and nondiscriminatory treatment, with a few limited exceptions designed to protect national security. Many of our railroads, for example, were originally financed by foreign investors. Foreigners currently invest in non-PPP projects through tax-exempt bond purchases. We believe that such investment continues to be useful and do not believe that foreign investment in domestic transportation infrastructure projects should be limited.

Dennis J. Enright
NW Financial Group, LLC
10 Exchange Place, 17th Floor
Jersey City, NJ 07302
Tel: (201) 656-0115

Written Testimony
U.S. House of Representatives
Committee on Transportation and Infrastructure
Highways and Transit
Tuesday, February 13, 2007
10:00am

Innovative Public Private Partnership Financings
and
Protection of the Public Interest

Executive Summary

Public Private Partnerships have long been promoted as a way for government to lower costs to users of the public infrastructure or to increase the quality of services. Over the past 30 years many sectors within the public domain have experimented with public private partnerships, including:

- Water
- Sewer
- Solid Waste
- Health Care
- Affordable Housing
- Mass Transit
- Transportation

The history of success has largely been measured by the provision of services at a cost less than the public sector could achieve. Although there have been failures, by and large the approach of utilizing the private sector to deliver public services has been successful by this measure when carefully planned and implemented with the goal of public user benefit in mond.

The recent dubbing of asset sales to the private sector as public private partnerships has largely tunred these historic policy objectives on their heads. In asset sales, concessions, long term leases and monetizations done to date the historic objective of lower costs to users has been reversed to impose much higher charges on users than the public sector would have imposed in exchange for a chunk of upfront cash to help fund short term needs of the selling governmental entity.

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This reversal in objectives has raised public policy concerns both about the equitiable nature to users and about whether governments are receiving more value than they could obtain through a self help financing approach.

Background and History

Public private partnerships are not a new vehicle for infrastructure development in the United States. These partnerships have been used for a variety of infrastructure projects prior to the recent emphasis on the transportation sector with both positive and negative results. Outside the United States Public Private Partnerships have been widely utilized in the transportation area, primarily in third world countries but also in Europe and other developed countries such as Australia. In the non-US experience the need for private capital is largely credit driven due to three primary factors:

1- Undeveloped local capital markets that cannot support either the size of the financings or the implied credit exposures given the limited capital base of each local economy
2- No market for governmental enterprise finance in the manner that it exists in the United States
3- Lack of availability of low cost public funding through tax law at the local governmental level versus the use of tax exempt bond financing in the US

Thus the primary reasons for widespread public private partnerships around the world is primarily capital and credit driven.

In the US the Public Private Partnership experience has been most successful when there are significant technology, revenue demand or efficiency challenges rather than capital considerations given the ready availability of capital for public projects in the US and the extensive network of high quality public employees with extensive experience in the implementation of large public works and infrastructure projects.

One of the best examples of successful Public Private Partnerships is in the area of environmentally acceptable waste disposal. Beginning in the late 1970's it became apparent that continuing to rely on landfills in urban areas as the only disposal option was not good public policy. As a result there was a nationwide movement to implement waste to energy or resource recovery plants as the preferred disposal option. Since these plants required sophisticated equipment to process the waste, meet air quality standards and produce electricity it was an ideal candidate for Public Private Partnerships. Today there are over 30 large resource recovery plants that have been operating for in excess of 20 years. Many have renewed their agreements with the private operators and expect to be in operation for another 20 years. The original financing structures were generally limited to only 20 years due to market concerns about technology risk; today those risks are largely not a concern. The key to success in this sector was the sharing of risks between public and private sectors and the plants were generally delivered as design, build, operate, maintain contracts with specific risk allocation to those parties best able to take each risk. Thus, as an example, technology risk was taken by the private sector and change in law risk was taken by the public sector.

In the transportation sector there is little technology risk to share and the primary risk is the production of future revenues to pay for the cost of the road. Traditionally these risks have been low and acceptable as a public risk. Again in the US the use of revenue backed governmental bonds has been a widely accepted and easily marketable security to fund both the building of new toll roads and expansion of existing roads. US toll road authorities have a proven track record of efficient operations and have a mission of providing mobility through affordable tolls

designed only to fund the needs of the roadway system within the control of the toll road authority.

Along comes Chicago

In 2005 The City of Chicago undertook a groundbreaking transaction that has brought new attention to the use of Public Private Partnerships in the transportation sector. This transaction was not the first time a public asset had been "sold" to the private sector through a lease transaction, however, it was the first time that the P3 mandate was utilized to increase costs to users rather than decrease costs through the application of improved efficiency of the private sector. The Chicago Skyway transaction (see full analysis in Appendix A) was however the first time that a public sector asset value was driven by projected future toll increases and the revenue stream was "monetized" in order to produce the price of the asset.

The Chicago Skyway transaction proved only one thing, that the capital markets would accept a long-term projection of revenue increases based upon economic indexes as a basis for financing. Previously toll roads were financed using an underlying assumption that increases would only be imposed based upon the revenue need of the toll road authority and that would be driven primarily by expectations about traffic flows and capital needs. The ability or desire to maximize the bottom line returns through compounding annual increase in tolls was never considered since the agencies that owned the toll roads were driven by a public policy mandate that treasured minimizing tolls.

Next Stop Indiana

Shortly after the Chicago Skyway transaction the State of Indiana determined to sell its statewide east west toll road through a similar structure as was utilized in Chicago. Once again value was achieved through the monetization of future toll increases and a long-term lease was the structure.

In the case of Indiana new public policy issues are apparent. As compared to the Chicago deal which was basically a bridge between Chicago and the State of Indiana, the Indiana Toll Road was the sale of a 150 mile stretch of road that serves not only as a key link in the federal interstate highway system but also, like all statewide toll roads, is perhaps the most important economic development tool available to a state government. By selling this key asset to the private sector the State of Indiana has put itself at a disadvantage in spurring economic development projects along this route since every desired improvement to the toll road will have to negotiate with the new owner and every additional dollar spent will need to return profit to the private sector. Just the cost of capital for any new improvement will be at lease 60% higher than it would if the road was publicly owned, never mind any other profit considerations to the operator. This gives the private sector considerable leverage in negotiations, after all its lease is not up for renewal anytime soon.

Protecting the Public Interest

Despite the billions of dollars paid, the Chicago and Indiana transactions have actually shown that the private sector is not willing to overpay for toll road assets. The combination of credit discipline imposed by the lending community and the high cost of equity has assured that the valuation utilized by these private buyers is no greater than the amount of dollars that could have been generated by the public agencies undertaking the monetization financing on their own. As a matter of fact the cost of capital in today's markets for public financing is only 60-70% of the cost of a private monetization and therefore can either deliver greater value or require significantly lower toll increases.

As a result, all of the upside to the buyer from higher than expected traffic growth and tolling increases will be captured as profits to the new owners rather than as pubic transportation system-funding dollars. This leaves a huge amount of future cash flows on the table that could have been captured for public purposes.

Based upon publicly available information it would seem that the governmental decision makers in both cases were led to believe that the private sector would take a more aggressive view of

future traffic flows and thus be willing to pay a price higher than the public sector could achieve. In actuality this has not been the case to date. See Appendices A and B for a complete analysis.

Given the results of these two groundbreaking transactions what are the public policy implications and how can the public interest best be protected. There are several protections that can be implemented for asset monetization type of transactions that would go a long way to protecting the public interest:

1- The valuation of the asset should be undertaken on an independent basis that allows for the independent development of assumptions and the reasonable input of the existing toll road owner as to achievable efficiencies.
2- If the public toll road owner is prepared to undertake the monetization desired by the State government then a target amount of upfront payment should be identified and the public agency should be allowed adequate time to arrange a funding.
3- When monetization is undertaken by the public entity then any future non- monetized increases in revenues should be pledged to the public transportation system. This ***Public Ownership Dividend*** can be used to fund mass transit, freeways or other statewide transportation needs.
4- If public monetization is not desirable then when a private option is pursued a more sophisticated approach to procurement should be taken, including evaluating the bids based upon the length of the concession, limits on return on equity and risk sharing parameters, as well as, the value of the upfront purchase price. Around the world the "normal" concession for a private toll road does not usually exceed 30 years and in many cases is much shorter, even for to be built roads. Other factors used in the international experience include a termination of the concession when the equity returns have been achieved if that period is shorter than the original concession, thus returning the revenue producing asset to the public sector rather than allowing ongoing increases in equity returns to the private vendor.

Summary

The Chicago and Indiana transactions are so exciting because, like Columbus, they found a new world. A world where dollars could be realized today based upon future revenue streams from what is essentially a monopoly roadway. These future cash flows are reliable since even if higher toll increases reduce traffic flows the increased traffic on free routes will only make the time advantage of the toll road even more valuable and less expensive to operate. The upfront dollars realized are highly attractive to units of government reluctant to increase gasoline or other taxes to fund transportation or other needs.

From a public policy point of view the lessons learned to date are:

In the US both the availability and the cost of publicly funded monetization is readily available at levels that were utilized in Chicago and Indiana. Until it is proven that the private sector is willing to take substantially more risk and thus produce substantially higher valuations the public option should be preferred.

In the case of existing toll road assets there is little risk and little reason to pursue the private monetization approach that doesn't capture the ***Public Ownership Dividend.***

In the case of to be built toll roads the use of the private sector may be more appropriate since the projection of traffic growth and toll acceptability has more inherent risk than existing assets, however, if a public toll road authority is prepared to undertake the project and dedicate future excess revenues to the public transportation needs then that should be the preferred approach, even in those cases where the upfront dollars might be slightly less.

Among the public policy questions remaining are:

When is a toll a tax?

Is it equitable to impose a toll increase on an east/west corridor when the proceeds are used for north/south roadways? Is this a "corridor tax"?

Isn't it more equitable to charge a broad based transportation tax such as a gasoline tax or a motor vehicle ownership surcharge to pay for needed transportation infrastructure improvements?

Appendices

Appendix A - *The Chicago Skyway Sale, An Analytical Review*
Appendix B – *Then there were two..Indiana Toll Road vs. Chicago Skyway, An Analytical Review of Two Public/Private Partnerhips, A Story of Courage and Lost Opportunity*

The Chicago Skyway Sale

An Analytical Review

May 1, 2006

Introduction

Now that the much publicized sale of the Chicago Skyway, at what seemed to be an astronomical price to foreign buyers, has been followed by the sale of the Indiana Toll Road to the same buying group, it is time to review the details of the Skyway transaction and evaluate its benefits, costs, risks and, in retrospect, other options that would have achieved the same results. Was this a public benefit sale or was it a leveraged buyout for corporate profits?

Privatization of public infrastructure assets is not new in the United States. In recent times there have been significant privatization initiatives in the water and wastewater sectors in both large cities (Indianapolis, Atlanta) and small cities (Perth Amboy, NJ). Prior to the wave of water and wastewater there was waste-to-energy plants, which were virtually all built in some form of public/private partnership. Other public assets have been privatized, such as nursing homes, but none has made the impact of water and solid waste. Toll roads have also been privatized but primarily as start-ups.

There are many lessons to be learned from these past privatizations both good and bad, however, very few of these efforts have been a pure monetization of assets in the fashion of the Chicago Skyway' and now the Indiana Toll Road. In the past governments undertook privatizations primarily to reduce costs and stabilize, not increase, rates to users. These prior efforts were also contracted to more limited terms of 5-30 years so that retention of public control was always nearby. In some circumstances there has been monetization in order to raise money to solve budget problems, but the funds were quite limited due to sensitivity to ratepayer's costs.

In the case of the Chicago Skyway sale there was no apparent sensitivity to ratepayer impact, with an allowance for initial rate increases averaging 12.50% per year for a total of 150% in a twelve-year period and ongoing increases of 2% to 7% or more over the life of the franchise that will drive the beginning $2.00 toll up to over $60.00 per passage if rates increase at 3.00% per annum and vastly higher at greater per annum increases. A large part of this willingness to impose large toll increases may likely have been the fact that these increases will largely be paid by commuters from another state (Indiana), not voters in Chicago, Illinois. In some respects the Chicago Skyway was the perfect candidate for long-term privatization because the seller gained all the proceeds and the seller's constituency will pay virtually none of the costs. If the Skyway were an in-state road, it is highly unlikely that the toll increases would have been politically palatable.

Review Features

Our review of the Chicago Skyway transaction will focus on the following questions:

1) How high could toll increases really get?

2) How much of the purchase price was directly driven by toll increase versus traffic increases?

3) What is the real return on equity that the winning bidder will achieve?

4) How much money will be diverted from the public highway coffers by allowing private profits?

5) Could the same economic value have been delivered through a public financing rather than a private sale of the road?

Toll Increase on the Chicago Skyway

The Concession agreement allows toll increases, after the initial twelve years, at the highest of three factors:

- 2.00% per annum
- Increase in the Consumer Price Index (CPI)
- Increase in nominal Gross Domestic Product per capita (GDP)

Thus the private buyer has been guaranteed a floor and is limited by a ceiling of either CPI or GDP growth. Most of us think in terms of 3-3.5% CPI increases being a likely case over time, however most people do not know the history of GDP growth. In a recent research report by Fitch they revealed this historic growth of GDP at between 4.30% and 7.40%. Obviously the GDP index is likely to drive the growth in toll rates given its higher historic results. Additionally the private operator can impose higher tolls for vehicles with three or more axles during peak hours.

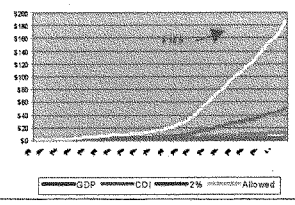
Using these three options we have modeled the likely dollar toll results for passenger cars and likely percentage increases over time as shown below:

Year	Initial Tolls Maximums	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
	Passenger Car Toll					
	$ 2.00					
1	$ 2.50					
3	$ 3.00					
6	$ 3.50					
8	$ 4.00					
10	$ 4.50					
12	$ 5.00					
20		$ 5.86	$ 6.33	$ 6.84	$ 7.67	$ 8.59
50		$ 10.61	$ 15.37	$ 22.19	$ 38.24	$ 65.40
75		$ 17.41	$ 32.19	$ 59.17	$ 145.84	$ 354.93
99		$ 28.00	$ 65.43	$ 151.66	$ 527.15	$ 1,800.36

Thus if GDP growth were to continue at the high historical rates of 4-7% ultimately tolls to cross this 7 mile span could be over $1,000 per trip.

To give these toll increases some perspective, if the appropriate index were used to control toll rates from the time of opening of the Holland Tunnel, connecting New York and New Jersey, beginning in 1927 when the toll was $1.00 (50 cents each way) until today the river crossing toll would now be $185.13 based on actual application of the three factors since 1930, rather than the $6.00 that is being currently charged. This is an average annual increase of 7.20%, including a number of years with negative GDP in the depression where the 2% floor was applied. It is interesting to note that if tolls were increased by GDP alone they would "only" be $49.45 in 2005; by CPI alone $11.42; but when combined with the 2% floor for low inflation and low growth years the toll escalates to the $185.13 level. Thus this formula not only protects the private operator from slow economic growth but it also allows for toll increase compounding when other indicators would force tolls downward.

Holland Tunnel Toll Growth at Chicago Skyway Formula



Purchase Price Drivers

Given the ability to increase tolls with a known floor and a high historic ceiling, how did the private sector determine its ability to fund the attractively high purchase price of $1.8 Billion? In toll road economics there are two primary drivers of gross toll revenues: toll rates and traffic flows. In order to analyze the thinking behind the bidding we believe it is necessary to separate these two factors and quantify the value of each. In order to do this, we have modeled four cases on traffic volume growth as follows:

No Growth – This case assumes that traffic volume is static at the 2005 levels. This case allows us to value the economics of the allowed toll increases alone without regard to any growth created by increased volumes.

Historic Growth – This case assumes linear growth at the recent historic annual growth rate for the road of 3.78%.

Modest Growth – This case assumes traffic growth at 2% per annum to allow for a growth slow down over time as the road matures.

Aggressive Growth – This case assumes annual growth on a more aggressive basis of 5%, reflecting some of the bidder's comments on the strength of growth in the corridor.

For the purposes of this overview we have not delved into operating and capital costs, which could impact bottom line results either positively or negatively, depending on traffic volumes. Our view is that the operational cost of the road will be little impacted by traffic volumes and capital costs can easily be absorbed in the overall revenue flows without significant impact on valuation.

These four cases provide the following results:

Chicago Skyway Transaction
Projected Increased Revenues (Net Present Value)
Revenues Available to repay Franchise Fee of $ 1.80 Billion

Annual Traffic Growth	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
No Growth	$ 1.47	$ 1.92	$ 2.60	$ 4.48	$ 8.62
Historic Growth (3.78%)	$ 8.37	$ 13.08	$ 21.59	$ 49.89	$ 124.72
Moderate Growth (2%)	$ 3.48	$ 4.93	$ 7.36	$ 14.85	$ 33.26
Aggressive Growth (5%)	$ 16.63	$ 27.85	$ 48.90	$ 121.97	$ 322.38

Thus, even at the floor toll rate increase of 2%, the net present value of increased revenues from tolls alone total over $1.4 Billion or 75% of the upfront franchise price of $1.8 Billion. If the indexes allow 3% rate increases then the full franchise fee is recovered from toll increases alone. The breakeven traffic growth required to recover the franchise fee at the floor of 2% is a growth rate of less than 1% per annum.

Loss of Public Road Funding

The net result of an economic model that allows recapture of the franchise fee from the agreed upon toll increases alone is to allow the private operator to obtain the full financial benefit of traffic growth over the term of the franchise, 99 years in the case of the Chicago Skyway. All of these private profit dollars would otherwise flow back to the public transportation funding system and allow for investment in infrastructure over this extended period, including roads that are impacted by the growth in traffic volume connecting to the sold roadway.

In the case of Chicago these lost transportation dollars are substantial:

Chicago Skyway Transaction
Lost Transporation Funding Dollars (Net Present Value)
Net of Franchise Fee Paid of $ 1.80 Billion

Traffic Growth Case	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
	Lost Funding in Billions				
No Growth	$ (0.33)	$ 0.12	$ 0.80	$ 2.68	$ 6.82
Historic Growth (3.78%)	$ 6.98	$ 12.00	$ 21.08	$ 51.41	$ 131.84
Moderate Growth (2%)	$ 1.68	$ 3.13	$ 5.56	$ 13.05	$ 31.46
Aggressive Growth (5%)	$ 14.63	$ 26.05	$ 47.10	$ 120.17	$ 320.58

This significant loss of public funding is a direct consequence of permitting private profits based upon toll and traffic growth factors, not a cost based approach.

Return on Equity

Given the large cash flows that are likely to accrue to the private sector operator, what are the real returns on equity that can be achieved given the 2% toll increase floor, the historic GDP ceiling increases that might be allowed and the traffic growth that might actually be achieved in the corridor? We once again applied our model to project return on equity based upon two scenarios:

- Original equity Contribution of $887.7 million made by the private operator at the time of closing with $1 Billion in debt financing.
- Reduced Equity investment achieved at refinancing a few months later of $652.6 million with $1.4 Billion in debt financing.

Our methodology is to compare the initial investment against the available cash flows less imputed debt service over 30 years to determine an internal rate of return on invested equity.

This analysis produces the following return on equity matrix depending upon actual toll increase and traffic growth:

Chicago Skyway Transaction
Projected Average Annual Return on Equity
Based on Initial Equity Investment of $887.6 Million

Annual Traffic Growth	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
	Internal Rate of Return on Equity				
No Growth	5.3%	5.3%	7.3%	8.7%	9.9%
Historic Growth (3.78%)	11.0%	11.0%	12.6%	13.8%	14.9%
Moderate Growth (2%)	8.5%	8.5%	10.2%	11.4%	12.6%
Aggressive Growth (5%)	12.7%	12.7%	14.2%	15.3%	16.4%

Chicago Skyway Transaction
Projected Average Annual Return on Equity
Based on **Final** Equity Investment of **$652.6 Million after refinancing**

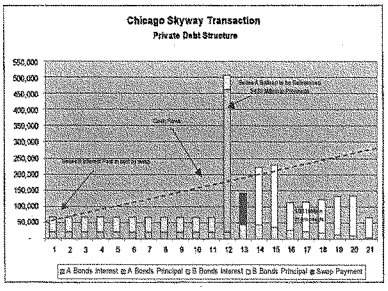
Annual Traffic Growth	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
	Internal Rate of Return on Equity				
No Growth	5.9%	5.9%	7.9%	9.3%	10.6%
Historic Growth (3.78%)	12.0%	12.0%	13.5%	14.7%	15.8%
Moderate Growth (2%)	9.3%	9.3%	11.0%	12.2%	13.4%
Aggressive Growth (5%)	13.8%	13.8%	15.2%	16.3%	17.4%

Public Funding Feasibility

Given the strong economics underlying the Chicago Skyway privatization – why sell? Shouldn't the public sector try to retain these strong cash flows for the public benefit? One of the publicly given reasons for going the privatization route was the availability of "patient capital" that could wait for revenues if they did not develop and not be obligated to a fixed payment on debt service. Some advocates for privatization have suggested it would not be possible for the public sector to raise the same level of capital due to the restraints associated with an all debt funding. In order to try to analyze this issue, we have reviewed the structure of the financing utilized by the private operator and compared some of the features to what might be achieved in a public sector financing.

The Chicago Skyway Financing Structure

Although initially funded as equity with bank loans, the private operator very quickly refinanced to a permanent funding structure that incorporated many innovative features. The private operator was able to structure their refinancing in a manner acceptable to a "AAA" bond insurer (FSA) for their senior debt traunch, even with debt rollover risk. In some respects this is a groundbreaking event since the bond insurers have traditionally been averse to rollover risk. However the price paid for this was a senior debt coverage requirement of 1.50 and a projected coverage for determining leverage of 2.00. Thus this limited the amount of leverage at the senior debt level. In order to increase leverage to the desired level, the operator structured a deferred payment swap structure (much like zero coupon bonds or capital appreciation bonds). The result of this two-layer debt structure was to increase leverage over the original financing and withdraw over $200 million in equity. Thus the post financing equity was reduced from 49% of the purchase price to 36% of the purchase price. This lower equity level could be recovered in full in 12 years based upon expected cash flows. After recovery the private operator is in the deal for the remaining 87 years with no equity at risk.

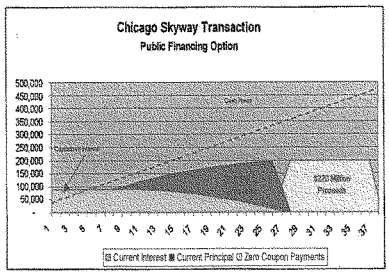


Public Sector Options

An alternative mechanism to raise the $1.8 Billion in upfront funding would be for a the public entity with a track record of running the toll road to issue toll road revenue bonds in a structure similar to the private financing and use deferred and/or subordinated debt in place of equity. There are many options to structure this type of debt financing plan so we have chosen a rather basic approach in order to simplify the presentation. In our structure, utilizing interest rates available at the time of the sale, a public entity could raise the same dollars - $1.8 Billion, using the following debt program:

- Series A, $1.8 Billion of Current Interest Senior Debt with interest only for 8 years, then debt service to cover at 1.50 times for 20 years until fully paid.

- Series B, $220 Million (or more if required) of deferred interest Zero Coupon Debt maturing serially in years 30-40. Proceeds to be used as capitalized interest to add to available cash flow in first 8 years to meet interest due on Series A.



This structure would produce the $1.8 Billion as desired. This structure could also be enhanced to reduce the cost of funds through the use of other financing products and this is presented as a simplified solution to show that the funding can be achieved. Costs of funds could be reduced by shortening amortization to allow for less compounding of interest; subordinated bonds could be secured through the use of cash flows in excess of debt service; rates could be reduced by using put structures or derivative products, etc.

An effective public sector monetization of toll road assets would not only be possible but also allow the public sector to retain all of the positive cash flows above the cost of debt service plus all of the positive cash flows after debt is repaid.

Summary

The privatization of the Chicago Skyway has demonstrated two important facts:

1) There is a strong private sector interest in acquiring toll road assets

2) It is possible for the future cash flows of a toll road to be monetized through an upfront financing

These two facts are important because they show how receptive the investment community is to the strength of toll road revenues and the willingness of banks, bond insurers, bond rating agencies, bond buyers and equity providers to fund the control of a toll road asset and rely upon future performance tied to rate increases and traffic flows. This opens the possibilities for governmental bodies to raise upfront capital by securitizing future toll road and other user rate supported cash flows, a relatively seminal event in the history of municipal finance.

The questions for public policy makers is whether ceding control of toll road assets to the private sector for extremely long periods of time is in the best interest of the public sector or should the public sector seek to raise capital on its own.

Our study of the Chicago Skyway transaction has indicated the following findings on the five questions we analyzed:

1) Use of GDP per capita as an index drives user charges to extremes. We would suggest the public sector carefully analyze the impact of the toll increases it chooses and stick more closely with CPI or floor/ceiling structures. These rate structures can produce acceptable monetization results, especially if combined with additional pass through adjustments for special circumstances. The pass through design is a proven technique in the water and solid waste privatization models.

2) The expected increase in toll rates is the primary driver in establishing value, not the expected growth in traffic. Thus the buyer heavily discounts traffic growth in their pricing model and establishes a cushion that allows them to reduce risk and earn outsize returns on equity when traffic growth comes to fruition. It is important to note that variable operating expenses are a very small portion of overall costs.

3) Turning control of toll roads over to the private sector deprives the public transportation funding network of very large and much needed future revenues to pay for capital projects both on and off the toll road. Instead these revenues are directed to private corporate profits and shareholders. If road users are willing to pay higher tolls why not capture those funds for the public good. Use of bridge and tunnel tolls by the Port Authority of New York and New Jersey for mass transit and port operations is one example of how this can be achieved.

4) Projected returns on equity in the Chicago Skyway transaction are extremely high as a result of the toll increase regime, the limited equity requirements and the highly leveraged nature of this transaction. Like any innovative transactions there is always additional profit potential in something unproven and this transaction follows that trend.

5) Public financing at the same (or even greater) monetization levels would have been very feasible for the Chicago Skyway transaction and should be considered as a public policy alternative to privatization. Obtaining the upfront benefit but leaving the control of the road and the future cash flows in the hands of the public sector to fund transportation needs. Partial privatization may also be a strategy for this approach if the all-in cost of capital provides additional economic benefit.

6) Another alternative financing structure would be a toll surcharge that could be securitized on its own without direct debt on toll road operations.

7) A hidden cost of the privatization approach is the increased cost of future capital improvements at either higher taxable borrowing rates or equity return rates. This will increase the financing cost of future capital expenditures by at least 60% over the tax exempt rates available to a publicly owner toll road.

In conclusion, the Chicago Skyway transaction has opened the door to new funding structures for transportation by monetizing future cash flows based largely upon known increases in toll rate user charges. The question for the public sector is:

Should the public sector capture the excess revenues generated for public transportation purposes or should they allow the private sector to capture these revenues?

The author of this Research Report is Dennis J. Enright, Principal, NW Financial Group, LLC. He may be contacted at NW Financial Group, LLC, 10 Exchange Place, Jersey City, New Jersey 07302. Phone: 201.656.0115. Email: dje@nwfinancial.com.

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Then there were two..

Indiana Toll Road vs. Chicago Skyway

An Analytical Review of Two Public/Private Partnerships

A Story of Courage and Lost Opportunity

November 1, 2006

NW FINANCIAL GROUP, LLC

Exceeding Expectations

Overview

In the aftermath of the Chicago Skyway transaction, the State of Indiana decided to privatize the statewide Indiana East-West Toll Road through the awarding of a 75-year concession agreement. The winning bidder of this long-term lease agreement is the same Cintra/Maquarie syndicate that won the Chicago Skyway concession. In the case of Indiana the winning bid was $3.85 Billion. Proceeds from the transaction will be used to fund a ten-year transportation capital needs initiative of the Governor of Indiana called "Major Moves".

The Indiana transaction differs from the Chicago deal in several major ways:

- Concession is for period of 75 years versus 99 years
- Indiana initial toll increases of between 73% and 113% were put in place by the Governor prior to the concession bid
- The roadway is a full statewide thoroughfare not a limited access road such as the Chicago Skyway
- Traffic on the road is mainly commercial
- Indiana Toll road is not a major commuter route for most of its length

The Governor of Indiana demonstrated tremendous courage when he instituted toll increases of over 70% on the Toll Road, however, by using the concession method of monetization lost the opportunity to raise the capital at much lower rates and thus either raise more capital for the his "Major Moves" initiative of capital spending over the next ten years or to allow for lower future toll increases. Major Moves is a 10-year transportation capital program for the State of Indiana, however the State has given up 75 years of revenues from the sale of Toll Road revenue stream.

Query:

Where will State transportation funding come from in years 11 through 75?

In the past governments undertook privatizations primarily to reduce costs and stabilize, not increase, rates to users. These prior efforts were also contracted to more limited terms of 5-30 years so that retention of public control was always nearby. There are many lessons to be learned from past infrastructure privatizations' both good and bad, however, very few of these efforts have been a pure monetization of assets in the fashion of the Indiana Toll Road and the Chicago Skyway. In some circumstances there has been monetization in order to raise money to solve budget problems, but the funds were quite limited due to sensitivity to ratepayer's costs.

In the case of the Indiana Toll Road sale there was no serious sensitivity to ratepayer impact, as evidenced by initial rate increases of between 73% and 113% and ongoing increases of a minimum of 2% to 7% or more over the life of the franchise. This will drive the beginning $8.00 passenger car through trip toll up to over $71.00 per passage if rates increase at *only* 3.00% per annum and vastly higher at greater per annum increases. A large part of this willingness to impose large toll increases may likely have been the fact that these increases will largely be paid by drivers, primarily truckers, from other states passing through Indiana, not voters in Indiana. If the Toll Road were a

significant in-state commuter road, it is highly unlikely that the toll increases would have been politically palatable.

Review Features

These differences drive a somewhat different analysis than the one we prepared on the Chicago Skyway transaction (published in *Tollways* Autumn 2006) and raise different issues. Among these policy issues are:

1) What is the economic value of the State's initial pre-privatization toll increase?

2) How high could toll increases really get?

3) How much more would tolls need to be increased to achieve the $3.85 Billion price?

4) What is the impact of the privatization on toll payers?

5) What is the projected profit margin for the winning bidder?

6) Could the same economic value have been delivered through a public financing rather than a private sale of the road?

We will also analyze the impacted loss of funding on the public transportation system and the potential for public funding to achieve the same results as we did in the Chicago Skyway analysis.

The Pre-Privatization Toll Increase

In early 2006 Indiana put into place a massive toll increase on the Indiana East West Toll Road of 73% on two axle vehicles and phased 113% on larger vehicles. This was the first toll increase in 21 years. Assuming no increase in traffic volume and no future toll increase, over the next 75 years, this upfront toll increase would have an economic value in 2006 dollars of $.93 Billion or 24% of the $3.85 Billion concession fee.

After the initial toll increase, assuming the same traffic volumes, the annual toll road revenues would increase to $173.56 million (a 97% increase). The expected contribution to revenues was disproportionately increased to put a higher toll burden upon commercial traffic.

Value of 2006 Toll Increase

Using a range of expected traffic growth assumptions would produce the following potential upfront economic benefit from the 2006 toll increases *alone* without *any* future toll increases:

Indiana East West Toll Road Transaction
Value of 2006 Toll Hike

Initial Toll Increase Only	
Annual Traffic Growth	2006 Values
Zero	$ 928,062,098
1.00%	$ 1,396,183,595
2.00%	$ 2,034,977,564
3.00%	$ 2,931,315,485
4.00%	$ 4,224,537,126
5.00%	$ 6,141,107,496

Meeting a $3.85 Billion Bid

Thus in order to produce the same results as the concession sale without any further toll increases the traffic growth on the road would need to be between 3% and 4% per annum. In the world of mature toll roads this is a very unlikely annual growth to obtain; therefore it would be necessary to increase tolls in combination with traffic increases in order to create the same economic value as obtained in the

concession offer. Conversely the $3.85 Billion could be obtained by having toll increases of between 3-4% with no real growth in traffic. Using a spectrum of toll increases and traffic volume increases would allow a variety of scenarios to achieve the $3.85 Billion economic result:

Indiana East West Toll Road Transaction
Spectrum of Values to Achieve Concession Price
Values above Concession Price Highlighted in Yellow

Values in 2005 Dollars						
	Future Annual Toll Increases					
Annual Traffic Growth	Zero	1.00%	2.00%	3.00%	4.00%	5.00%
Zero	$ 0.93	$ 1.43	$ 2.11	$ 3.07	$ 4.46	$ 6.53
1.00%	$ 1.40	$ 2.08	$ 3.04	$ 4.45	$ 6.56	$ 9.79
2.00%	$ 2.03	$ 3.00	$ 4.41	$ 6.52	$ 9.79	$ 14.98
3.00%	$ 2.93	$ 4.33	$ 6.44	$ 9.71	$ 14.91	$ 23.34
4.00%	$ 4.22	$ 6.31	$ 9.67	$ 14.75	$ 23.20	$ 37.22
5.00%	$ 6.14	$ 9.34	$ 14.47	$ 22.86	$ 36.85	$ 60.51

Thus given the low traffic growth expectations an annual toll increase of approximately 3.00% is required in order to justify the $3.85 billion purchase price. This expected increase is highlighted in the chart in the following section.

Impact on Toll Payers

The Indiana concession sale was structured with the same toll escalation regime (after initial toll increases) as was designed for the Chicago Skyway transaction, namely:

The Concession agreement allows toll increases at the highest of three factors:

- 2.00% per annum
- Increase in the Consumer Price Index (CPI)
- Increase in nominal Gross Domestic Product per capita (GDP)

Thus the private buyer has been guaranteed a floor of 2% per annum and is limited by a ceiling of either CPI or GDP growth. Most of us think in terms of 3-3.5% CPI increases being a likely case over time, however most people do not know the history of GDP growth, which has **averaged greater than 7%** over the last 50 years. Obviously the GDP index is likely to drive the growth in toll rates given its higher historic results.

Using these three options we have modeled the likely dollar toll results for the 75 year term of the concession agreement for both passenger cars and 5 axle commercial vehicles as shown below:

Indiana Toll Road Transaction
Projected Passenger Car Tolls

Year	Initial Tolls Maximums	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
2005	$ 4.65					
1	$ 8.00	*(72% Initial Increase)*				
2	$ 8.00					
3	$ 8.00					
4	$ 8.00					
5		$ 8.66	$ 9.00	$ 9.00	$ 9.91	$ 10.49
6		$ 8.83	$ 9.27	$ 9.42	$ 10.46	$ 11.22
7		$ 9.01	$ 9.55	$ 10.12	$ 11.03	$ 12.01
8		$ 9.19	$ 9.84	$ 10.53	$ 11.64	$ 12.85
9		$ 9.37	$ 10.13	$ 10.94	$ 12.28	$ 13.75
10		$ 9.56	$ 10.44	$ 11.38	$ 12.95	$ 14.71
20		$ 11.65	$ 14.03	$ 16.85	$ 22.13	$ 28.93
50		$ 21.11	$ 34.05	$ 54.67	$ 110.27	$ 220.24
75		$ 34.63	$ 71.29	$ 148.77	$ 420.51	$ 1,195.33

Indiana Toll Road Transaction
Projected 5 axle Truck Tolls

Year	Initial Tolls Maximums	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
2005	$ 14.60					
1	$ 17.90	*(113% Initial Increase over 4 years)*				
2	$ 22.81					
3	$ 27.32					
4	$ 31.87					
5		$ 34.50	$ 35.67	$ 37.26	$ 39.48	$ 41.78
6		$ 35.19	$ 36.95	$ 38.78	$ 41.65	$ 44.70
7		$ 35.89	$ 38.06	$ 40.35	$ 43.95	$ 47.83
8		$ 36.61	$ 39.20	$ 41.96	$ 46.36	$ 51.18
9		$ 37.34	$ 40.37	$ 43.62	$ 48.91	$ 54.78
10		$ 38.09	$ 41.58	$ 45.365	$ 51.60	$ 58.59
20		$ 46.43	$ 55.89	$ 67.15	$ 88.14	$ 115.26
50		$ 84.10	$ 135.85	$ 217.79	$ 439.31	$ 877.41
75		$ 137.98	$ 284.02	$ 590.53	$ 1,675.24	$ 4,762.06

The highlighted 4% column above represents the approximate toll increase need to support the $3.85 billion purchase price.

What Tolls In Indiana Would Have Been

In order to give this toll regime some context we applied the agreed upon allowable toll increase formula under the actual concession agreement to the Indiana Toll Road. From 1985, the last time they raised tolls, over 21 years ago, the application of these variables would have resulted in a 2006 toll for passenger vehicles of $12.16 for a through trip and a 2006 toll for commercial vehicles of $38.19 for a through trip, as compared to the actual 2005 tolls of $4.65 and $14.60 respectively. This increase would have represented a compounded toll hike of ***262%*** *over the 21-year period. In all but 3 years the toll increase was driven by the GDP per capita component of the formula.*

Purchase Price Drivers

As mentioned in our Chicago Skyway Analysis, toll road economics dictate there are two primary drivers of gross toll revenues: toll rates and traffic flows. In order to analyze the thinking behind the bidding we believe it is necessary to separate these two factors and quantify the value of each. In order to do this, we have modeled four cases on traffic volume growth for the Indiana Toll Road as follows:

No Growth – This case assumes that traffic volume is static at the 2005 levels. This case allows us to value the economics of the allowed toll increases alone without regard to any growth created by increased volumes.

Historic Growth – This case assumes linear growth at the recent historic annual growth rate for the road of approximately 1.50%.

Modest Growth – This case assumes traffic growth at 1% per annum, which is consistent with traffic growth on mature toll roads.

Aggressive Growth – This case assumes annual growth on a more aggressive basis of 3%, reflecting a high level of economic activity in the State of Indiana and the surrounding region.

For the purposes of this analysis we have utilized the basic assumptions used in the Crowe Chizek study, commissioned by the State of Indiana prior to the privatization decision, with a reduction in operating expense escalators to 3.00% per annum.

These four cases provide the following results:

Indiana Toll Road Transaction
Projected Increased Revenues (Net Present Value)
Revenues Available to repay Franchise Fee of $ 3.85 Billion

Annual Traffic Growth	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
	Gross Revenue Increase in Billions				
No Growth	$2.1	$3.1	$4.5	$7.9	$14.6
Historic Growth (1.5%)	$3.7	$5.4	$8.0	$14.9	$29.1
Moderate Growth (1%)	$3.0	$4.4	$6.6	$12.0	$23.0
Aggressive Growth (3%)	$6.4	$9.7	$14.9	$29.4	$60.5

Thus, even at the floor toll rate increase of 2%, the net present value of increased revenues from tolls alone total over $2.1 Billion or 55% of the upfront franchise price of $3.85 Billion. If the toll

rate indexes allow 3% rate increases then 81% franchise fee is recovered from toll increases alone with no traffic growth. The breakeven traffic growth required to recover the franchise fee at the floor of 2% equates to the approximate historic traffic growth of the road (1.50%).

Projected Profit Margins

Given the large cash flows that are likely to accrue to the private sector operator, what are the real returns on equity that can be achieved given the 2% toll increase floor, the historically high GDP ceiling increases that might be allowed and the traffic growth that might actually be achieved in the corridor? We once again applied our model to project return on equity based upon an assumed equity contribution of 25% of the purchase price. (There is currently no public information describing the actual financing.)

Our methodology is to compare on a net present value basis the gross increase in operating cash flows less the debt service payments incurred to determined an annual cash flow available for return to equity and then determine the internal rate of return for those cash flows versus the equity invested.

This analysis produces the following return on equity matrix depending upon actual toll increase and traffic growth:

Indiana Toll Road Transaction
Projected Internal Rate of Return on Equity
Based on Assumed 25% **Equity** Investment of $0.963 Billion

Annual Traffic Growth	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
	Internal Rate of Return on Equity				
No Growth	2.2%	8.4%	10.1%	12.3%	14.2%
Historic Growth (1.5%)	4.8%	10.8%	12.2%	14.2%	16.0%
Moderate Growth (1%)	5.7%	10.1%	11.6%	13.6%	15.4%
Aggressive Growth (3%)	8.2%	12.8%	14.1%	16.0%	17.7%

Public Transportation Funding Lost Revenues

Although not as severe as the Chicago Skyway transaction, the Indiana Toll Road sale allows the private operator to obtain a large financial benefit from traffic growth over the term of the 75-year franchise. These private profit dollars would otherwise flow back to the public transportation funding system and allow for investment in infrastructure over this extended period, including improvement to roads that are impacted by the growth in traffic volume by diverting traffic that do not wish to pay the higher tolls.

In the case of Indiana these lost transportation dollars are also substantial:

Indiana Toll Road Transaction
Lost Transportation Funding Dollars (Net Present Value)
Net of Franchise Fee of $ 3.85 Billion

Annual Traffic Growth	With 2% Floor	With 3% CPI	With 4% GDP	with 5.5% GDP	with 7% GDP
	Gross Revenue Increase				
No Growth	($1.7)	($0.8)	$0.6	$4.1	$10.8
Historic Growth (1.5%)	($0.2)	$1.5	$4.1	$11.1	$25.2
Moderate Growth (1%)	($0.8)	$0.6	$2.7	$8.2	$19.2
Aggressive Growth (3%)	$2.6	$5.9	$11.1	$25.6	$56.7

This significant loss of public funding is a direct consequence of permitting private profits based upon toll and traffic growth factors, not a cost based approach.

The Public Funding Option

As in the Chicago Skyway analysis, we have structured a public financing alternative which demonstrates how public control of the Indiana Toll Road could have been maintained and $3.8 Billion raised for the State in an efficient manner other than a sale to the private sector. However it is important to

comment on the State's position that it had a financial analysis done that showed a roadway valuation of only $1.92 Billion. As in all valuations and appraisals the key is in the assumptions and variables used. The study, which was prepared by the well-respected accounting firm of Crowe Chizek and Company LLC of Indianapolis, projected and analyzed 75 years of future cash flows of the Indiana Toll Road and discounted them to a net present value of $1.92 Billion. This valuation included outstanding debt that would ultimately be paid from the concession fee under the actual privatization deal and therefore should be added back for comparison purposes and show a value of $2.16 Billion. Unfortunately some of the assumptions are circumspect:

- Operating Expense growth at a constant 5.1%
- Toll increases only every 7 years and then at 22%, effectively an average of 3% per annum. This does not reflect the actual historical performance of the toll increases allowed under the concession agreement, which would be more than twice this amount.
- Traffic growth of 0.55% per annum after 2030
- Investment earnings rates frozen at "current" very low rates
- A net present value discount rate of 6.00% which is much higher than the cost of public funding, particularly when done as tax exempt financing.
- Assumed a dramatic traffic decline of 14% in first year after the initial toll increase and took 5 years to recover to 2005 traffic levels

In our view all of these assumptions drive a very low valuation, which is not in line with reality. Toll road operating expenses are not likely to increase at a 5.1% rate with the advent of electronic tolling and other cost saving measures. Toll increases every 7 years avoids showing the value of compounding annual toll increases as permitted in the concession agreement and 22% every 7 years is far below the toll regime agreed to in the actual concession agreement. Although projecting traffic growth is clearly difficult beyond 5 to 10 years, an annual growth rate of just 0.55% (chosen as 50% of the pre-2030 rates) is a highly pessimistic statement on growth in the Indiana corridor and highly unlikely to remain that low over a 50 year period. Interest rates are at historic lows and average short term investment rates over the future 75 years are likely to average two times 2005 rates, or even greater.

In order to show how these assumptions can impact the valuation we replicated their valuation model and tested some of these variables to see how much they would need to change to achieve the $3.85 Billion private bid. **By adjusting just 2 of the variables we were able to replicate the $3.85 billion valuation offered by the private sector.** The adjustments were to reduce the annual escalation of operating expenses from 5.10% to 3.00% (equal to the average CPI for the last 20 years), a more reasonable assumption in our view, and to change the discount rate representing cost of capital from 6.00% to 5.30%. This reduction in discount rate is well justified by the elimination of the high cost of equity capital from the private sector as a part of the transaction.
In our opinion the public ownership monetization model was not fairly considered as a true alternative and, given the expedited timetable, decision makers seemed unwilling to weigh the benefits versus private ownership.

The Lost Opportunity – Tax Exempt Financing

In contrast to the Chicago Skyway deal, where the proceeds where used for a variety of purposes, the proceeds of the Indiana deal are being specifically dedicated to transportation capital funding needs. If the State of Indiana had chosen the public monetization approach they would have been able to fund the valuation amount through the issuance of **tax-exempt bonds** rather than accept a monetized value based upon a combination of taxable debt and high cost equity financing. Utilizing the tax-exempt bond approach would have reduced the cost of capital by over 100 basis points (1.00%) and this alone would have increased the valuation by **over $1 Billion dollars.**

An effective public sector monetization of toll road assets would not only be possible but also allow the public sector to retain all of the positive cash flows above the cost of debt service for the full 75 years.

Summary

The question for public policy makers that remains after both the Indiana Toll Road and the Chicago Skyway transactions is whether ceding control of toll road assets to the private sector for extremely long periods of time is in the best interest of the public sector or should the public sector seek to raise capital on its own.

Our study of the Indiana Toll Road transaction has indicated the following findings:

1) Consistent with our findings in the Chicago Skyway transaction, use of GDP per capita as an index drives user charges to extremes. We would suggest the public sector carefully analyze the impact of the toll increases it chooses and stick more closely with CPI or floor/ceiling structures. These rate structures can produce acceptable monetization results, especially if combined with additional pass through adjustments for special circumstances. The pass through design is a proven technique in the water and solid waste privatization models.

2) For the Indiana Toll Road transaction it would appear reliance upon toll increases at rates exceeding 3% is the primary driver in establishing value, not the expected growth in traffic, given the maturity of the underlying asset. Thus in order to develop the high purchase price the buyer has heavily discounted traffic growth and is relying upon the higher formularized toll increases to recover the investment.

3) Indiana's sale of the Toll Road, while helping fund transportation projects for the next ten years, will result in depriving the public transportation funding network of very large and much needed future revenues in the final 65 years of the concession agreement to pay for publicly needed capital projects both on and off the toll road. Instead these revenues are directed to private corporate profits and shareholders. If road users are willing to pay higher tolls these funds should be captured for the public good.

4) Projected returns on equity in the Indiana Toll Road transaction, although not as high as on the Chicago Skyway deal, are extremely generous for a mature asset, as a result of the toll increase regime, the limited equity capital requirements and the highly leveraged nature of this transaction. Given this is only the second transaction of its type it is still in the innovative stage where profit margins remain high until market competition improves.

5) Public financing at the same (or even greater) monetization levels would have been very feasible for the Indiana Toll Road transaction and should be considered as a public policy alternative to privatization. Public monetization produces the upfront economic benefit but leaves the control of the road and the future cash flows in the hands of the public sector to fund transportation needs.

6) A hidden cost of the privatization approach is the increased cost of future capital improvements at either higher taxable borrowing rates or equity return rates. This will increase the financing cost of future capital expenditures by at least 60% over the tax-exempt rates available to a publicly owned toll road. In the future Indiana will need to have ratepayers absorb these costs if the State wishes to expand the roadway for public policy purposes, including new exit/entrance ramping to encourage economic development projects.

In conclusion, the Indiana Toll Road transaction has largely been a mirror image of the Chicago Skyway transaction and reenacted the approach of raising upfront dollars for the public sector by monetizing future cash flows based largely upon known increases in toll rate user charges.

The two key question for the public sector remains:

1) *Should the public sector capture the excess revenues generated for public transportation purposes or should they allow the private sector to capture these revenues for private profit?*

2) *Are these types of transaction a public benefit sale or are they a leveraged buyout for corporate profits?*

Additionally the Indiana Toll Road transaction raises a significant new question:

> ***How will the loss of State control over a statewide thoroughfare impact future economic development efforts in the State given the critical role that transportation infrastructure plays in driving economic development and growth?***

The Author of this Research Report is Dennis J. Enright, Principal, NW Financial Group, LLC. He may be contacted at NW Financial Group, LLC, 10 Exchange Place, Jersey City, New Jersey 07302. Phone:201.656.0115. Email: dje@nwfinancial.com.

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Testimony of
Karen J. Hedlund
Partner, Nossaman, Guthner, Knox & Elliott, LLP

Before the
Subcommittee on Highways and Transit
Committee on Transportation and Infrastructure
U.S. House of Representatives

Hearing on "Public-Private Partnerships: Financing and Protecting the Public Interest"

February 13, 2007

Good afternoon, Mr. Chairman, Ranking Member Duncan and Members of the Committee. My name is Karen Hedlund and I am a partner of the law firm of Nossaman, Guthner, Knox & Elliott, LLP. It is my pleasure to review with you today statutory and contract provisions used to protect the public interest in carrying out public-private partnership (PPP) programs. My firm has had the privilege of advising on PPPs in over 15 states in, including Alaska, California, Florida, Georgia, Massachusetts, Minnesota, Nevada, North Carolina, Oregon, Texas, Utah, Virginia and Washington. Our advice is frequently sought on PPP legislation, and I will describe the varying approaches that the states have taken in this area.

I was honored to be called to speak to this Subcommittee in May 2006 when I described how state transportation agencies select private partners and the major projects being financed through PPPs. My remarks today will be focused more particularly on discrete public policy issues that arise in these transactions and how these are resolved through legal and contract requirements. My remarks will focus primarily on use of PPPs to finance and deliver new facilities. I will also briefly mention some additional issues that arise in the context of the long-term concessioning of existing assets.

State PPP Enabling Legislation

As of today over 24 States have adopted legislation authorizing the contracting with private entities for the financing, delivery and operation of new transportation facilities. As with other governmental activities, such laws vary greatly from State to State in their scope and detail,[1] including with respect to such matters as the agencies authorized to implement PPPs; the type, number or location of eligible transportation facilities; project selection and proposal approval; procurement processes; contract types; the role of regional planning agencies, state transportation commissions and advisory committees: and funding and bonding mechanisms.

[1] Compare Texas Transportation Code, §§ 223.201-209 with South Carolina Code Ann. § 57-3-200.

While there are differences in approach, there are many similarities as well. What the states have in common in their approach to PPPs is that they view them as but one "tool in the toolbox" to be used to advance important mobility projects for which traditional sources of funding are lacking.

The basic approach taken in state authorizing laws is two-fold: first, these laws provide the necessary authority to enter into agreement with private sector entities for a combination of services, including design, construction, financing, operation and maintenance. Secondly, they set out the conditions for exercise of this authority. State legislation may itemize issues that should be addressed in PPP agreements,[2] but they usually forbear from prescribing particular solutions. Many state transportation agencies have also adopted detailed rules and guidelines to implement their PPP authority.[3]

Some of the key issues include the following:

How can competition be encouraged?

Most States authorize the responsible public entity to solicit PPPs through a formal request for proposal process. This approach contemplates that the responsible public entity will evaluate its projects in the planning stage to determine which of them may be appropriate for a PPP, taking into account its transportation project priorities, project feasibility, and the agency's relative capabilities to complete the project on its own. Some states also permit consideration of unsolicited proposals. These provisions enable the private sector to propose innovative solutions to mobility that the normal state planning processes might not have produced, provided they satisfy the criteria outlined in the governing statutes and regulations, and are consistent with the state's overall transportation plans. The public entity does not have any obligation to accept an unsolicited proposal, but if the entity is interested in pursuing it, applicable laws or regulations will typically require issuance of a request for competitive proposals to enable interested qualified teams to prepare meritorious competing proposals.[4]

What is the appropriate procurement process?

PPPs require flexibility in the procurement process because such contracts go beyond mere construction to include design as well as operations, maintenance, and, in some cases, financing. Public agencies need to be able to select a procurement process that is most appropriate for a particular project. These might include, for example, calls for projects, competitive RFQs and RFPs, qualifications review followed by an evaluation of proposer concepts, and selection based on financial terms such as return on equity rather than on price.

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[2] See, e.g. Oregon. Revised Statutes § 367.806(b)(2). Virginia Code § 56-566.

[3] See, e.g., the Commonwealth of Virginia, Public Private Transportation Act of 1995, Implementation Guidelines, http://www.virginiadot.org/business/ppta-Guidelines.asp.

4 Georgia's Public Private Initiatives Act, Georgia. Code Annotated §§ 32-2-78 to 32-2-80, originally authorized only unsolicited proposals but was later amended in May 2005 by SB 270 to permit solicitation of proposals. The amendment also increased the minimum time for receipt of competitive proposals from 90 to 135 days.

To effectuate such procurements, exemptions need to be provided from traditional low-bid "design-bid-build" procurement laws so that contracts may be awarded on the basis of "best value" taking into account both short and long-term benefits of the project proposal. In evaluating proposals and awarding a contract, the government sponsor needs to be able to take into account not just the proposed capital cost, but also the value of the commitments made by the private partner, risks associated with the proposal, and public policy issues.[5]

State PPP laws, regulations and guidelines typically call for a two-step procurement process using procedures modeled after practices and procedures that have been used successfully at the federal level.[6] Proposers must first demonstrate their qualifications to undertake a project based on relevant experience in development, design, construction, financing and/or operation of projects with attributes similar to the project being procured; the financial resources they bring to the undertaking and their legal structure. Step two involves issuance of a request for proposals to the shortlisted firms, receipt and evaluation of proposals, and award to the firm that submitted the best value proposal.

How can the integrity of the procurement process be maintained?

Low-bid procurement processes, involving award of construction contracts based solely on price, generally contemplate that bids will be made public upon opening. However, where proposals are being evaluated based on a range of technical issues, as well as price, the evaluation process can take several days, even weeks. In order to maintain the integrity of the process, especially where a second round of "best and final offers" may be sought, it is critical that the agency be able to maintain the confidentiality of the proposals during the review process.[7] . Following actual execution of the contract, almost all agencies release to the public the contracts themselves, the proposals and relevant evaluation information, excepting only proprietary data, such as the financial statements of private companies. This ensures a transparent process.

Where unsolicited proposals are put out for competition, competitors need to know enough about the initial proposal to address essentially the same project. States have taken a variety of approaches with respect to how much of the initial proposal is described in the request for competition. To encourage innovative proposals, sponsoring agencies need to be able to protect the unique intellectual property of the initial proposal from unfair use by other firms in preparing their competitive proposals.

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[5] Virginia's Public-Private Partnerships Act lists non-price factors that may be considered in evaluating proposals. Virginia Code § 56-573.1.

[6] Federal Acquisition Regulations, 48 CFR 36.300 et seq.

[7] See, e.g., Texas Transportation Code § 223.204; Oregon Revised Statutes §367.806(7).

How should the term of the PPP agreement be determined?

Some statutes establish a maximum number of years for the duration of the public-private agreement.[8] The term of any specific agreement should be established with regard to financial feasibility of the project. Projects with weak revenue streams may require longer term for the private operator to be able to achieve its targeted rate of return. Projects with lower revenue risk, such as those where the concessionaire is paid from state funds rather than user fees, can have relatively shorter terms. Some transactions have been structured using "shadow tolls" or "availability payments" involving annual payments by the government from other public sources, based on the actual performance of the project.[9]

On robust projects, the length of the term will also impact the amount of upfront concession fee that the private entity may be willing to bid. The trade-off between term and concession value is a public-sector decision.

How can increases in user fees be limited?
Howe can unreasonable private operator profits be controlled?

One of the most important benefits of public-private partnerships is the contribution of private capital to pay the costs of design and construction of a project, as well as long-term operation and maintenance, rehabilitation and upgrades. Typically the private partner is repaid, and is permitted to earn a return on its investment, through assignment of a stream of revenues which consists of an interest in the tolls or other fees paid by users of the project.

Such agreements are structured to cap, directly or indirectly, toll rates and private sector returns; they do not guarantee a profit. In other words private investors have a ceiling on the profits they can make but no floor on how much money they can lose. If in fact private investors are losing money on a project, generally speaking the public agency sponsor has no legal or moral obligation to assist—and in practice, they do not.

Thus, authorizing statutes address who has rate-setting authority to impose user fees and under what circumstances may they be changed or otherwise reviewed. Authorizing legislation must contain provisions permitting the adjustment of toll rates to allow the private partner to obtain a reasonable rate of return on its initial capital investment, repay its lenders and pay the costs long term operations and maintenance and other improvements, which are subject to inflation. However, the decision on how much and how fast user fees should be permitted to rise is a public sector decision involving significant public policy considerations, and public input may be

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[8] See, e.g. Texas Transportation Code § 227.023(f) which limits public-private agreements for the Trans-Texas Corridor to fifty years. Colorado permits a franchise or long-term lease of up to 99 years, Colorado Revised Statutes §43-1-1202(1)(d)(II).

[9] The proposed concession agreement for the Miami Port Tunnel will be the first transaction in the United States involving an "availability payment" scheme. The proposed term of the concession is 35 years. http://www.portofmiamitunnel.com/faq_finan.html

sought. The final decisions can be implemented through contract terms specifying maximum annual toll rate adjustments, which may be tied to a formula or an index.

Laws that require public commission approval of specific increases tend to create uncertainties that may discourage private investment. The maximum profits that a private entity can secure is be controlled through the use of other contractual devices. For example, contracts can require that if the private entity's rate of return exceeds a specified percentage, excess revenues are returned to the sponsor agency. Such revenue sharing provisions also provide the governmental authorities the option of requiring the private operator to lower user fees to the level where excess revenues are minimized.

In congested corridors, where mobility and environmental considerations require time of day variations, the public sector may want to require that the private operator implement "variable pricing," where tolls are increased in order to assure free flow of traffic. In this case public agencies use contractual provisions strictly regulating allocations of resulting revenues between the private entity and the public sector.

Are there reasonable approaches to the issue of unplanned revenue impacting facilities?

To finance against a long-term stream of revenues, lenders and investors need to be able to make projections of revenues based on reasonable assumptions about future demand. The public sector, on the other hand, needs to be free to make investments in the future to meet actual growth, foreseen or unforeseen.

Today PPP agreements have moved away from prohibiting the public sector from building what have been termed "competitive facilities," but are more accurately termed "unplanned, revenue impacting facilities. The public sector should not be enjoined from making whatever public investments are required to meet future public needs. There was only one project actually built that allowed that—the SR 91 facility; the market has evolved dramatically away from that in the 16 years hence.

Instead, agreements now provide for possible compensation to be paid to the private operator if and only if the construction of facilities <u>not currently planned</u> result in a proven reduction in revenue produced the privately operated facility. And in making their initial projections, the private investors can be required to take into account everything that may be included in the region's long-term plans, whether or not funding is currently provided for.[10]

How can long-term performance be assured?

One of the most often-expressed fears about public-private partnerships is that the private operator, in an effort to maximize its profits, will fail to maintain the asset or make necessary improvements. In contrast many observers point out that, in fact, the private entity will be highly

[10] This approach is codified in California Streets and Highways Code § 143(d)(3).

motivated to maintain the facility in top condition in order to protect its investment and attract the greatest number of customers.

Contract terms can secure these expectations with detailed performance requirements that have become standard in these transactions. Additional security for the operator's performance can be provided through requiring deposits to be made to reserves for operation and maintenance and rehabilitation ahead of distributions to equity investors. Other forms of financial security can be required to assure that the facility is in good repair when it is handed back to the public at the end of the term of the agreement. These state laws and contract provisions also provide the public sponsor the ability to monitor, inspect and audit the private operator's performance. In addition, the operator's lenders will also have a strong interest in policing the operator to avoid any threat of contract termination due to the private operator's default.

What if the private operator defaults?

Concession contracts will typically provide that if the private operator materially defaults in carrying out its obligations or becomes bankrupt or insolvent, the private sponsor can terminate the agreement and either contract with another entity to operate the facility or step in and operate the facility itself. As a result, some state statutes address the issue of whether tolls or user fees can continue to be imposed by the governmental entity or a substitute operator after termination of the original agreement and whether such tolls may be used to satisfy the liens of the original operator's lenders.[11]

Most public agencies retain the right to terminate a contract "for convenience" when they deem it in the public interest, as a result of changed circumstances or a change in public policy, but the private investors will require that in such event the public sector pay "fair value" to the private operator, as would be the case in a condemnation proceeding.

Can PPPs be used to avoid prevailing wage and WMBE requirements?

PPP projects are not generally exempted from other state law requirements applicable to public works projects, such as prevailing wage and women and minority business enterprise requirements, at least if they receive any public funds. PPP projects that receive federal support, including grant funding, TIFIA and Private Activity Bonds, are likewise subject to all otherwise applicable federal requirements, such as Buy America and Davis Bacon.

What other issues arise in long-term leases of existing assets?

These statutes I have described above, primarily relate to the development of new transportation facilities. With respect to long-term concessioning of existing assets, specific authorizing legislation may be enacted as was the case for the Chicago Skyway and Indiana Tollroad

[11] See, e.g., Virginia Code §56-568.

leases.[12] . This class of transactions is very different than the public-private partnerships employed primarily to build capacity that otherwise would be deferred for many years or not built at all. The monetizing of existing state-owned enterprises involves a number of issues in addition to those discussed above. These include such things as the need for independent verification of asset value, how proceeds of the transaction should be used and what protections should be afforded existing public employees.[13]

Conclusion

Public-private partnerships can be a powerful tool to deliver needed infrastructure improvements, especially where traditional public sources of funding are lacking. The authorizing legislation in many states reflects significant thoughtfulness about the proper processes to be used to implement PPPs in such a way that the public interest is protected over the term of the agreements. Public agencies also have at their disposal a wealth of contract provisions used around the world to insure that private partners keep their end of the bargain and not take unfair advantage of the public in operating public use facilities.

Justice Louis D. Brandeis wrote in 1932, "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[14]

The experiments of individual states with public-private partnerships are proving successful in providing new funding to meet mobility and safety challenges. These state endeavors should contribute to new ways to help provide a national transportation system that serves the social and economic needs of the entire county.

[12] With respect to the lease of the Indiana Toll Road, see Indiana General Assembly, 2006 Session, HEA 1008.

[13] See labor provisions in act authorizing lease of Midway Airport, 94th General Assembly, State of Illinois, Public Act 094-0750.

[14] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932).

Karen J. Hedlund
Nossaman, Guthner, Knox & Elliott, LLP
2111 Wilson Blvd., Suite 1110
Arlington, VA 22201-3001
703-682-1751; fax 703 682-1755

Statement for Highways and Transit Subcommittee Hearing
Public-Private Partnerships
By Rep. Grace F. Napolitano
February 13th, 2007

I want to thank Chairman DeFazio for this important hearing. I hope public-private partnerships successfully improve transportation in our country, but I have been wary of public-private partnerships in California.

The SR-91 freeway is just south of my district and the private sector built 4 ten mile express lanes in 1995. It cost them $135 million to build these express toll lanes. The problem was that the project contained a non-compete clause that prevented public agencies from increasing highway capacity within 1 ½ miles of SR-91. This restricted the state from widening the free lanes and building mass transit. This non-compete clause contributed to congestion in the area and created unsafe conditions along SR-91 and arterial routes. The Orange County Transportation Authority had to buy the toll lanes in 2003 from the private sector for $207 million to eliminate the non-compete clause. The project ended up costing taxpayers more than necessary and increased congestion and created unsafe conditions. The lanes are used today as a HOV / tollway hybrid.

Additionally, **Foothill Transit** is a Public Private Partnership transit agency operating in my district. A Joint Powers Authority of 21 cities and Los Angeles County govern the routes, services, and investment in the transit agency. A foreign, private company (Veolia Transportation) manages and operates the transit service. Foothill Transit's

public-private arrangement has resulted in a cost per hour operating cost of $80.33, well below peer agencies in California. It has been lauded by some as a great example of how public-private partnerships can increase efficiency and lower costs in the transportation industry. Others have criticized Foothill's economic efficiency as a result of cutting workers' salaries and benefits.

The Department of Transportation must take into consideration these concerns as they encourage public-private partnerships. They must make State DOTs aware of the risks involved and educate them on how to avoid the risks, especially with non-compete clauses and workers pay issues.

I thank the Chairman again for this important hearing and highlighting the concerns that many state DOTs have with public-private partnerships.

PUBLIC-PRIVATE PARTNERSHIPS FOR TOLL HIGHWAYS

Testimony of Robert W. Poole, Jr.
Director of Transportation Studies
Reason Foundation

Subcommittee on Highways and Transit
House Committee on Transportation and Infrastructure

February 13, 2007

Reason Foundation
3415 S. Sepulveda Blvd., Suite 400
Los Angeles, CA 90034
310-292-2386
www.reason.org/transportation
bobp@reason.org

My name is Robert W. Poole, Jr. I am the director of transportation studies at the Reason Foundation, a pubic policy research institute based in Los Angeles. I have been researching privatization and public-private partnerships (PPPs) since the late 1970s, and transportation PPPs since the late 1980s. In 1988 I wrote the Reason policy paper that led to California's pioneering private toll road pilot program, which brought about two of the first U.S. toll road concession projects. I have advised the departments of transportation of half a dozen states, along with the U.S. Department of Transportation and its Federal Highway and Federal Transit Administrations. I have also served on several special committees of the Transportation Research Board dealing with highway finance issues.

Today's hearing is being held because the last two years have seen a major increase in interest, on the part of investors and toll road companies, in the U.S. highway market. The underlying reason for this interest is the large and growing funding shortfall in the highway sector. The most recent Conditions and Performance Report from the Federal Highway Administration estimated annual capital investment in our highways at $68 billion—yet simply to properly maintain the condition of our highways and bridges, we should be spending $6 billion more every year. And to improve the system, to cope with increases in auto and truck travel, we should be spending $51 billion more every year.

The existing state and federal fuel tax and highway trust fund system seems to be unable to meet these investment needs. Neither the Congress nor most state legislatures have increased fuel taxes to levels that would even offset increases in fuel efficiency and the ravages of inflation, let alone coping with increased travel demand. So increasingly, states are turning to toll finance and PPPs to begin to fill the funding gap.

The newest trend is the rediscovery of the long-term concession model of public-private partnership. Under this model, in exchange for a long-term license to operate a toll road, an investor-owned company will finance, design, build, operate, modernize, and maintain a highway project, financing its expenditures from the toll revenues it is allowed to charge. This is a modernized version of the toll road charters issued by governments in the U.K. and states in the USA in the 18th and 19th centuries for the original turnpikes in both countries. It was revived in the 1990s with the Dulles Greenway in Virginia and the 91 Express Lanes and SR 125 toll projects in California.

This model is what built most of the postwar toll motorway systems in France, Italy, Portugal, and Spain. That's why investor-owned companies from those countries are among the world leaders in the toll road business. Australia discovered this model in the 1980s, and today both Melbourne and Sydney are well-served by modern urban toll roads—and two Australian companies have become investors in the U.S. toll road market. The model was adopted in Latin America in the 1990s, especially in Argentina, Chile, and Brazil. And today the concession model is being used, as well, in Canada, Britain, Ireland, Germany, Norway, Greece, as well as Eastern Europe.

Essentially what this model is all about is extending the investor-owned utility concept from network industries like electricity and telecommunications to the network industry of limited-access highways. Just as those vital industries are affected with the public

interest, so too is the highway industry. And just as the public sector has a role to play in protecting the public interest in those network industries, so it has a comparable role to play in the highway industry.

What has worked best around the world for protecting the public interest is to incorporate detailed provisions and requirements into the long-term concession agreement. And the issues that need to be addressed in the concession agreement turn out to be pretty much the same, whether the agreement concerns the leasing of an existing toll road or the development of a new one. Over the span of 50 or 75 years, major construction or reconstruction will be required in either case, so all such concession agreements must address the same set of issues. The only major differences between agreements for existing toll roads and those for new ones is that the former involve large new revenues for the states and smaller construction commitments, while the latter involve much higher levels of initial risk for the private partner, including very large construction commitments.

Advantages of Long-Term PPPs

Since toll finance can help this country close the financing gap, why not simply rely more on traditional public-sector toll agencies to do the job? In working on these issues for the past two decades, I have identified six important advantages of the PPP concession model.

1. Access to large new sources of capital.
The tax-exempt toll revenue bond market appeals to one particular class of investors: people who pay taxes and like the ability to add tax-exempt bonds to their portfolios. The concession model opens the door to equity investors as well as lenders. And especially important, it opens the door to institutional investors such as pension funds that do not purchase tax-exempt bonds because they don't pay taxes. Infrastructure has become a fashionable asset class for a host of investors that don't invest in toll-agency bonds. Michael Wilkins of Standard & Poor's recently estimated that $100-150 billion was raised last year to invest in infrastructure. Goldman Sachs alone recently raised over $6.5 billion to invest in infrastructure. All this should be welcome news to those of us who have been concerned over the huge shortfall in U.S. highway investment.

2. Ability to raise larger sums for toll projects.
New highway capacity is far more costly these days than it was when the Interstates were built. Hence, rebuilding and modernizing our freeways and Interstates will be far more costly than most people realize. There is growing evidence that the long-term concession model can raise significantly more funding for a given toll project than the traditional toll agency financing model. For a new toll road in Texas, for example, a toll traffic and revenue study estimated the ability to finance $600 million, but the project's cost was $1.3 billion. Texas DOT turned to a long-term concession approach, in which the private sector will finance the entire $1.3 billion project, in exchange for a 50-year concession. Three factors seem to drive such results. First, the concession agreement adds certainty to future toll increases that always far less predictable with toll agencies. Second, the private

sector seems more aggressive in both attracting traffic and in reducing costs (e.g., by making full use of electronic toll collection). And third, the private sector can take depreciation as a tax write-off, like any other business, but toll agencies can't, since they pay no income taxes.

3. Shifting risk from taxpayers to investors.
Public-private partnerships involve parceling out duties and risks to the party best able to handle them. Thus, the state is the party best able to handle right-of-way acquisition and environmental permitting, so those tasks and risks are assigned to the state. The private sector in these deals nearly always takes the risks of construction cost overruns and possible traffic and revenue shortfalls. Given the poor track record of the public sector in transportation mega-projects (e.g., Boston's Big Dig), being able to shift construction and traffic/revenue risk to investors is a major advantage.

4. Multi-state potential.
One of the most important unmet needs for highway investment is to cope with the growth in truck traffic. Much long-haul truck traffic involves several states, connecting a port or other origin to a major destination (such as a logistics hub). State toll agencies are legally limited to doing projects within their own state. By contrast, now that both are privatized, the Chicago Skyway and the Indiana Toll Road are being managed jointly, as an integrated system. Long-term concessions are a good vehicle for organizing multi-state projects such as truck-only toll lanes to serve major shipping routes. These projects need to be developed in a unified manner, offering seamless service from origin to destination. The federal government can continue to play a vital role in standardization, but individual states or their toll agencies are not well-positioned to develop such unified projects; concession companies are.

5. More businesslike approach.
There are some very businesslike toll agencies, but most are constrained in significant ways by being part of the public sector. Many toll agencies are run by short-term political appointees, rather than by career toll road professionals. Some also are constrained to deal with politically favored contractors. Some come under civil service rules, which may prevent them from attracting the best talent or paying market rates for people. They offer more-limited career paths for professionals, due to their being limited to a single state and perhaps a handful of toll roads. And some have been very slow to adopt cost-saving, customer-friendly technology such as electronic toll collection. Comparing the typical U.S. toll agency with the typical European or Australian toll road company, it's clear that the latter are far more customer-oriented, more innovative, and generally more commercial in their approach to the business of toll roads.

6. Major innovations.
One of the most important advantages of investor-owned toll road companies is their motivation to innovate, in order to solve difficult problems or improve their service to customers. Here are three examples:

- Today, we know that variable pricing (also known as value pricing) works very well to eliminate traffic congestion during peak periods, actually maximizing

throughput while maintaining high speeds. Electronic toll collection makes value pricing possible—but it was a private toll company in California that took the initiative to introduce and perfect value pricing; no state toll agency was willing to take the risk of doing so.

- Toll road companies are also good a value engineering—thinking outside the box to dramatically reduce the costs of new capacity. A case in point is the forthcoming HOT lanes on the Beltway in northern Virginia. Virginia DOT's plan to add two HOV lanes in each direction on that section of the Beltway would have cost $3 billion—money that VDOT did not have. The private sector team's unsolicited proposal called for adding two HOT lanes in each direction, the same amount of physical capacity. That project will cost about $1 billion, thanks to value engineering that reduced or eliminated many "bells and whistles" that added large costs but very little real benefit.
- In France, an unsolicited proposal from a private toll firm resolved a 30-year impasse over completing the missing link—through Versailles—of the A86 Paris ring road. The company is completing the link as a deep-bore tunnel *underneath* Versailles, and is financing the $2 billion project with value-priced tolls.

Misconceptions About Toll Road Concessions

Although it has been used successfully in Europe for some 40 years, the long-term toll road concession model is still novel in America. So it is understandable that people are still trying to understand what it is all about. Here are some common concerns and my responses to them.

1. Sale vs. lease

None of the transactions that have occurred or are being planned—either for existing toll roads or for new ones—involves the *sale* of any roads. Some forms of PPP involve short-term contracts to design and build a road or bridge, or to design, finance, and build it. The most dramatic form—the long-term toll concession—still involves only a long-term lease, not a sale. The government remains the owner at all times, with the private sector partner carrying out only the tasks spelled out for it within the concession agreement and according to the terms set by the state. Done properly, these deals are truly partnerships, in which the state does what it does best (right of way, environmental permitting, policymaking, enforcement of performance requirements, etc.) and the concession company does what it does best (design, finance, construction, operation, marketing, customer service, etc.).

2. Foreign investment

In the early years of U.S. adaptation of the concession model, states want to deal with firms that have extensive experience as toll road providers. The simple fact is that the United States has no such industry, as yet, because we have used only public-sector agencies to build and operate toll roads. Thus, a responsible state government, wanting to ensure that the toll road is in experienced, professional hands, will weight prior experience very heavily in its selection criteria. As the U.S. market matures, we will see the emergence of a U.S. industry. Already, joint ventures between U.S. and global

companies are bidding on such projects—Fluor/Transurban, Zachry/Cintra, Kiewit/Macquarie, to name several recent examples. Likewise, U.S. financial institutions have been creating multi-billion-dollar infrastructure investments funds, so these deals are about to start tapping U.S. capital in a major way. It's important to remember that even deals that involve 100% non-U.S. companies are very good for the U.S. economy. Attracting billions of dollars in global capital (and expertise) to modernize America's vital highway infrastructure is a large net gain for this country. We might keep in mind that 150 years ago, European capital played a major role in creating America's railroad network.

3. Eminent domain

There is understandable concern that toll road privatization might lead to private companies acquiring the power to condemn land for right of way. To the best of my knowledge, none of the nearly two dozen state PPP enabling acts has delegated any such power to private partner companies. The eminent domain power is always reserved by the state, in its traditional role of acquiring rights of way for public-use infrastructure. Toll road companies with the available use of eminent domain by their state DOT partner have tended to avoid its use wherever possible, preferring to acquire land by negotiation.

4. Uncontrolled tolls

There are concerns that PPP deals will lead to sky-high toll rates in future years, leaving the impression that tolls are uncontrolled. That is not the case in any actual or proposed PPP toll road that I'm aware of. Most concession agreements, to date, have incorporated annual caps on the amount that toll rates can be increased, using various inflation indices. It is important to note that those caps are *ceilings*; the actual rates a company will charge depends on market conditions. Before entering into any toll road project, a company (or a toll agency) does detailed and costly traffic and revenue studies. A major goal of such studies is to determine how many vehicles would use the toll road at what price; too high a toll rate means fewer choose to use the toll road, which generally means lower total revenue. So the toll road must select the rate that maximizes total revenue. That rate may well be lower than the caps provided in the concession agreement, especially in recession years.

There are some cases, such as HOT lanes or Express Toll Lanes, where a main purpose of value-priced tolling is to manage traffic flow. In those cases, pre-defined limits on toll rates defeat the purpose. Those rates must be allowed to vary, as needed, to keep traffic flowing freely at the performance level specified—such as Level of Service C. When such value-priced lanes are operated under a concession agreement, instead of limiting the toll rates, the agreement should limit the rate of return the company is allowed to make, with any surplus revenues going into a state highway or transportation fund. That is how California's original pilot program for long-term concessions dealt with the issue, and similar deals have been done in Texas and Virginia.

5. Up-front payments versus long-term revenue sharing

Many have expressed concern that Chicago and Indiana opted to take all of their lease payments from their concession companies up-front, as a lump sum payment. In each

case, the governments in question are using those proceeds largely or entirely for debt retirement and/or capital expenditures, with Indiana investing all their proceeds in long-lived highway improvements. But there is clearly a trade-off between up-front payment versus ongoing lease revenues over the life of the agreement. Several recent concession agreements—the Pocahontas Parkway in Virginia and the SH 130 (segment 5 and 6) in Texas—involve a small up-front payment and revenue sharing in later years. In Britain there have been concession agreements with annual fees paid to the government. The trade-offs for a state entering into a concession deal are twofold: (1) current capital needs versus long-term needs, and (2) sure thing (up-front payment) versus some risk as to what future revenues may be. There is clearly no single right answer; each state must weigh the trade-offs involved with each individual project.

6. Could the public sector do equally well?

Some commentators, such as Dennis Enright of NW Financial Group, have argued that a public-sector toll agency could raise just as much money as is being realized via the lease of existing toll roads by aggressively refinancing their toll roads. I disagree with that assessment. The single most important factor driving the higher valuation accorded to concession toll road deals is the certainty of being able to raise toll rates over the life of the agreement. No one has yet figured out a way to bind future elected officials from interfering in the toll-setting decisions of state toll agencies—and the capital markets take that into account in judging what they will finance. But by allowing the state to enter into concession agreements—which are legally enforceable long-term contracts—a legislature can choose to limit its future ability to intervene in toll-setting decisions. This is analogous in some respects to Congress's innovation in creating a base-closing process with which individual members cannot intervene. Both change the rules of the game in ways that create economic value.

7. Losing control

The widely expressed fear that states will lose control of vital highways reflects a misunderstanding of the true partnership created by the long-term concession agreement. These documents typically run to several hundred pages, and may incorporate other documents (e.g., detailed performance standards) by reference. Hence, ensuring that the public interest is well-protected is the key challenge in drafting such agreements. It is vital that a state planning to make use of such agreements hire and pay for top-quality legal and financial expertise to assist it in drafting and negotiating concession agreements. The agreements need to spell out who pays for future expansions and reconstruction, how decisions on the scope and timing of those projects will be reached, what performance will be required of the toll road, how to deal with failures to comply with the agreement, provisions for early termination of the agreement, what protections (if any) will be provided to the company from state-funded competing routes, what limits on toll rates or rate of return will be, etc. Most importantly, the concession agreements spell out procedures for amending the agreement itself without unfairness to either party. Neither the City of Chicago nor the State of Indiana has bound itself irrevocably to the initial terms of their concession agreement for 75 or 99 years. (Indeed, Indiana and its concession company negotiated a major amendment to their agreement, delaying toll

increases for commuters, between the time the concession was signed and the date it went into effect.)

Fortunately for the United States, we do not need to start from scratch, since Europe has four decades of experience with toll road concessions, and Australia and Latin America also have valuable experience we can draw from.

Summing Up: 21st Century Highways

The two mainstays for highway finance and development in 20th century America were the fuel tax plus highway trust fund and the state toll agency. Both played key roles in developing a high-quality urban and inter-city roadway network. But as we move into the 21st century, we have come to see that both have serious limitations.

The tax and grant system has run into serious problems of raising enough money even to maintain the physical condition of our existing road system. And most state toll agencies fall well short of the performance and financing ability of the toll road concession system now widely used in Europe, Australia, and Latin America for limited-access roadways.

In the 20th century, America showed the world that investor-owned electric, gas, and telecommunications utilities worked better than the state-owned utilities then carrying out these functions in virtually all other countries. Late in the century, nearly every developed country privatized those utilities, learning from the U.S. model. But even before doing that, those countries had developed the concession model for investor-owned roadway utilities, mobilizing billions in private capital to develop high-quality toll motorway systems, both urban and intercity. Now it's time for us to learn from our counterparts overseas, adapting the concession model to U.S. highway needs.

We should be grateful that the hard work of figuring out how to protect the public interest while drawing on private capital and private-sector expertise has largely been done by our counterparts in Europe and Australia. All we need do is tailor and fine-tune their models. We should also be grateful that the global capital markets have discovered the U.S. highway market, just when we need to mobilize hundreds of billions of dollars to rebuild and expand our highway network.

As the think tank that has done the most research on public-private partnerships and their applicability to transportation infrastructure, the Reason Foundation welcomes the opportunity to be of further assistance to the Congress, as you learn more about these new approaches. Please feel free to call upon us.

Testimony of

Alistair Sawers,

Director, RBC Capital Markets

Before the Subcommittee on Highways and Transit,

Committee on Transportation and Infrastructure,

U.S. House of Representatives

on February 13th 2007

PPPs: Protecting the Public Interest

Good morning, Mr. Chairman, Ranking Member Duncan and Members of the Committee. My name is Alistair Sawers and I hold the title of director at RBC Capital Markets where I head the Western region of the Infrastructure and Project Finance Group. It is my pleasure to discuss with you today the experience of other jurisdictions, particularly in Europe, in protecting the public interest while carrying out public-private partnership (PPP) programs.

In the last 13 years I have had the privilege of advising either the Public or Private sectors on over 40 PPP procurements in 12 different countries including the UK, Canada, Spain, Portugal, Sweden, Chile and the Russian Federation as well as in 5 different States in the US.

My remarks today will be focused on public policy issues that arise in these transactions and the approaches to resolving these issues adopted in other jurisdictions. My remarks will focus primarily on use of PPPs to provide the design, construction, financing, and operation and maintenance of new facilities.

Defining the concepts

Defining Public Private Partnerships

- Public Private Partnership ("PPP") relationships are very different from privatization, in which the market and price mechanism defines the service provided. The private sector has always been involved in the building and maintenance of public infrastructure. PPP ensures that contractors are bound into long-term maintenance or operating contracts and take responsibility for the quality of the work they do. With PPP, the public sector defines what is required to meet public needs and remains the client throughout the life of the contract. The public sector also ensures, by contract, delivery of the outputs it sets and has rights under those contracts to change the output required from time to time. In a PPP, the government role changes from that of directing and managing infrastructure to one of oversight and maintenance of quality service outcomes.
- The term PPP covers a broad spectrum of Private involvement in the procurement of Infrastructure which is summarized for reference in the table below. It does highlight that the default method of procurement in the majority of international jurisdictions is Design Build. As a result most international comparisons between PPPs and conventional procurement are comparisons with Design Build.

Procurement Option	Design & Construction	Operations & Maintenance	Tolling Operations	Construction Finance	Repayment	Examples
Government Procurement					Milestone payments	Design & Build (D&B) most countries
Construction Finance					Lump sum on completion	German A Model
Build Transfer Lease					Lease payments over time	Korean BTL, and UK Design Build Finance Transfer (DBFT)
Concession without tolling					Availability payments	UK & Hungarian DBFO, Canadian P3s
Concession with shadow toll					Shadow toll payments	Early UK DBFO, Portuguese SCUTs
Concession with toll operation					Toll revenue	Croatia, Spain, Chile, USA Toll Roads, German F Model
Concession collecting tolls					Availability payments	Some Norwegian PPPs

- Similarly more of the International PPPs in the Highway and Transit sectors are focused on new construction projects, which are also known as Greenfield projects rather than refurbishment or enhancement projects, which are also known as Brownfield projects. Currently in the US the focus has been more on Brownfield projects, though again these vary from: the mainly Operations & Maintenance focused such as Chicago Skyway; to the Refurbishment focused such as the Missouri Bridge Replacement PPP; to the enhancement focused such as the I495 Managed Lanes/HOT Lanes. Each has different risks and requires a slightly different approach.
- These warnings aside there is much to be learnt from the international experience in PPPs, especially as many of the engineering companies and investors in the US PPP market have international experience. Examples include Fluor, Bechtel, Kiewit, Granite, KBR (Halliburton), Aecom, John Hancock and GE Capital as well as the well publicized Macquarie Infrastructure Fund and Cintra.

Issues of Public Interest Regarding PPPs

Benefit to the User

- The primary focus should be maximizing the benefits to the user given the finite sources of revenue to pay for them. These breakdown into:
    - improving the user benefits in terms of reduced journey times and variability in those times and improved quality of service;
    - reducing the whole-life cost of the service (highway/bridge/streetcar etc) either by increased efficiency or by cost reductions; and
    - maximizing alternative revenue sources or reducing revenue volatility to maximize the amount of funds which it can be used to raise.
- Improving user benefits is not just a matter of delivering a new project. It is also a matter of addressing policy objectives regarding issues such as congestion, corridor management, safety and land development. In a PPP the public sector loses the ability to modify project once it is defined in the concession contract, in return for transferring cost risks. As a result, the outputs of the PPP have to be carefully defined in the concession and the incentives have to be carefully structured. In the case of the latter, Norway has procured PPP toll roads where it has chosen to retain the tolls and pay an availability payment with safety and performance deductions to match its policy objectives. In contrast, the second phase of the Manchester Transit PPP had a performance regime which was not detailed enough, so when traffic did not grow as expected the operator fell behind on station maintenance and cut other discretionary costs and the Public Sector had no remedy.
- In the UK which was one of the first countries to wholeheartedly embrace PPPs in its Private Finance Initiative (PFI), one of the key motivations for PPPs was to transfer risks away from the Public sector where the Private sector was best placed to manage them. The focus on maximizing efficiency by optimizing risk transfer required a move away from low bid procurement to a more negotiated concept which took into account the risks accepted. This was named "value for money" and the concept is used now in many jurisdictions both to compare a PPP procurement to a publicly funded one and to a lesser extent to compare PPP bids with different risk allocations.
- Another objective of international PPP procurement programs has been to allow innovation in terms of both efficiencies and improving revenues. Simple cases have included peak hour pricing for tolls, regular pricing indexation and addition of the proceeds of Transit oriented development. Here the concern is that the public sector or the user gets value for these innovations rather than just being upside for the private sector.

Political Issues

- A significant concern, even if a project is thought to be good value for money is that the expected risks do not occur and the private sector earns unexpectedly high returns. Politically this is one of the key issues, especially where tolls or transit fares have been the source of the revenue, even though the private sector may be able to argue it was taking a high risk and should be recompensed. Another source of high returns on UK projects has been the refinancing of PPP project debt which resulted in equity investors receiving large windfalls due to the large drop in interest rates between the late 1990s and 2002-4.

- PPPs have created significant Labor issues in Canada, UK and some other European countries despite generally creating more jobs, especially in the construction industry. The issue has been more about the less favorable terms of employment in the private sector and the immediate reduction in headcount. In the US the issue is complicated by the reduction in work for the public sector Designers in some states.
- A typical PPP Highway or Transit project which is funded by user fees will be a monopoly (though may have competing modes) so there will be concern that the right Toll or Fare increases could be abused before revenues started to fall. Unfortunately this is more an issue of public perception regardless of how increases are controlled by the Concession Contract.

PPP's Inherent Protections

Contractual

- Contractual process forces the public sector to either more closely define the project or to create output specifications for the service. Once set the nature of the contract makes the changes much more difficult which cuts down variations and claims so while construction is typically more expensive using the initial prices, the final price is cheaper than a pure (Design) Bid Build. Initial experience with PPP procurement in the UK was that a large amount of the benefit of PPP came from reductions in change orders which reduced cost and delay. This effect should be especially pronounced compared to pay-as-go style projects where there are long gaps between phases which make changes and abortive work much more common.
- With PPP projects the Public Sector has 3 layers of protection against failure to complete construction compared only the Surety Bond under a normal procurement. The first layer is the concession company requiring bonds from the contractor, the second is the equity which stands to lose all of its investment (and frequently includes the contractor) and the final layer is the debt which has the option to step-in to the contract and ensure performance to save its money (which is typically 80-90% of the deal). A study by the UK Treasury in 2003 detailed in the box to the right found that these protections resulted in 89% of projects being delivered on time. Previous research had shown that 70 per cent of non-PFI projects were delivered late and 73 per cent ran over budget.
- As the Debt has only one form of security – the PPP contract – it is incentivized to police contract and many of its incentives are aligned with the Public Sector. In order to give the debt a cushion to remedy any problems before a default can be triggered, the debt will typically require stronger versions of the performance terms in the concession contract

Research conducted by the Government and others, particularly the National Audit Office (NAO), confirms the largely positive impact of PFI to date and highlights areas where there is scope for further improvements. Chapter 4 provides details of HM Treasury research of 61 PFI projects. The key findings were:

- 89 per cent of projects were delivered on time or early;
- all PFI projects in the HM Treasury sample were delivered within public sector budgets. No PFI project was found where the unitary charge had changed following contract signature – other than where user requirements changed;
- 77 per cent of public sector managers stated that their project was meeting their initial expectations; and
- there is scope to reduce procurement times, although there is evidence that new initiatives to tackle this problem are having an impact.

PFI: meeting the investment challenge – UK's H M Treasury July 03

Note: PFI was the former name if the UK's PPP program

to be reflected in the PPP company's construction and operation contracts. Another frequently quoted example is the bankruptcy of the PPP construction firm, Jarvis in 2005. All of its deals were restructured at no cost to the public sector, and despite having 21 at various stages of construction, new contractors were brought in to complete all of the projects.

- The PPP contract fixes the revenue sources for the PPP company for 30-99 years. Within that the PPP company is incentivized, subject to the construction and performance requirements, to optimize its initial investment and design to minimize the combined cost of construction, operation and maintenance ("whole-life cost") of the project. Examples include more robust pavement design which requires fewer maintenance interventions or toll gantry designs which allow maintenance without lane closures.

Procurement process

- The competitive process to procure a PPP project allows competition on both price and on acceptance of risk. This gives significant protection for a public sector procurer against signing a deal which is bad value for money as the PPP company needs to bid higher than its competitors.

Market Pressure

- Like a full privatized entity a PPP company which takes Toll or Fare risk, even if it has some monopoly characteristics is already incentivized to provide a quality service and to avoid pricing users away. On projects such as managed/HOT lanes this dynamic and the free alternative can very effectively regulate the toll and quality levels. This was amply demonstrated on the Mexican Toll road concessions when the PPP company attempted large toll increases to recover losses due to currency depreciation and the traffic diverted to the much lower quality free alternative.

Additional Protections used in International Projects

Contractual

- The problem of excessive returns has been addressed by several mechanisms including: a revenue share which triggers at high levels of traffic or equity return; or by terminating the concession when the return reaches a pre-defined target level. In most cases however, toll or fare restrictions are the main focus. Also a large number of international projects use capped Availability/Performance Payments or Shadow Tolls which are paid by the public sector and are capped.
- In addition to being capped Availability Payments include with specific incentive payments to address the public sector's policy objectives. In Norway the Roads Directorate pays a bonus based on the safety record of the PPP highway, in British Columbia on the Sea to Sky Project the are additional payments for meeting First Nations employment targets and deductions for closing lanes which vary according to the impact on the traffic flow. The UK Government has implemented a Congestion Payment regime on their A1 Darrington to Dishforth PPP project which is based on maintaining the average traffic speed above target levels.

- As mentioned above the Refinancing PPP projects can lead to windfall returns and many International PPP contracts now include provisions to share in the benefit. TxDOT has also included such a provision in its programmatic term sheet for its CDA projects.
- The issue of Compensation for Competing Roads or Transit projects has not had quite the same profile it has had in the US. Obviously, it is not an issue for Availability Payment schemes but it is an issue for Shadow toll roads, where the public sector payment is based on traffic levels, but there it is possible to rebase the payment to reflect the lower traffic levels which automatically compensates the PPP company. In most other cases, the agreement has been compensation for a demonstrated impact within a very narrow corridor, rather than any kind of non-compete like the one that caused the problems on SR91 in California.
- An early objective of the UK's PFI program was to turn procurement away from asset provision to service provision so the UK PPPs focused on specifying the service output rather than the design or procedures to be used. For highways this meant using performance payments based on indicators such as surface quality, skid resistance and incident response times. These standards had the added benefit of not being dependent on a particular technology.
- Labor protections have been incorporated into PPP agreements. Several countries have legislation which specifically addresses the transfer of Public Sector workers to the Private Sector and provides protection for all or a portion of their benefits and these have been integrated into PPP agreements.

Procurement

- As mentioned above, several jurisdictions undertake a value for money analysis of their PPP concessions at various stages of the procurement to ensure that the PPP project delivers better value than the conventional methods of public procurement (in the UK called the Public Sector Comparator, in Canada called the Shadow bid). While the valuation of the risks transferred in not an exact process, these reports have also proved useful in demonstrating value (or not as the case may be) of the PPP project to stakeholders such as the users or the appropriate legislature.
- In some Availability Payment projects this analysis is formalized into an affordability number (or else it is just based on the capacity of the public sector to pay). This provides a cap on the potential bids and puts pressure on the private sector bidding for the project. In the case of the Sea to Sky Project in BC it was used in a tender that defined the payment and asked the bidders to maximize the improvements to the highway for that price.
- Many countries have set up public entities to promote sharing of best practice in PPPs. Generally, the public sector teams procuring these projects will only work on one or two projects but they face bidders who have worked on many more projects. As a result the public sector needs access to past experience and PPP legal and financial advisors – in some cases these are provided by the entity or it just helps in the selection of external advisors. Examples include Partnerships UK, Partnerships BC in Canada, Partnerships Victoria in Australia and the Chilean Ministry of Public Works PPP team. Other countries have set up national PPP procurement teams focused on particular industries. Some of these authorities are involved in efforts to standardize PPP contracts to reduce bid costs and reduce procurement times. However these efforts are more successful where the countries are sufficiently centralized to enforce the use of these terms

Conclusion

- While the key motivation to undertake PPP projects will continue to be to find alternative sources of finance in order to deliver a project much earlier than by conventional means of financing, which in itself provides a significant public benefit, more attention will have to be given to value of risks transferred to the private sector.
- It should be noted that many of these protections can increase the risks, costs and complexity of the PPP project driving down overall value.
- Thus, as with risk transfer it's a trade-off between protection and price, and that trade-off is different for different types of PPP transactions.

Statement of Frank J. Wilson
President and CEO
Metropolitan Transit Authority of Harris County

Before the

Committee on Transportation and Infrastructure
Subcommittee on Highways and Transit
U.S. House of Representatives
February 13, 2007

Public-Private Partnerships: Innovative Financing and Protecting the Public Interest

Mr. Chairman, Ranking Member Duncan, and Members of the Subcommittee:
Thank you for the opportunity to testify before you today on Public-Private Partnerships: Innovative Financing and Protecting the Public Interest.

I am Frank J. Wilson, President and CEO of the Metropolitan Transit Authority of Harris County, Texas, commonly known as Houston METRO. Previously, I was president of AECOM Enterprises, an international engineering and construction management consulting firm, for six years. I also served as president of Daniel, Mann, Johnson & Mendenhall. I served as Commissioner of the Department of Transportation for the State of New Jersey and was responsible for all transportation development, construction, maintenance, operations, and finances. I also served as General Manager of the Bay Area Rapid Transit District (BART) in San Francisco and as Deputy Director of mass transit systems in Philadelphia and Chicago. I earned a B.S. in civil engineering from Drexel University and an M.S. in civil/urban engineering from the University of Pennsylvania.

Houston's growth is staggering and our population is expected to double in the next 15 years. This population increase will only exacerbate our already poor traffic conditions. Houston METRO is aggressively working to manage this problem by providing transit alternatives as quickly as possible.

Houston will need massive capital investment in transportation infrastructure over the next 20 years. But more importantly over the next five years, the spend rate necessary to meet our short term goals will be even more demanding. In short, federal, state, and local financial resources, although significant, will be insufficient to meet these needs. Also, the traditional public financing model results in lengthy project delivery schedules something that Houston can no longer afford if we are to meet the binding deadlines resulting from a 2003 voter referendum and respond meaningfully to public antipathy toward excessive commute times. It is estimated that the cost of congestion in Houston alone is over $2 billion per year. It is our belief that federal programs will not be modified in the near-term to meet these immediate needs. We also believe that private equity investments in infrastructure projects across the globe have resulted in a very sophisticated marketplace where we cannot only find investors, but also experienced and reliable private operators and managers of transportation infrastructure.

When we look at all modes of transportation (i.e. highways, aviation, and transit), there is a noticeable change underway in how public-use infrastructure projects are approached. Entities like METRO can no longer wait, sometimes for decades, for our turn to receive evermore scarce federal and state resources to undertake projects that are needed immediately. Today, a vibrant private equity market is providing opportunities for financing, building, and operating these needed facilities. It is not an option that works in every circumstance, but there are often circumstances where a partnership between public and private makes better sense than one party "owning" the project. What we need from the federal government is a policy that embraces these options and doesn't discourage private investment. There are proven experiences throughout the world where the public's interest in public-use infrastructure is preserved without sacrificing the ingenuity and innovation that accompanies private sector involvement.

The demand and competition of transportation improvements continues to grow, while typically the byzantine process involved to secure the funds discourages the private sector from participating. Public-Private Partnerships are a tool to help finance and deliver these improvements in a timely fashion. While most people focus on the highway sector when it comes to Public-Private Partnerships, I believe there is a tremendous potential to apply the concept in the transit sector. The benefits to transit lie in the project delivery and finance method which can help the public sector deliver more improvements faster, without giving up quality, control or public protections.

Public-Private Partnerships allow our transit agencies to focus on their core business, operating their already overtaxed transportation systems. Our skills lie in providing comprehensive transportation services, but we are ill equipped to tackle the large and exceptionally complex system expansion programs needed to meet our future needs. We have neither the skills nor the resources required to execute complicated design and construction projects that routinely range in the hundreds of millions of dollars, nor can we rapidly expand our workforce to meet these demands, only to shrink them when the project is complete. The private sector, on the other hand, has an abundance of the skills we need and routinely adjusts its workforce to meet the demands of our market. Our ability to tap into their ingenuity and flexibility is critical to the future of our industry.

The private partnership comes in the form of expediting design and construction, managing risk, providing costs and schedule certainty, and providing performance guarantees through the operation and maintenance portion of the contracts.

My views are not mere academic assertions. They were formed in the crucible of real world experience, over 30 years, involving eleven projects in seven states.

The common benefits from the partnerships I have been involved with include:

- Expedited schedules
- Cost certainty
- Reduced exposure to claims
- Allocating appropriate risk to the private sector

- Maintain public accountability
- Shared liability
- Access to private entrepreneurialism and innovation

In Houston, we are currently moving forward on a Public-Private Partnership to expand our rapid transit network. We have worked with our community and our state legislature to give us the ability to use this contracting model. We selected a partner just a few weeks ago and we are now negotiating the terms and scope of our project. Our private partner will be helping us take four different transit corridors from concept to operation as quickly as possible. We intend to have them finance the construction costs, which would be reimbursed through federal New Starts funds in the coming years. In fact, we are working closely with the Federal Transit Administration to determine the best way to facilitate our approach within their existing program. We are hopeful that the most likely outcome will be to serve as a pilot project under their newly announced Public-Private Partnership Pilot Program.

Key Factors of our METRO Solutions program include:

- The program is multi-modal in nature. It includes a central intermodal terminal that will eventually bring together commuter rail, light rail, bus rapid transit, interstate highway, carpool, vanpool, airport connections, and provisions for future high speed intra-state rail connections.
- The local community has committed to providing a significant portion of the total program costs through a local sales tax and has authorized $640 million in bonds.
- The program is being implemented through a classic 3P contract model using a Design-Build-Operate-Maintain (DBOM) contracting strategy.
- The program will be delivered through a few major contracts, not numerous individual projects, giving the private partner responsibility for all of the coordination risks.
- METRO is willing to guarantee the program costs and schedule.
- The program is implemented on an exceptionally aggressive schedule. Construction will begin in 2007, with the first lines expected to be operational in 2010 and all construction completed by 2012.
- The program will include private sector financing, as well as private sector equity.
- Cost risk, schedule risk, and performance risks will be shifted to our private sector partner.

As you consider options and alternatives to enhancing the tools available to getting critical infrastructure deployed, I urge you to implement federal policy that encourages Public-Private Partnerships. They can help our nation keep up with critical infrastructure investments.

That concludes my remarks. Again, thank you for this opportunity and I welcome your questions or comments.

February 13, 2007

Securities Industry and Financial Markets Association

Statement Submitted for the Record

House Committee on Transportation and Infrastructure Subcommittee on Highways and Transit

Public-Private Partnerships: Financing and Protecting the Public Interest

The membership of the Securities Industry and Financial Markets Association[1] appreciates the opportunity to submit this statement for the record for the House Committee on Transportation and Infrastructure's Subcommittee on Highways and Transit hearing: Public-Private Partnerships: Financing and Protecting the Public Interest. The dramatic need for an increase in infrastructure investment in the United States makes this an important area of inquiry for the Subcommittee, and indeed, Congress. The growing interest among various state and local governments in public-private partnerships as a way to generate much-needed infrastructure investment is borne of the real fiscal pressure these governments face. Any assessment of possible policy solutions to the U.S. investment gap in transportation infrastructure needs to include a thorough look at public-private partnerships and how they can be made to work best for our economy.

SIFMA Members' Role in Infrastructure Finance

SIFMA's membership includes municipal bond underwriters and dealers who for centuries have facilitated the relationships of state and local governments with the capital markets mainly through the issuance of tax-exempt bonds. Municipal bond issuance by American cities dates back to the 1700s. In 1812, New York City issued the first publicly recorded municipal bond to finance the construction of a canal. Recorded issuance grew in the years that followed. In 1843, U.S. cities had issued a total of $25 million to finance mainly transportation infrastructure.

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more that 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has office in New York, Washington, D.C. and London, and its associated firm, the Asia Securities Industry Association, is based in Hong Kong.

Today, the municipal division is one of the most active within SIFMA and its members underwrite 95 percent of the tax-exempt municipal bonds issued by state and local governments to fund important public infrastructure such as roads, schools and hospitals. It is important to note, however, that SIFMA members play an intermediary role in the approximately $2 trillion municipal market.

Bond dealers and underwriters, however, are generally neither significant long-term investors in, nor end users of, municipal financing. Because of their broad and disparate nature—more than 50,000 governments at the state, local and district levels—and volume of projects to be financed, Association members have over time developed deep and binding relationships with municipal bond dealers. SIFMA members are in a unique position to understand both the peculiar financing and physical infrastructure needs of these governments. As such, they have played a significant role in the development of U.S. infrastructure privatization, a role they are poised to continue.

Infrastructure Investment in the U.S.

U.S. infrastructure investment currently lags far behind what is necessary to maintain a robust and efficient economy. In the past years and months, several studies have quantified the cost of growing surface traffic congestion to the economy in terms of lost productivity and higher delivery costs. The numbers speak for themselves. In the past quarter century, the U.S. population has grown about 20 percent and vehicle miles traveled 72 percent. Road capacity, however, has only grown about five percent over the same period. As a result, the cost to the economy in terms of lost productivity and wasted motor fuel is upwards of $68 billion annually.[2]

Just to maintain our current surface transportation system would require a current investment of $235 billion with another $304 billion in 2015 and $472 billion in 2030. The revenue streams currently available to support such investment—mainly the gas tax—will fall a full $500 billion short through 2015. To bridge the investment gap and bolster the U.S. transportation infrastructure to meet expected needs, new transportation spending across all levels of government would need to be $288 billion, followed by $368 billion in 2015 and $561 billion by 2030. Current revenue streams will fall $1.1 trillion through 2015.[3]

Beyond a simple funding shortfall, the investment gap is complicated by the complexities of the interconnecting surface transportation systems. A number of projects critical to more that one municipality will cost billions of dollars each to complete and cannot be managed in any existing capital program.

Need for a New Financing Framework

As noted above, the municipal bond market has historically played a major role in providing the required capital for the type of an expansion the U.S. surface transportation

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[2] See http://www.ntweek.org/publications/ARTBA_Congestion.pdf and http://tti.tamu.edu/documents/mobility_report_2005.pdf

[3] See *Future Highway and Public Transportation Financing* National Chamber Foundation 2005

system would require. The major sources of financing for highways have of course included federal loans and grants funded by the federal gas tax.

Today, local tax bases are not sufficient to back the level of bond financing that would be required to close the transportation investment gap. The federal gas tax has not been adjusted since 1993 and its value in real terms has declined considerably since its inception. The rising price of gasoline combined with the general resistance in Congress to tax increases of any type have helped fuel the adoption of public-private partnerships as a policy solution as have several other developments within the past 12 months.

The leasing of both the Chicago Skyway and the Indiana Turnpike, by the City of Chicago and the State of Indiana respectively, prompted considerable attention and the interest of this Subcommittee. The governors of other states, notably New Jersey and Pennsylvania have, in the wake of those deals, both announced reviews of state transportation assets for possible public-private partnership arrangements. The leasing of existing toll roads has proved so far to be an efficient way for the City of Chicago and the State of Indiana to establish private-equity investment in a transportation asset. The deals have produced sizeable up-front payments to those governments while simultaneously removing the liabilities associated with operating toll roads, such as maintenance, from the state's balance sheet.

The Federal Role

When considering the need to bridge the transportation investment gap, it is clear public-private partnerships do not, in and of themselves, represent a total solution to the problem. There are many instances—such as the foregoing—where privatization makes sense. It follows that this approach is most easily transferred to certain projects better than others, high-volume corridors and urban connectors for example. It is in this context where federal policy can be the most helpful as a guide.

In the most recent reauthorization of the highway trust fund, SAFETA-LU, this subcommittee helped craft provisions that increase the ways in which tolling can be used on federal highways. These include the Express Lane Demonstration Program, the Interstate System Construction Toll Pilot Program and the Value Pricing Pilot Program. These programs offer the potential for public-private partnerships to make important inroads. Another program, the authorization of $15 billion in private-activity bonds for highway and rail-truck transfer facilities should similarly encourage private investment in transportation infrastructure. This sort of leadership at the federal level is invaluable.

Another positive example of federal leadership comes in the form of the model state enabling legislation recently produced by the Department of Transportation's Federal Highway Administration. At present, only 21 states have legislation to enable some form of public-private partnership on the books. California has been a leader in this area, though only on a project-specific basis. Virginia was the first state to enact a broad enabling statute, which became law in 1995. While several states have followed suit, there remains a need to streamline existing statutes and provide a blueprint for

legislatures so they may produce the most useful legislation possible.

Conclusion

We applaud your leadership and consideration of this issue. The need to close the investment gap in transportation infrastructure is well recognized today as is the useful role of public-private partnerships in closing the gap. SIFMA members, who for centuries have linked state and local governments with the capital markets, encourage Congress to boost those policies that help spur further use of public-private partnerships to facilitate new investment in transportation infrastructure.

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