

# THE PENNSYLVANIA TURNPIKE: A GOLDEN GOOSE IN THE BRAVE NEW P3 WORLD

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## I. Introduction: Have the Financial Alchemists Found the Philosopher's Stone? Or Is It All Just Fool's Gold?

**A. Historical Perspective: The Pre-Asphalt and Post-Asphalt Ages.** The alchemists of the Middle Ages long sought the philosopher's stone, a mysterious unknown substance which they believed had the power to change base metals into gold. In the wake of recent transactions for the Chicago Skyway and the Indiana Toll Road, modern day financial alchemists suggest that the private sector – through public-private partnerships (“P3’s”) and long-term concession agreements – is able to transmute asphalt into gold. Are they right? And if they are (at the risk of a minor mixture of metaphors), isn't the Pennsylvania Turnpike the ultimate “golden goose”?

**B. New Public Infrastructure Finance 101 – Basic Definitions and an Important Distinction.** According to the Federal Highway Administration,

*“Public-Private Partnerships refer to contractual agreements formed between a public agency and private sector entity that allow for greater private sector participation in the delivery of infrastructure projects.... The expanded private sector role may be in any or all of the planning, financing, design, construction, operation and maintenance functions for a particular facility.”<sup>2</sup>*

This is a rather innocuous definition and encompasses an underlying, admirable concept: that the public sector should look to the private sector as a valuable resource – one that should be tapped in a collaborative way, and without reluctance, when the private sector proves itself able to provide higher quality or more cost-effective services with respect to the delivery of critical public infrastructure projects.<sup>3</sup>

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<sup>2</sup> See U.S. Department of Transportation, Federal Highway Administration, “What is a PPP?” at <http://www.fhwa.dot.gov/ppp/defined.htm>.

<sup>3</sup> The Pennsylvania Turnpike Commission has been a long-time proponent of utilizing P3's where they are determined to be cost-effective. Examples include the outsourcing of our Customer Service Center and Violations Processing Center for electronic toll collection and maintenance of our fare collection equipment. Most recently, in September 2006, the Turnpike Commission entered into a



The most recently touted P3 vehicle for more comprehensive involvement by the private sector in infrastructure delivery is the “Concession Agreement” which the Federal Highway Administration describes as follows:

*“Concession agreements typically allow the [private] concessionaire to design, build, and operate a project with the right to receive revenues from the operation...of the project.... The concessionaire carries out all of the capital investment, operates the resulting service and is remunerated by service fees paid by users. The facilities are to be handed over to the oversight public authority at the end of the contract period.”<sup>4</sup>*

Although only a minimal number of private transportation concessions have been awarded in the United States, concession agreements have been extensively used in Third World and European countries for both the construction and operation of highways. The most active concession markets are in Third World countries where there is a lack of internal capital, weak governmental credit and the cost differential between public and private capital is minimal. The reasons most often cited for the growth of concession agreements involve the beliefs that: first, the private sector can provide the same services at a higher quality and lower cost; and second, that the public sector is not capable of or is not willing to make the financial investment required to complete major infrastructure projects. The terms of concession agreements outside the United States have generally not exceeded 35 years.

Most recently, concession agreements (incorporating long-term leases<sup>5</sup>) have been used to “monetize” public assets, *i.e.*, to extract value from the asset (and its revenue generating capability), oftentimes in the form of a very substantial up-front payment by the private entity to the public entity. There is an important distinction, however, between these recent P3 transactions and more traditional P3 transactions. Historically, P3 transactions were used to *reduce* the costs to users of the asset; new P3 transactions utilizing long-term concession agreements are premised on the imposition by the private entity (the concessionaire) of much *higher charges* on users of the asset than those that were previously imposed by the public entity — all in exchange for a large up-front payment which can be used by the public entity to address its short-term financial needs.

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P3, concession-type agreement with HMSHost which agreed to invest \$100 million to upgrade 17 service plazas across the state in return for certain operating rights over 30 years.

<sup>4</sup> See U.S. Department of Transportation, Federal Highway Administration, at <http://international.hhwa.dot.gov/contractadmin/07.htm>.

<sup>5</sup> Much is made by proponents of concessions that the transactions are not really *sales* of the subject assets, but merely *leases*. From a substantive standpoint, the distinction is largely illusory. The concession deals consummated thus far have had terms of 75 (Indiana Toll Road) and 99 (Chicago Skyway) years, granting the private entity full operating control and the right to collect aggressively increasing tolls during the applicable contract periods. Thus, as many as four generations of Pennsylvanians could be subject to any concession agreement that might be entered into today. Under the U.S. Internal Revenue Code, the distinction between such long-term leases/concessions and actual sales is deemed to be so slight that the private concessionaire is considered to have “ownership” of the asset for tax purposes.

## **II. The Chicago Skyway and Indiana Toll Road Transactions: Are Those Really Pots of Gold at the End of Those Roads?**

The first two concession financings of major transportation assets in the United States were the Chicago Skyway transaction which closed in January of 2005 and the Indiana Toll Road transaction which closed in July of 2006. A brief comparison of the two transactions follows:



## **Comparison of Chicago Skyway and Indiana Toll Road Transactions**

	<b>CHICAGO SKYWAY</b>	<b>INDIANA TOLL ROAD</b>
<b>Asset</b>	7.8 mile limited access, elevated highway	Statewide(east/west) toll road, 157 miles
<b>Primary Customers</b>	Indiana residents commuting in and out of Chicago	Commercial, pass through truckers (not a major commuter route for most of its length)
<b>Term of Concession</b>	99 years	75 years
<b>Concessionaire</b>	Cintra/Macquarie syndicate	Cintra/Macquarie syndicate
<b>Up-front Payment</b>	\$1.8 billion	\$3.85 billion
<b>Toll Regime</b>	<ul style="list-style-type: none"> <li>- Initial – 150% increase (12.5%/year for 12 years)</li> <li>- Ongoing – Annual increase: greater of 2%, CPI, or nominal GDP per capita</li> </ul>	<ul style="list-style-type: none"> <li>- Initial – 73 % to 113% increase (prior to concession)</li> <li>- Ongoing – Annual increase same as CS – greater of 2%, CPI, or nominal GDP per capita</li> </ul>
<b>Private Finance Structure</b>	Taxable bank debt and private equity (quickly refinanced with long-term insured bonds sold into the capital markets, swaps, etc. allowing equity to be reduced from 49% to 36% of purchase price)	Taxable debt and private equity
<b>Use of Concession Proceeds</b>	Included a variety of non-transportation related causes (General Fund relief, G.O. debt service, social programs, etc.)	Used to fund 10 year transportation capital needs initiative of Gov. of Indiana (“Major Moves”)
<b>Date of Closing</b>	January, 2005	July, 2006

These transactions have been promoted by some as the future salvation of United States transportation infrastructure finance and condemned by others as nothing more than leveraged buyouts of irreplaceable public assets by greedy global corporate interests with no motivation other than profit maximization.

In Pennsylvania, the Chicago Skyway and Indiana Toll Road transactions sufficiently caught the attention of Governor Edward G. Rendell that on December 6, 2006, he announced that the Pennsylvania Department of Transportation (“PennDOT”) would solicit expressions of interest from firms to determine the potential value of leasing the Pennsylvania Turnpike under a long-term concession agreement. On December 22, 2006, responses to the PennDOT solicitation were received from forty-seven private firms and from the Pennsylvania Turnpike Commission. In his Annual Budget Address on February 6, 2007, Governor Rendell stated his intention of moving ahead with a potential long-term lease of the Turnpike which might generate “between \$10 and \$12 billion” that could be used to “meet our funding target for roads and bridges of \$965 million per year.” In pursuing this “all eggs in one P3 basket” approach, Governor Rendell effectively rejected the findings of his own Pennsylvania Transportation Funding and Reform Commission (“PTFRC”) which had recommended increases in the Oil Company Franchise Tax and in various motor vehicle and driver licensing fees as the primary sources for additional highway and bridge funding.

In this paper, I will attempt to assess whether private concession financing — specifically in the context of a possible long-term lease of the Pennsylvania Turnpike — should have a preferred role in closing Pennsylvania’s acknowledged, substantial transportation funding gaps recently verified in Governor Rendell’s Pennsylvania Transportation Funding and Reform Commission’s November 2006 report (“PTFRC Report”). In so doing, I will identify certain financial and public policy issues which must be analyzed and suggest alternative strategic initiatives which might be considered to address these funding shortfalls.

### **III. Policy Issues and Misconceptions Concerning Privatization Transactions and Asset Monetizations.**

**A. “Where’s the Road Map?” Need for Comprehensive Pennsylvania Transportation Policy Guidelines Before Considering a Transaction which Could Impact Four Generations of Pennsylvanians.** As recommended in the PTFRC Report<sup>6</sup>, comprehensive transportation policy guidelines and principles should be established to guide the analysis and structures of potential long-term P3 arrangements. I respectfully submit that in looking to move from the PTFRC’s funding recommendations to a singular reliance on the P3/monetization alternative, this important preliminary work has not been done. There are many misconceptions among Pennsylvania public decision-makers about the private monetization transaction now offered by Governor Rendell as the potential solution to our highway and bridge funding quandary. A transaction which will potentially

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<sup>6</sup> See “Investing in Our Future: Addressing Pennsylvania’s Transportation Funding Crisis”, Final Report of Pennsylvania Transportation Funding and Reform Commission (November 2006), p. 97.

impact as many as four generations of Pennsylvanians should not be made precipitously amid misconceptions and in a virtual policy vacuum.

**B. Ten Specific Policy Concerns.**

**(1) Debunking the Myths of a “Free Lunch” and the Magical Unlocking of “Trapped Value.” Asset Monetizations are NOT Financial Rocket Science.** Prospective concessionaires will often extol the private sector’s ability to unlock the “trapped value” (or “stranded equity”) in an allegedly underperforming public asset, offering a large up-front payment in return for the right to operate the asset and collect user fees over the life of a concession agreement. Cash-strapped public officials are understandably tempted to view the private concessionaire’s offer as the proverbial “free lunch” which is made possible through the “secret sauce” of some ultra-complex transaction devised by financial rocket scientists and the multi-billion dollar global financial behemoths which employ them.

Not surprisingly – and, as a public transportation official myself, I state this with great regret – once again there is no free meal being provided. Monetizations of public assets by the private sector are in essence very rudimentary financial transactions. The “buying” private concessionaire assesses the financial risks, projects the future net revenues which can be expected from the operation of the asset (under the terms and conditions set forth in the concession agreement) and calculates an up-front payment it is willing to make in return for such future revenue stream. Thus, the financial analysis is little different than that performed when any private entrepreneur decides whether to invest in or buy an asset or enterprise.

The “trapped value” or “stranded equity” which is purportedly unlocked with a large up-front payment by the private concessionaire is nothing more than the financial realization that under the terms and conditions of the concession agreement, the acquiring private entity can expect that the customers of the asset have no real choice (here, given the absence of competing facilities and the essential nature of the service) but to pay greatly increased future user fees (tolls) for the services provided, resulting in very profitable future revenue streams and a willingness on the part of the prospective acquirer of the enterprise to pay a substantial up-front price.

A monetization of the Pennsylvania Turnpike could be accomplished by either the private sector (financed by taxable debt and equity) or the public sector (utilizing tax-exempt bonds). The ultimate source of payment or security for a private or public monetization is exactly the same – increased tolls which will be paid by future users of the Turnpike.

**(2) “That’ll be \$553, Ma’am.” No Secret Sauce: Aggressive User Fee Escalation Formulas are the Real Value-Driver in Concession Agreements.** Both the Chicago Skyway and Indiana Toll Road transactions are premised on extremely aggressive permitted toll increases over the lives (75 years in Indiana, 99 years in Chicago) of their concession agreements. Both transactions involved very high initial toll increases (between 73% and 113% in Indiana, 150% in Chicago) followed by annual toll increases at the *highest* of three factors: 2.00 %; the increase in the Consumer Price Index (CPI); or the

increase in nominal Gross Domestic Product (GDP) per capita (an index which has averaged nearly 6% annually over the last 50 years). To put all of this in perspective, an outside financial consultant has calculated that if the original financing of the Pennsylvania Turnpike (which opened in 1940) had been done under a concession agreement using the same schedule of permitted toll increases used in Chicago Skyway and Indiana Toll Road, the maximum allowable toll for a passenger vehicle to travel the 358-mile length of the “main road” from the Delaware River to the Ohio border would now be, at least theoretically, \$553 (compared to the actual current toll of \$22.75).

**(3) “Whose Ox is to be Gored?” User Profile: A Basic Distinction Between Chicago Skyway/Indiana Toll Road and the Pennsylvania Turnpike.** The Chicago Skyway and Indiana Toll Road transactions are cited by private sector interests as models with far-reaching applicability to other United States transportation facilities. However, upon closer examination, Chicago Skyway and Indiana Toll Road were easy candidates for public officials to choose for concession financing. The greatly increased tolls for Chicago Skyway and Indiana Toll Road will be paid primarily by out-of-state drivers – commuters from Indiana into Chicago on the Chicago Skyway and out-of-state, “pass through” truckers on the Indiana Toll Road. Pennsylvania Turnpike traffic is primarily Pennsylvania drivers (passenger and commercial) who would be required to bear the burden of greatly increased toll rates. The Turnpike is a major commuter and commercial artery for Pennsylvania workers and the businesses which employ them. Pennsylvania public officials will not be able to act with the same relative political impunity as those in Chicago and Indiana in agreeing to a Turnpike concession agreement which incorporates aggressively escalating toll schedules.<sup>7</sup>

Moreover, there are issues of fundamental fairness and equity when the entire burden for additional highway and bridge funding in Pennsylvania is to be borne by a relatively small subset of Pennsylvania vehicular travelers – Turnpike customers (and perhaps only “Main Road” patrons<sup>8</sup>). This would seem to amount to little more than a crushing “corridor tax” on users of a mere 358 miles (537 miles if it includes the entire Turnpike system) of the approximately 40,000 miles of state-owned roads.<sup>9</sup>

**(4) Proposed Turnpike Mission Metamorphosis – from Mobility to Profit: Collateral Traffic Diversion and Social Justice Implications.** It is the inflated toll rates in the

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<sup>7</sup> One commentator concluded, “If the Skyway were an in-state road, it is highly unlikely that the toll increases would have been politically palatable.” Enright, Dennis “The Chicago Skyway Sale: An Analytical Review,” *Tollways*, Autumn, 2006. Nevertheless, in Indiana, political pundits have attributed the loss of a U.S. Congressional seat and control of the State House of Representatives to Republicans’ support for the Indiana Toll Road transaction.

<sup>8</sup> In remarks recently made at the National Press Club in Washington, D.C. Governor Rendell suggested that it may only be the “Main Road”, i.e., the 358 miles of the Turnpike’s 537 mile system, between the Delaware River and the Ohio border, that would be subject to a potential long-term lease/concession agreement.

<sup>9</sup> According to the PTFRC, more than 8,500 miles (21%) of state-owned roads are in “poor” condition (none of which are found in the Turnpike system). Of the more than 25,000 state-maintained bridges identified by the PTFRC (an estimated 23% of which the PTFRC considered “structurally deficient”), 843 are on the Turnpike. Of the Turnpike bridges, only 58 (7%) are considered structurally deficient with 37 of those bridges currently in design for major rehabilitation or complete replacement.

Chicago Skyway and Indiana Toll Road transactions which provide the future revenue streams that justify large up-front concession payments. Similar toll escalations on the Pennsylvania Turnpike would necessitate a change in the longstanding mission of the Pennsylvania Turnpike from mobility maximization (through operation on an essentially “break even” basis) to a much more profit-focused orientation. Nobody contends that in implementing a more corporate-driven pricing model a private concessionaire would attempt to charge \$553 (the maximum allowable toll in our Pennsylvania Turnpike hypothetical) for a passenger car to travel from the Delaware River to the Ohio border. However, the private concessionaire would be expected to set the toll at the optimized level (not exceeding \$553) that, when coupled with resultant vehicular volume, would produce the greatest revenues and healthiest profit. It is safe to assume — given the paucity of acceptable alternative routes — that the profit-optimizing toll to be charged would certainly be a healthy multiple of the existing \$22.75. At some elevated levels, the tolls charged will certainly discourage less affluent travelers from choosing the Turnpike route and divert them onto other local roads and highways which would, of course, require increased public sector expenditures to maintain acceptable service levels.<sup>10</sup> At what toll level will we find that Pennsylvania transportation mobility has been rationed just to the well-to-do? Should this denial of basic “rights of passage” offend our traditional social justice principles?

**(5) A Walk on the “Squishy Side”: Non-Quantitative Implications of the Potential Fragmentation of the Pennsylvania Transportation Network.** John Foote, Senior Fellow in Transportation Policy at Harvard University’s Kennedy School of Government recently stated that “We ought not to be thinking of these [privatization] deals as purely financial transactions. The assets are too important.”<sup>11</sup> The qualitative benefits of maintaining public control of transportation assets may resist monetary quantification but are nonetheless real. The PTFRC recognized the importance these more qualitative factors in its Report when it articulated its first two “Guiding Principles” which were to be used as a basis for its deliberations and recommendations: (i) “Transportation must be integrated with land use, economic development and environmental policies, programs and goals;” and (ii) “The highest priority is to provide for the mobility of all Pennsylvanians....”<sup>12</sup>

**(a) A Valentine’s Day Case Study – Importance of an Integrated, Cohesive Pennsylvania Highway System.** Transportation mobility is a vital factor in the everyday quality of life for millions of Pennsylvanians. In a post-9/11 world, and in the wake of weather disasters exemplified by Katrina, travel mobility is also an important component of the Commonwealth’s emergency preparedness system established to protect the security of its citizens.

The recent Valentine’s Day “perfect storm” which shut down major portions of three interstate highways in Central Pennsylvania for more than two days, stranding hundreds of motorists in their vehicles for as long as 24 hours, underscores the fragile nature of transportation mobility. At a minimum, we should be concerned that the Pennsylvania

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<sup>10</sup> Note that there is a certain perverse reliability in the future cash flows of the private concessionaire 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.

<sup>11</sup> Philadelphia Inquirer, January 22, 2007, p. B-2.

<sup>12</sup> PTF&RC Report, p. ES-4.

transportation system is a cohesive, integrated system, and that communications and coordination among those responsible for the Commonwealth's transportation systems and emergency preparedness and response are maintained at all times.<sup>13</sup> In this context, public policy decision-makers must ask themselves if a fragmentation of the Pennsylvania transportation system with the delegation of operating responsibility for major highways to various private entities, is in the best interest of Pennsylvania.

(b) **“No Slip Ramp for You Today!” Impact on Future Economic Development in Pennsylvania.** The simple predictive beauty of our private enterprise system will guarantee that decisions of the private operator over the life of the concession or franchise will be driven by one factor – profit maximization. This may result in a non-collaborative, “disconnect” between future Pennsylvania economic development initiatives and the private operator of the Turnpike. Strategic investments (for example, individual slip ramp projects to accommodate site-specific economic development projects) that might have a favorable “return on investment” in a broader sense for Pennsylvania will not be undertaken by a private operator unless there is demonstrated evidence of profit enhancement. How will the loss of control over a statewide thoroughfare impact future economic development efforts in Pennsylvania given the critical role that transportation infrastructure plays in driving economic development and growth? How will greatly increased tolls impact the movement of goods and passengers in Pennsylvania? Will, for example, commercial truck traffic be diverted off a more-expensive PA Turnpike onto non-tolled Route 80 and to the Port of New York instead of the Port of Philadelphia? We must be mindful that decisions reached today with respect to the Turnpike do not place us at future competitive disadvantage to other states and nations in the global economy.

Furthermore, the Turnpike Commission has prioritized the employment of Pennsylvania residents in its work force and, where possible, the utilization of Pennsylvania companies where outside services or other expertise are required. This commitment to in-state economic development may be inconsistent with a concessionaire's strategy of maximizing profits and investor returns.

(6) **The Threat of Invasion: Inability to “Bind Future Parliaments” and Bullet-Proof Proceeds of a Concession Agreement without an Amendment to the Pennsylvania Constitution.** Thankfully, there seems to be some general agreement among Pennsylvania public officials (at least for now!) that the expenditure of any proceeds of a potential concession agreement or other monetization transaction involving a Pennsylvania transportation facility should be restricted to Pennsylvania transportation infrastructure. However, absent an amendment to the Pennsylvania Constitution, the proceeds of such a concession agreement could be invaded at some later date by a future Governor with a majority of the General Assembly and diverted to non-transportation purposes. (An amendment to the Pennsylvania Constitution – always a painstaking and uncertain process – would take a minimum of 3 years under the best circumstances.) The

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<sup>13</sup> At the request of Governor Rendell, the Pennsylvania Turnpike Commission suspended toll collection on its Northeast Extension for more than 2 days to facilitate movement of traffic off the blocked interstates. The Northeast Extension (Route I-476) was plowed to the Turnpike's “bare pavement” standard and remained clear throughout the storm. PA Turnpike equipment was also loaned to PennDOT to help clear the blocked highways.

prospects of protecting such funds are much greater with a public sector monetization involving tax-exempt debt issued under trust indentures with bond covenants restricting the use of facility “revenues.”

**(7) The Seemingly Irresistible Allure of One-Shot, “Magic-Bullet” Solutions to Complex (and Expensive) Public Policy Issues.**

**(a) Near-Term Governmental Gratification with Long-Term Public Pain.** A long-term concession effectively puts the present value of decades of future toll collections in the hands of current or near-term administrations that are compelled to respond to current or near-term fiscal problems. Even if we assume the proceeds of a concession/long-term lease are used in a similar fashion as Indiana to fund a ten-year capital program to address Pennsylvania highway and bridge needs, where will Pennsylvania transportation funding come from in years 11 through 75 (or 99)? How will a long-term lease of a critical transportation asset such as the Turnpike affect the Commonwealth’s ability to shape transportation policy in the decades to come? What financial burdens are we willing to place on future generations of Pennsylvanians after cannibalizing certain irreplaceable components of our transportation system? A long-term lease/concession is a one-time transaction, applicable for the next 50+ years. Is reliance on a non-recurring technique the best solution to an ongoing, structural problem concerning transportation funding?

**(b) Facing the Hard Reality of the Ever-Eroding Value of Money.** In his February 6, 2007 Budget Address, Governor Rendell, in explaining his Turnpike privatization proposal, suggested that if the Commonwealth were to receive \$10-12 billion as an up-front concession payment, that amount could be set aside, invested, and the income on it would provide the \$965 million of annual additional highway and bridge funding recommended by the PTFRC. Even if we assume that the up-front concession payment amount (the “corpus” or “principal”) is not invaded by future revenue-challenged Pennsylvania public officials for non-transportation purposes over the next 75 (Indiana Toll Road) or 99-year (Chicago Skyway) term of the proposed concession agreement, the adequacy of the projected income on the investment of the concession principal amount must be critically examined. The PTFRC’s needs assessment identified \$965 million *in 2007 dollars* as the additional necessary annual funding. Let us be optimistic again and assume that the annual income on the investment of the up-front concession payment exceeds expectations and amounts to \$1 billion per year. In the last twenty years, highway construction costs have increased at an average of 3.9% per year according to the Federal Highway Administration – 7.6% annually over the last five years. If we assume an annual rate of 4% as the future highway construction cost increase factor, the projected annual investment income of \$1 billion will have the following future purchasing power *in 2007 dollars*: \$815 million in 2012; \$664 million in 2017; \$442 million in 2027; \$195 million in 2047; \$46 million in 2082 (75 years); and \$17 million in 2106 (99 years).<sup>14</sup> Clearly, while there would be some near-term funding assistance provided, the greatly-diminishing effective real purchasing power of the income on the concession payment principal in the

<sup>14</sup> With a 3% (5%) annual cost increase factor, future purchasing power of \$1 billion is as follows: \$858 (\$773) million in 2012; \$737 (\$598) million in 2017; \$543 (\$358) million in 2027; \$295 (\$128) million in 2047; \$101 (\$21) million in 2082; and \$49 (\$6) million in 2106.

later years of the potential concession agreement term calls into serious question the viability of Governor Rendell's proposed financial model. Four generations of Pennsylvanians will have to live with the terms and consequences of a potential concession agreement. As we cede control of a vital public asset to a private operator for 75 or 99 years, surely we can do better than bequeath to our grandchildren's grandchildren a transportation funding inheritance of something less than 2¢ or 5¢ on the dollar.

**(8) How about the Higher-Hanging Fruit? Brownfield vs. Greenfield**

**Projects: Where is the Private Sector of Most Value?** The very essence of P3 usefulness and benefit revolves around risk transfer and risk sharing. The real potential, therefore, for P3 concession transactions is in new capacity-enhancing ("greenfield") construction projects – extensions, expansions and new highways. It is in these more challenging types of projects that the private sector is able to provide the greatest benefit to the public sector. Under joint development agreements, the public sector can potentially share the construction, traffic volume and revenue risks (and attendant profit potential) with its private partner. As *Fitch Ratings*<sup>15</sup> points out, there is very little risk transfer benefit to the public entity when a private entity enters into a long-term concession agreement involving an existing ("brownfield") transportation facility (e.g., the Pennsylvania Turnpike) which is already an established and profitable enterprise on whose historic and very predictable cash flows any first-year Wall Street analyst is able to perform present-value calculations. Unfortunately, preliminary informal overtures to the private sector to partner with the Pennsylvania Turnpike Commission in reaching for the "higher-hanging fruit" such as the completion of the Mon-Fayette Expressway and Southern Beltway projects in Western Pennsylvania have thus far elicited disappointing responses.

**(9) Working Without a Net: Private Partners Bring Riskier Capital**

**Structures.** The Chicago Skyway and Indiana Toll Road financial models demonstrate that the prospective private concessionaire is incentivized to put as little equity as possible into the transaction, creating a low-rated or non-rated, highly leveraged financing that may leave little flexibility to deal with unforeseen financial or operational circumstances, increasing the risk of default under the concession agreement. In the event of a default by the private entity, there is the prospect of the transportation facility being "trapped" with adverse impact on the traveling public and the public entity left with the task of recapturing the asset. (Re-establishing control over the asset may involve payment of lender "make-whole" termination costs which may substantially exceed the amount of the up-front payment.) By contrast, the Pennsylvania Turnpike Commission's \$1.7 billion of toll revenue bonds are conservatively structured and there is ample borrowing capacity to fund its ambitious \$4.5 billion capital improvement program. The Turnpike Commission's toll revenue bonds are among the highest rated of any toll agency.

**(10) "Pay Now – and More Later!" Hidden Increased Future Capital Costs.**

The Pennsylvania Turnpike has embarked upon an ambitious, 10-year \$4.5 billion capital program which includes not only the reconstruction of its entire 537-mile system (much of it more than 65 years old), but also highway widening in more congested areas, linkage with U.S. Route I-95, the replacement of major bridges and other substantial projects.

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<sup>15</sup> "U.S. Toll Road Privatization: Seeking the Right Balance", Fitch Ratings March 22, 2006, p. 7.

There is a threshold issue as to the willingness of a potential private concessionaire to undertake these projects. If the concessionaire would agree to assume this responsibility, it would, of course, reduce the amount of proceeds from any privatization. (There is no apparent thought that any prospective private concessionaire would have any interest in assuming responsibility for completion of the Mon-Fayette and Southern Beltway projects.) A hidden cost of the privatization approach is that future capital improvements to the Pennsylvania Turnpike would have to be financed at high taxable borrowing rates or even higher equity return rates. This will increase the financing costs of such future capital expenditures by at least 60% over tax-exempt rates available to the public sector. These increased costs will have to be absorbed by Pennsylvania Turnpike customers.

#### **IV. Pennsylvania Turnpike Commission as Part of the Solution to the Commonwealth's Transportation Funding Shortfalls — Proposed Strategic Initiatives.**

The Pennsylvania Turnpike Commission took the opportunity to respond to Governor Rendell and PennDOT's recent Request for Expressions of Interest. In doing so, the Commission acknowledged the critical transportation infrastructure funding gaps identified in the PTFRC Report and sought in a proactive way to offer potential ideas and strategies for addressing these critical needs. The Commission has a 67 year history of providing transportation mobility to millions of Pennsylvanians on "America's First Superhighway" – *all without the expenditure of tax dollars!* It is entirely consistent with the Commission's legislative mission to participate in this vital public policy debate. We respectfully submit that with the acquiescence and direction of the General Assembly and Governor Rendell, the Pennsylvania Turnpike Commission is prepared to help solve Pennsylvania's transportation problems by adapting our traditional mission and becoming a more entrepreneurial public enterprise and assuming major responsibilities in implementing the specific following proposed strategic initiatives which we offer for consideration.

**A. Strategic Initiative #1 — Consider "Public-Public" as well as "Public-Private" Partnerships.** The ideal public policy objective should be to *foster collaboration between and among public and private entities to allow the most suitable and cost-efficient entities to assume defined transportation development responsibilities.* There is no one model or "magic bullet" that will be the answer in all situations. The Pennsylvania Turnpike Commission recently tapped the private sector hospitality industry's construction/development expertise and entered into a public-private partnership with HMS Host to redevelop and reconstruct all its service plazas. That doesn't mean that if, for example, the Commonwealth were to decide to expand the tolled roads in Pennsylvania (see Strategic Initiative #2) that a *public-public partnership* of PennDOT (for operation and maintenance) and the Pennsylvania Turnpike (for toll collection and financing functions) might not be a better approach, especially given the expertise and experience of the respective state agencies and the availability of lower cost, tax-exempt financing. Public-public partnerships including regional mobility authorities and/or funds may also potentially be used to channel highway-generated funds to mass transit. See discussion of Strategic Initiative #4).

**B. Strategic Initiative #2 – Strategic Expansion of Tolled Facilities.** Much of Pennsylvania’s extensive interstate highway system requires substantial and ever-growing capital renewal, putting enormous and ever-mounting pressure on PennDOT’s annual operating budget. Under recent federal legislation, it may be possible to *fund the rehabilitation and selective expansion of these key interstate highways through tolling*. This approach could free up hundreds of millions of dollars each year of Motor License Fund receipts for other highway operating and capital purposes. As mentioned previously, a public-public partnership of PennDOT (for operation and maintenance) and the Pennsylvania Turnpike Commission (for toll collection and financing functions) should be considered as a cost-efficient method of implementing such a program.

The most logical (and long-discussed) candidate for tolling would be the 311 Pennsylvania miles of I-80, the major highway between Chicago and New York City which is already tolled from Chicago, through Indiana and Ohio, to just short of the Pennsylvania border. With modern electronic toll collection technology, the tolling of I-80 could be configured in such a manner as to capture long-haul, out-of-state traffic while minimizing local traffic impacts. In addition to other prospective Pennsylvania interstates such as I-81, I-83, I-79 and I-78, there is the additional possibility of tolling the Schuylkill Expressway (Route I-76) and Route I-95 in Southeastern Pennsylvania. The morning and evening congestion on the Schuylkill Expressway and I-95 suggest that drivers would be willing to pay for express routes to Philadelphia. The Pennsylvania Turnpike Commission could design, construct and operate elevated tolled express lanes on I-76 and on I-95 to relieve traffic congestion, encourage express bus operation and provide additional traffic capacity. A similar express lane facility recently opened in Tampa, Florida.

**C. Strategic Initiative #3 – Prudent use of Debt.** Pennsylvania’s current “pay-as-you-go” approach to transportation infrastructure does not take advantage of the opportunity to structure the cost of investment across the life of the assets.<sup>16</sup> Pennsylvania’s reliance on pay-as-you-go funding for highway capital projects has severely constrained the volume of such projects and has been a major contributor to the large investment backlog identified by the PTFRC. As recommended in the Pennsylvania Economy League’s recent report<sup>17</sup>, *predictable revenue sources should be identified to pay debt service on a prudent amount of debt to be incurred to finance long-term projects* such as major road reconstruction, limited expansion of existing facilities and public transit capital investments. For example, a portion of PennDOT’s existing Motor License Fund revenue stream could be leveraged to generate more revenue for capital spending for highways and bridges. Each \$100 million of annual Motor License Fund revenues applied

<sup>16</sup> In contrast, 97% of the Commonwealth’s non-highway capital outlays are debt-financed, including funding for state office buildings and general purpose infrastructure. Long-term borrowing is both an equitable and an efficient way to finance long-lived infrastructure assets: equitable, since both current and future beneficiaries share in the expense through annual debt service payments; and efficient, since the bond proceeds free the construction schedule from the otherwise-necessary annual availability of current revenues,. The accelerated timetable minimizes the impact of inflation on construction costs and brings the improvements on line sooner.

<sup>17</sup> “Investing in Transportation: A Benchmarking Study of Transportation Funding and Policy” (October 2006), Pennsylvania Economy League, pgs. 9-10.

toward debt service could support over \$1.2 billion of up-front proceeds for long term highway improvements. It is conceivable that this approach could generate several billion dollars of immediately available funds, enough, for example, to jump-start a program to meaningfully address the Commonwealth's embarrassingly high number of structurally deficient bridges (5,913 bridges, according to the PTFRC – more than any other state). Long-term, limited recourse bonds backed by a pledge of such Motor License Fund revenues could be issued in a fashion similar to what over two dozen states already do (including neighboring states of Delaware, Maryland, New Jersey, Ohio and New York). The Turnpike's experience with its Oil Franchise Tax and Registration Fee Bonds would be relevant in this regard. The bonds would not have to be backed by the Commonwealth's General Fund nor pledge the full faith and credit of the Commonwealth, yet still would likely be eligible for an AA rating.

**D. Strategic Initiative #4 – Regional Mobility Authorities/Funds.** The transportation needs of Pennsylvanians vary greatly from region to region in our very diverse state. Mass transit funding shortfalls are most acute in our metropolitan areas where passenger and commercial vehicle traffic is also heaviest. Let us acknowledge the interdependency of different modes of transportation in the Commonwealth's more congested metropolitan areas by considering innovative public-public partnership initiatives. As an example, if the Commonwealth of Pennsylvania and the Pennsylvania Turnpike Commission partnered in a program to impose and collect a *\$1 surcharge on all vehicles exiting designated metropolitan area Turnpike interchanges, approximately \$150 million per year could be generated and funneled to designated regional mobility authorities (including SEPTA and PAAC) to address mass transit needs.* This funding mechanism could encourage use of mass transit, while creating a stable and growing revenue stream for regional transit priorities.

**E. Strategic Initiative #5 – Revisit Funding Recommendations of the Pennsylvania Transportation Funding and Reform Commission.** The PTFRC recommended that Pennsylvania invest an additional \$965 million/year above and beyond current funding levels to restore and adequately maintain existing roadways and make relatively modest capacity expansions. This represents a 30% increase over current PennDOT funding levels. The PTFRC proposed funding this additional investment on a pay-as-you-go basis, through an effective 11.5¢ per gallon increase in the Oil Company Franchise Tax to generate \$750 million more per year (plus an additional 1¢ per gallon – generating \$65 million/per year – for municipality-owned roads and bridges) and a \$150 million increase in motor vehicle registration and license fees. Even if tax and fee increases of the magnitude recommended by the PTFRC are not to be implemented, smaller increases should not be ruled out as elements of a multi-component proposed funding package.

**F. Strategic Initiative #6 – A More Cost-Effective Public Sector Monetization While Avoiding the Diversion of Excess Revenues Out of the Pennsylvania Transportation Network (the “Public Ownership Dividend”).** Both Chicago Skyway and Indiana Toll Road transactions allow the private operator to obtain a large financial benefit from traffic growth over the life of the franchise, especially after the private concessionaire has paid off the debt portion of its financing. Rather than have these private profits flow back to the private operator and its shareholders, shouldn't we consider alternative financing models

which would direct those dollars back into the Pennsylvania transportation network and badly needed infrastructure investments?

If the public policy decision is made that Pennsylvania drivers should pay greatly increased future tolls on the Pennsylvania Turnpike to underwrite the cost of transportation infrastructure improvements across Pennsylvania, rather than relinquishing control of the Turnpike to a private operator for an extremely long period of time, **consideration should be given to having the Pennsylvania Turnpike raise an equivalent amount of capital on its own.** This would involve the use of tax-exempt bonds with a cost of capital more than 100 basis points (1.00 %) lower than the high cost taxable debt and even higher cost equity used by private concessionaires. A financial analysis performed for the Turnpike Commission by Citigroup verifies that in each reasonable scenario, ***the Commission can generate a greater up-front payment through a tax-exempt bond financing than a private concessionaire can through a debt/equity financing.*** A more cost-effective public sector monetization of the Pennsylvania Turnpike would enable Pennsylvania not only to maintain operating control of a vital Pennsylvania transportation asset, but would also have the additional financial benefit of allowing Pennsylvania to retain the non-monetized positive cash flows above the cost of debt service for the life of what would have been the private operator's franchise under the concession model. ***If road users are willing to pay increased tolls, these earnings should be retained within Pennsylvania to help fund the Commonwealth's transportation needs — not exported as profits to private concessionaires.*** A public sector monetization, therefore, produces an additional public ownership dividend (not available with the private concessionaire and primarily realized on the "back end" or later years of the concession agreement) which can be quantified in present value terms. This amount must be added to the up-front proceeds that could be generated with a public sector monetization to calculate the intrinsic value of continued public ownership.

In the study done by Citigroup, depending on a variety of assumed toll escalation scenarios, a public sector monetization was estimated to produce between \$13 billion and \$30 billion, at least \$1 billion more than a comparable private sector monetization. In addition, the non-monetized public ownership dividend attributable to a public financing was estimated to have an additional present value of at least \$28 billion. Thus, in an asset monetization scenario, the intrinsic value of continued public ownership was approximately \$30 billion more than the private sector alternative.<sup>18</sup> If not captured by the public sector, these dollars become windfall profits to the private operator.

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<sup>18</sup> In 2007, the Pennsylvania General Assembly (both the House of Representatives and the Senate) is expected to consider enabling legislation to authorize and facilitate P3 transactions. There is always the danger that a public entity may undervalue the asset on which privatization proposals are received. Given that concern and the inherent value of maintaining long-term control over a public asset, it is respectfully suggested that any proposed Pennsylvania legislation contain a provision requiring that (whatever procurement process is utilized) the public sector be given a "last look" opportunity to beat the "best and final offer" (BAFO) of the private sector. The State of New Jersey is currently considering P3 legislation with such a provision. Other possible protections against asset undervaluation and/or windfall profits for the private entity include provisions requiring an independent appraisal of asset valuation, and a maximum rate of return for the private entity.

The experience and elaborate study performed by Harris County (Houston, TX) Toll Road Authority (“HCTRA”) in 2006<sup>19</sup> is very illuminating. HCTRA ran a controlled experiment by furnishing a set of uniform operating assumptions to three different investment banking teams to perform a financial analysis under three different models: (i) continued public agency ownership and operation; (ii) a long-term lease/concession to the private sector; and (iii) an outright sale to the private sector. HCTRA concluded that using the same tolling and traffic assumptions, governmental ownership could generate financial valuations of the same order of magnitude as the other options, yet still leave control of an important governmental asset in the hands of the public. HCTRA opted to retain public ownership and operation.

## **V. Conclusions and Coming Attractions.**

The coming months will see a very interesting public policy debate in Pennsylvania. In the wake of the Chicago Skyway and Indiana Toll Road transactions, global financial institutions have identified and prioritized the United States public transportation infrastructure sector as a burgeoning prospective market, and they have made multi-billion dollar investments in the hope of realizing the perceived potential profits. The recent exhaustively rigorous study performed by the Harris County Toll Road Authority, which concluded that continued public ownership of the Authority’s toll road system was preferable to the private concession alternative, dealt a major blow to the privatization-by-concession movement. The national publicity generated by Governor Rendell and PennDOT’s recent Request for Expressions of Interest (“RFEI”) in a long-term lease/concession with respect to the Pennsylvania Turnpike will now shine the national privatization spotlight on Pennsylvania (along with New Jersey which is considering similar privatization/monetization proposals). The many global financial institutions that responded to the RFEI are apt to view Pennsylvania as a privatization Armageddon, pouring substantial, high-priced resources into Pennsylvania in an attempt to influence public official decision-makers and affected constituents in the impending public policy debate.<sup>20</sup>

Far from an evil concept, privatization should be embraced by all public entities as a viable alternative for any or all of the functions involved in the development and operation of public facilities. However, in the United States (as opposed to South America, China or Europe) where lower-cost, tax-exempt financing is available to public entities, the comprehensive privatization represented by long-term concession agreements will continue to be more difficult to justify, given the lower cost of capital enjoyed by the public

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<sup>19</sup> *Harris County Toll Road Authority: Analysis of Financial Alternatives, First Southwest Corporation, June, 2006.*

<sup>20</sup> As an example of the length to which at least one private P3 concessionaires is apparently prepared to go, we might look to Texas where a public debate has been raging over the potential privatization of the ambitious Trans Texas Corridor (TTC) Project, a proposed 314-mile, four-lane highway between Dallas and San Antonio. It was recently reported that Macquarie Media Group Ltd., a subsidiary of the Australian financial conglomerate, Macquarie Bank (an active “player” in the privatization world and a participant on both the Chicago Skyway and Indiana Toll Road financings), has acquired, for \$80 million, American Consolidated Media, a media holding company which owns and operates 40 small, mostly rural newspapers in Texas. Many of these newspapers have been waging an intensive editorial battle against the privatization of the TTC Project.

sector. It must be noted, however, that in analyzing any proposed privatization initiative which involves a monetization component to release so-called “trapped value” of the asset, the public sector alternative will maintain its advantage only if the public entity is disciplined enough to impose upon itself (by inclusion in bond indentures or otherwise) the same toll escalation regimes that it would allow (and the private sector would implement) under the terms of a concession agreement.<sup>21</sup>

I applaud the initiative thus far shown by Governor Rendell on this critical issue. I complement the Pennsylvania General Assembly as well for its willingness to grapple with this difficult problem. Pennsylvania’s transportation infrastructure funding gaps identified in the PTFRC Report are real and in need of serious attention. Following in the wake of last year’s legislative pay raise controversy, there seems to be little appetite in the Pennsylvania General Assembly for a gas tax increase of the magnitude ( $11\frac{1}{2}$ - $12\frac{1}{2}$ ¢ per gallon) suggested by the PTFRC as a means to fund Pennsylvania transportation infrastructure needs. The Governor’s suggested P3 initiative involving the Pennsylvania Turnpike has clearly caught the interest of the private sector judging by the many responses to PennDOT’s RFEI. Many of these global financial institutions have billions of dollars invested in the potential market for concession financings. The initial reaction of certain public officials to the privatization initiative was unduly optimistic, in the mistaken belief that this was a potential “no pain” solution to the transportation funding crisis. Alas, it is not that easy!

We can only hope that our public officials entrusted with decision-making duties in this area educate themselves on the many issues involved. This paper is one Pennsylvania transportation official’s attempt to contribute to that educational process, with the hope that in some modest way it might provoke and stimulate other dialogue in this critical public policy debate. The false allure of purported magic-bullet solutions to complex public policy issues must be resisted. What remains for responsible public decision-makers is the difficult job of cobbling together a transportation funding plan with a number of different elements. In this paper, I have attempted to explain why this approach is necessary and suggest a few of the components that might be considered in such a plan. Informed, long-range decision-making by our public officials should be the hope of all current Pennsylvanians. Generations of future Pennsylvanians are counting on us to make the right decisions. Let us all be mindful of the legacy we leave for them, so that years from now they compliment our wisdom and foresight – not curse our selfish shortsightedness!

T.J.C.  
March 14, 2007

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<sup>21</sup> U.S. Representative Peter DeFazio (Dem., Oregon), new chairman of the U.S. House Subcommittee on Highways, Transit and Pipelines, has criticized various highway privatization proposals as “outsourcing political will” to private entities which don’t have to worry about being re-elected. Remarks of Congressman DeFazio to Indiana Governor Mitch Daniels during his testimony before House Subcommittee on Highways, Transit and Pipelines, May 24, 2006.