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Financing Options for Surface Transportation Investment & Public Interest Concerns of Private Participation

Statement before the Legislative Study Committee on Private Participation in Toll Projects

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Arthur Chan
Senior Advisor
202.585.6568
achan@manatt.com

Nationally Recognized Law Firm

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Good morning, Mr. Chairman and members of the Committee. My name is Art Chan, Senior Advisor at Manatt, Phelps & Phillips. Until I joined the law firm less than 3 months ago, I was Highway Policy Director on the Subcommittee on Highways and Transit of the U.S. House Committee on Transportation and Infrastructure.

Thank you for inviting me to testify today on surface transportation public-private partnerships and toll projects. While I will discuss the subject matter from the national perspective, I believe many of my remarks are equally relevant to the states such as Texas. My testimony is based largely on my experience and the knowledge I gained while working on the Highways and Transit Subcommittee. The views I am expressing are strictly my own, however, and should not be attributed to the members or staff of the Highways and Transit Subcommittee or the Transportation and Infrastructure Committee.

Federal Surface Transportation Financing

Let me begin by talking briefly about the way federal surface transportation programs are financed because it provides a frame of reference for newfangled mechanisms such as public-private partnerships.

It is no secret that public resources are insufficient to support all our highway and transit needs, including construction, maintenance, operation, and asset renewal. This is especially true if you limit the focus to our traditional financing mechanism, which is the federal fuel excise tax. Total fuel tax revenue has fluctuated from year to year mostly due to changing economic conditions; nevertheless, the long-term trend has been rising steadily.

Much has been said about the introduction of hybrid vehicles and the advent of alternative fuels such as biodiesel and even hydrogen fuel cell. It has been suggested that they would mean the demise of the Highway Trust Fund and the federal surface transportation financing system. Long-term empirical evidence simply does not bear this out. For the moment, alternative-fuel vehicles make up a tiny sliver of our nation's vehicle fleet. Although hybrids are rapidly gaining popularity among drivers, the total number of hybrids on the road remains relatively small. Their impact on the Highway Trust Fund for being miserly on fuel consumption accordingly is not significant – and will not be until they occupy a meaningful share of the market.

The Congressional Budget Office analyzed the impact on the federal Highway Trust Fund of incentives to promote greater production of biofuels (e.g., ethanol and biodiesel) that were included in the "energy bill" enacted in late 2007 and actually found a small positive impact of $1.7 billion over 10 years.

The fact is, so long as hybrids remain a small part of the nation's vehicle fleet, their impact on Highway Trust Fund revenue will not be large. The introduction of alternative fuels similarly will not affect the Highway Trust Fund in a negative way so long as distribution of such fuels to the consumers requires some central retail locations such as gas stations. Current collection of federal fuel excise tax from final users is carried out at such locations. A more serious threat to the Highway Trust Fund would be the introduction and widespread use of plug-in hybrids or natural gas-powered vehicles that can be fueled at home.

The fundamental problem with the federal fuel tax is that it is based on consumption,[1] and not on the price of the fuel or the amount of spending. As fuel prices rise, revenue going into the federal Highway Trust Fund does not go up; quite the contrary, if the fuel prices are high enough, people may curtail their consumption and revenue may actually decline. Perhaps that is what we are witnessing right now.

Historically, what has seriously affected Highway Trust Fund receipts is when Congress raised the fuel efficiency of our vehicles, the so-called Corporate Average Fuel Economy or CAFE standards. From the late 1950s to the early 1970s, the period when most of the Interstate highways were constructed, Highway Trust Fund revenue surpassed traffic demand. But beginning in the mid-1970s, when CAFE standards were first imposed in response to the 1973-74 Arab oil embargo, vehicle-miles traveled began to move ahead of Highway Trust Fund revenue. The gap gradually widened until Congress adjusted the federal fuel excise tax rates. That allowed the Highway Trust Fund revenue to catch up and temporarily closed the gap, but then it would widen again over time.

So the problem we are witnessing today, of insufficient resources to fund transportation investment needed to keep up with traffic demand, is nothing new. The solution has been to raise the federal fuel tax rates. It is entirely possible that the same solution will continue to work until around 2020, when higher CAFE standards enacted as part of last year's "energy bill" go into full effect. The same Congressional Budget Office analysis cited earlier showed the total 10-year impact of higher CAFE standards on the Highway Trust Fund to be only -$2.7 billion. But this was misleading, as the period of analysis ended in 2017 while the new CAFE standards would not achieve its highest level until 2020.

The current federal fuel tax rates were established in 1993. It has been 15 years since those rates were last revised. During that time, inflation has eroded much of the real value of the Highway Trust Fund revenue, which is used to fund the entire federal-aid highway program and half the federal transit program. Using the consumer price index, inflation has eaten away about 40 percent of the purchasing power of the revenue since 1993. That impact is more pronounced if we use the highway and street construction cost index instead to measure inflation for surface transportation projects.

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[1] Current rates are 18.4¢ a gallon for gasoline and 24.4¢ a gallon for diesel. Other blended and special fuels are taxed at rates proportionate to the thermal content of individual fuels in comparison to that of diesel.

To avoid having the Highway Trust Fund receipts constantly fall behind traffic demand, and to offset the effects of inflation, the fuel tax rates need to be adjusted more regularly. One option is to index those rates to some measure of inflation, such as the consumer price index or the highway and street construction cost index. Once put into law, the adjustment will automatically kick in without additional legislative action. This is a reasonable approach – one that is understood by the public. It also takes much of the political posturing and demagoguery out of the debate.

Congress was aware that fuel tax revenue alone was not sufficient to finance the federal surface transportation programs. So Congress created what are called innovative financing methods to supplement the primary financing mechanism that is based on the fuel tax. These innovative methods include enhancing the credit worthiness of transportation projects under the Transportation Infrastructure Finance and Innovation Act (TIFIA) by providing direct loans, loan guarantees, and lines of credit; accelerating project implementation through grant anticipation revenue vehicles, or GARVEE bonds; expanding the eligibility for federal financial assistance to include debt-related financing expenses; helping states leverage their federal transportation apportionment funds via state infrastructure banks; and providing credit subsidy directly to private investors by means of private activity bonds for surface transportation projects.

But as population grows and the economy evolves, our transportation system, which provides critical support to keep our economy strong and competitive, must also adapt. More projects are needed; as are different kinds of projects. The long-term financial impacts of this growth and evolution have been more severe on the states and local communities, which are responsible for the costs of their operation and maintenance in addition to the non-federal share of the cost of construction. As more projects are added to their transportation infrastructure inventory, operation and maintenance costs alone can overwhelm the states' and localities' transportation budgets.

Private Participation in Transportation Projects

It is to close this funding gap that Congress took steps to encourage private-sector investment in transportation infrastructure.[2] Under the Intermodal Surface Transportation Efficiency Act (ISTEA) of 1991, Congress authorized limited federal assistance in the construction of toll facilities, including privately-owned facilities, on the Interstates. Congress recognized that allowing such private investments meant that tolls likely would be imposed on Interstate highways. This represented a dramatic shift from past policy, which had kept new Interstate highways constructed since 1956 free from tolls.

These small, tentative steps were followed by the establishment of an Interstate reconstruction and rehabilitation pilot program in the Transportation Equity Act for the

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[2] Separate administrative and congressional efforts were made to enable wider and more flexible procurement procedures in order to accelerate the delivery of projects. Since that is outside the scope of this hearing, I will not address those issues. The intent of Congress to use private capital to supplement public resources in financing infrastructure construction is evidenced by the stipulation on the use of toll revenues.

21st Century (TEA 21) in 1998. However, high standards were set for participation in the program such that no states have participated in the pilot program.

By 2004, when Congress was in the midst of reauthorizing the federal surface transportation programs, public-private partnerships (PPPs) were being pushed in earnest in Washington. Advocates of PPPs argued that there simply was not enough public money to fund all our transportation needs, and governments at all levels must leverage private capital to fill the funding gap. In addition, by allowing private investors a larger role in infrastructure project development and operation, governments could benefit from the technical and managerial know-how of private companies.

On the basis of these arguments, Congress established two new pilot programs that permit private investment in, and tolls imposed on, highway projects. First, Congress authorized a pilot program to use toll revenues to help finance the construction of new Interstate highways. The participation standards were not as high as those in the earlier reconstruction and rehabilitation pilot program. But there was explicit prohibition against non-compete clause in the contract with private investors. The other program was designed to relieve traffic congestion and reduce emissions by expanding an existing highway, constructing a new highway, or converting a high occupancy vehicle (HOV) facility into a high occupancy toll (HOT) facility.

It should be noted that in authorizing these pilot programs, Congress' intent was to leverage private capital to help *finance* new, or "greenfield," projects to expand our system's capacity. Raising vast sums of money via long-term concessions was never discussed.[3] Needless to say, Congress – at least among the Democrats in the House of Representatives with whom I worked very closely and quite a number of Republicans as well – was surprised when the 75-year concession deal for the Indiana Toll Road, a much larger facility than the Chicago Skyway, was announced not long after the current federal surface transportation legislation (SAFETEA-LU) became law. That was followed shortly by another deal involving the Pocahontas Parkway outside Richmond, Virginia.

Public-Private Partnerships

Long-term concessions have been presented – or, more accurately, sold – under the label of public-private partnerships. But I have been calling these concessions in my testimony "deals" because that's what they are and how private investors view and call them – business deals. Many of these deals, perhaps even most of them, do not qualify as partnerships, which I define as assigning risks to the partner that is most capable of handling them and sharing the risks and rewards equitably among the partners.

[3] The 99-year Chicago Skyway deal was announced in late 2004 when members of Congress were busy with their elections. Democratic staff on the Transportation Committee were aware of the deal, but felt that it was an isolated occurrence. I have since learned that Republican staff, especially those in the Senate, were aware of the concerted effort to push long-term concession deals but they counseled against including concessions in the bills because they reasoned that Democrats in the House would not support such an idea.

The concessions mentioned above differed significantly from the pilot programs established by Congress. They involved basically *selling* an existing asset, or "brownfield project," to some private firm or consortium of firms. Proponents of these deals have argued – and will continue to argue – strenuously that the public agencies retain ownership of the facilities. But ownership is far less important than control, particularly when such control is turned over to private hands for 3 to 4 generations. Ceding control over a facility for such a long period of time is tantamount to selling the facility. These brownfield deals do not provide specific commitments by the private investors to add capacity to the facilities. Private capital is chasing brownfield deals right now because of the low risks.

Undertaking a new construction project entails far greater risks because it is during the project development and construction phases when things such as schedule and cost can deviate significantly from plan. A good example of this is the State Highway Route 125 south of San Diego, California. And it is in the early operating period when kinks get worked out and traffic and revenue projections get validated that give any project developer, especially a private developer, heartburns. Examples of projects running into trouble at this point of project implementation abound, ranging from the Dulles Greenway in northern Virginia outside Washington, DC to the Cross City Tunnel in Sydney, Australia, and Camino Colombia Toll Road near Laredo, Texas. It is for this type of projects that I think a genuine partnership can be structured for the benefit of all the partners.

Unlike the customary requirement in Europe, where a toll road is permitted to be constructed only if a viable non-toll alternative is available to drivers who may not choose, or be able to afford, to use the toll road, there is rarely a similar requirement in state law here in the U.S. What we are offering the private investor when setting up such a greenfield concession deal is something that approaches a monopoly. As such, it should be regulated in a manner similar to the regulation of public utilities, wherein private investors are provided a reasonable rate of return on their investments while the public is protected from undesirable monopolistic behavior.

If it is a bad deal for a state to create a monopoly or allow a monopoly to be created and neglect to regulate it, then it is a worse deal if the state enters into a concession agreement that runs longer than the design life of a facility. A road is typically designed to last for 25 to 30 years; a bridge 50 years. There is no public-interest reason for an agency to make a 75-year or 99-year lease deal. But there are strong incentives for the private investor to push for such a long agreement. Foremost among them are the very significant tax benefits, including accelerated depreciation for various types of tax asset. These hidden costs to the public obscure the true benefits governments and taxpayers are actually deriving from such deals, and they partly explain why concessionaires have been offering extraordinary amounts for upfront payments in their bids on long concessions.

In addition to the high cost to the public in the form of tax loss, long concession leases also rob current and future political leaders of management flexibility. Highways

are important economic development tools for state and local governments. Long-term lease on toll roads limits governments for generations to come the political and economic management flexibility they need for the wider regions through which the toll roads run. My colleagues in Europe with long experience in concessions told me that public agencies' political leverage over their private business partners dissipates very rapidly over time, and is virtually exhausted about 10 years into a concession agreement. They counseled that concessions be kept to the shortest term possible – 25 to 30 years would be about ideal.

They also advised me of the creative approach in which both the length of a concession and an overall rate of return for the investor were established in the agreement. If the actual traffic turned out to be higher than projected, and the investor's return also ran higher, then the agreement would terminate early when the investor realized the return for which it had bargained. If the choice is between ending the concession early when the targeted rate of return is achieved and the one now used in some states that allows the agency to share revenues in excess of the projected level, they prefer the former for reasons of retaining control and leverage. The simple rule is: keep the concession as short as possible.

In the current fiscal year, $299 million is made available under SAFETEA-LU for planning activities carried out by metropolitan planning organizations. In fiscal year 2009, it will be $304 million. These are large sums of money, but they do not include state and local funds for metropolitan planning. Nor do they include funds used for statewide transportation planning. Most people don't realize that we are investing an awful lot of money on transportation planning, easily surpassing half a billion dollars a year. What we get in return for that investment is orderly planning that reflects state and local transportation priorities and prudent project scheduling that takes into account the financial resources available.

Yet much of that money could be wasted if we allow unsolicited PPP proposals to circumvent the planning process and go to the front of the line of projects on the transportation improvement programs (i.e., TIPs and STIPs) and long-range transportation plans. But that is part of the Administration's model PPP legislation that Secretary Mary Peters has been urging the states to adopt. I do not believe the people will support re-ordering the transportation priorities of, or commitments made long ago to, the public for the purpose of enabling private investors the opportunity to make a profit.

Again, let me relate to you the practice in Europe since we have been told repeatedly we must catch up with the Europeans and others in the world. European governments do not permit unsolicited proposals from private investors. There is a good reason for doing so. Telling governments what infrastructure investments they should make is not a strong suit of the private concessionaire. That is the tragic lesson learned in the Metronet fiasco. Private businesses are better at delivering projects or services. We should play to the respective strengths of the parties, not their weaknesses.

For equity reasons, the money raised from a long-term concession should be used for transportation projects located within the corridor of the toll road. Proceeds from the concession must be dedicated for transportation projects because the investor will be paid by users of the toll road. Moreover, transportation projects that are to be funded with concession proceeds should be located in the same corridor as the toll road for which the concession agreement is made. Otherwise, the tolls are simply a corridor tax imposed on users of the road for the benefits of residents in other parts of the state.

Last but certainly not the least, the entire process of proposal solicitation, private business partner selection, project design and development, and the terms of concession agreement must be conducted, to the maximum extent possible, in an open, transparent, and inclusive manner. PPPs are controversial throughout the country. You are keenly aware of that in Texas; that's why you are here holding this series of hearings. I doubt any concession proposal will achieve political consensus and garner the public's support if public input is hindered or discouraged or relevant, non-privileged information withheld.

Public-Public Partnerships

One model that would avoid many of the pitfalls discussed above, but has not yet received much attention, is public-public partnerships (P2P). There are a number of options in setting up P2Ps, including public toll road authorities or public benefit corporations established to finance a toll project.

P2Ps enjoy a number of advantages. Clearly, the public will retain control over economic development, toll-rate setting, transportation planning, etc. And public agencies will be making infrastructure investment decisions. After investment decisions are made, there is no reason why private firms cannot be brought in to design, construct, operate, and maintain the facilities in a so-called DBOM arrangement.

That leaves out the question of financing the projects. Public money is almost without exception cheaper than private money. This is because governments are able to borrow money at lower interest rates in the bond market than private borrowers. If the private investors raise their money from the equity market, then the cost will be higher still. Lower cost of borrowing translates into lower project costs and lower toll rates needed to be imposed to support the project financially.

Finally, excess revenues (over costs) are kept in the region of the toll project and can be used for public benefits.

Conclusion

There is a legitimate role for the private investor to play in developing, financing, and implementing transportation projects in support of our economy. But it is a supporting role. The American Association of State Highway and Transportation Officials (AASHTO) calls it "the 7-percent solution" because tolls currently make up

about 5 percent of the total transportation-related revenues. Even with an ambitious program to expand PPPs throughout the country, it is difficult to see toll revenues more than double its share to 10 percent. AASHTO and many other transportation professionals think 7 percent is a more realistic target.

Long-term concession lease has been pushed very hard in the last few years as a way either to "liberate dormant value" in existing infrastructure or to tap into the rich vein of pension funds to help finance transportation infrastructure investment. We have been reprimanded by strong proponents of PPPs for not keeping up with the Joneses in just about everywhere else in the world. But do we really have to follow what others have done? I think not.

The United States is blessed with two features of transportation financing that are unique in the world. First, we have a dedicated revenue stream in the federal fuel excise tax. Second, states and local communities are able to finance their transportation projects with tax-free bonds. With the help of these two advantages, we struck out in a different direction than Europe, Australia, and South America. Furthermore, a policy decision was made in 1956 to finance our transportation investments on a pay-as-you-go basis so that current users would bear the cost of the projects instead of shifting that burden to future generations.

My British colleagues, experienced in PPPs, came to examine the PPP scene in the United States and were bewildered and shocked. They called it "the Wild West" because they thought private investors were trying to squeeze out as much profits as possible and as quickly as possible because they were not sure how long the good time would last. It is sort of like football, with the American brand being very different than the rest of the world.

So let me convey their advice to you. You need to be very careful when using PPPs to finance transportation projects. It may be good to learn a lesson or two from the Europeans before we plunge in without a clear understanding of what we are doing but based our decision solely on the representation of PPP promoters.

Mr. Chairman and members of the Committee, this concludes my testimony. I will be happy to answer any questions you may have.

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