Big BANG or Baby BOOM

The New Equity Investment in US Infrastructure

BY STEVE A. STECKLER

The terminal picture is of the opening day facility for the proposed Abraham Lincoln National Airport (Third Chicago Airport), a new privately-financed airport and an example of a "value added" lease.

The City of Chicago is considering leasing **Midway Airport** (MDW). The idea was first floated earlier in the year, just as the city's financial advisor, **Goldman Sachs**, was proposing to acquire global airport operator BAA plc for nearly $20 billion, a bid that was lost to Grupo Ferrovial, a huge conglomerate in Spain.

Last year, Goldman Sachs advised Chicago on its lease of a 3.6-mile toll road, Chicago Skyway, to an Australian-Spanish consortium for $1.8 billion. Earlier this year, the State of Indiana leased the Indiana Toll Road to a similar private consortium for $3.8 billion.

The Chicago and Indiana deals appear to have set off a stampede by major U.S. investment banks, ranging from Goldman and **Citibank** to the Washington-based power money firm, the **Carlyle Group**, to create new, multi-billion dollar infrastructure equity funds. They anticipate a huge new market for private investment in public-use U.S. airports, toll roads and utilities. In one of his last speeches before retiring as U.S. Secretary of Transportation, Norman Minetta called for sweeping changes in federal aviation and transportation programs to help make that happen. I strongly agree with Secretary Mineta, but two decades of experience in U.S. public-private partnerships assures me that it won't be easy.

Extraction Versus Enhancement Leases

The two big toll road deals are examples of "value extraction" leases, where the leasing government is interested almost solely in the size of the up-front check it gets by transferring control of the road to a private lessee for between 50 and 99 years. The private lessee is willing to write the government a big check because the lease allows them to raise tolls and keep any savings from better management; the higher the tolls, the bigger the check. They are also two of the rare instances in which most of the facility's users do not vote in the leasing government's jurisdiction: the Skyway's users are mostly commuting into Chicago from Northern Indiana, while the Indiana Toll Road's users are mostly interstate trucks and travelers. The leasing government is largely shielded from the political repercussions of higher tolls.

"Value added" leases, on the other hand, are very different and far more common outside of the U.S. From such leases, the government wants new or improved facilities, and not just a check it can use to close budget deficits or fund local schools (although Indiana claims it will use the proceeds mostly for other transportation projects). The deal at **Stewart International** (SWF), and Terminal 4, **New York-Kennedy International** (JFK) are both value-added leases, and in a sense, so is **Indianapolis International's** (IND) operations and management contract. At IND, it is the airlines that enjoy the fruits of private operator BAA's lower operating costs and higher concession revenues. Similarly, the lease-develop-operate structure proposed by the Abraham Lincoln National Airport Commission for building a third Chicago-area airport seeks to tap private know-how and capital to develop an airport faster and more efficiently than a pure public-sector approach. Outside of airports, Texas and Virginia have recently embarked on an extraordinary program of "value added" toll road public-private partnerships totaling tens of billions of dollars.

The Good Lease

Value added leases are much more complicated than value extraction leases, and for a good reason: the winning bidder is promising to build, operate and steadily expand an all-new facility (or major addition) of public-driven specifications and for a period of up to 99 years. The resulting detailed proposals must be carefully compared and then codified in an extensive lease agreement. And if the users of the facilities actually vote in the leasing government's jurisdiction, it is understandable that a lot more care will be taken to ensure that the users' experience is a positive one.

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> *--Steve A. Steckler*

As a matter of principle, I strongly support properly structured value-added leases, and I also support value extraction leases when they are combined with a value-added agreement that promises extensive new investment, greater efficiencies and new revenue sources in the target facility. It's like balancing a portfolio: extracting the value or money from where you have it, and moving it to where you need it most, while taking care to be fair to each group of users.

Based on comparables and my company's own analysis, a pure value extraction lease for Midway could yield between \$1.5 billion and \$2.4 billion for the City of Chicago, depending heavily upon the terms of the lease and how the embedded AIP grants and tax-exempt debt are handled. No matter what, it will be a much more complicated deal than either the Chicago Skyway or Indiana Toll Road transactions, and it will face fierce opposition from the airlines, especially Southwest. If the deal does go through, the airline opposition and the leverage afforded them by federal law and their current facility leases can be expected to result in terms that will sharply reduce the city's paycheck while making the deal more like a value-added lease with significant user benefits.

Imported Dreams of Pension Fund Investment

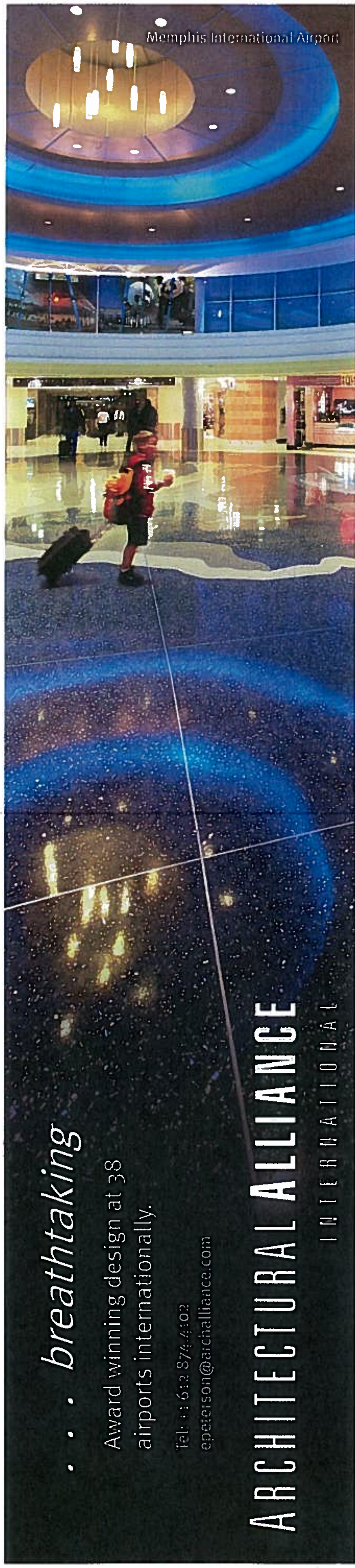
What, exactly, is behind this new push toward privatization?

Back in the early 1980's, when Great Britain's Prime Minister Margaret Thatcher's privatization successes emigrated to America via the think tanks advising the Reagan Administration, young policy wonks, including this one, dreamed of billions of dollars of new infrastructure investment from private equity firms. We were certain that pension funds and other retirement-oriented money pools would be eager for long-term investments that matched their participants' life cycle. We tinkered with federal transportation grant programs and talked up the investment houses about the endless possibilities, certain that they would see the opportunity.

We were wrong on both counts. The U.S. infrastructure finance environment is unlike any other in the world. The federal tax-exempt status of municipal bonds and the array of intergovernmental transportation grants amount to huge, sacrosanct federal subsidies that until recently were not available to any privately-financed projects. Moreover, every state in the union prohibits the state and its municipalities from owning stock in a private company, a common practice in many large infrastructure ventures abroad. Even U.S. investment banks, the conduits for capital for self-financing airports and tollways, are segregated into a municipal bond department, with all the cache and sophistication of a used car lot, and a private equity department, which enjoys the higher status and compensation afforded "real" global financiers. Municipal bonds are merely loans; equity is an investment.

Then Came the Skyway

More than 25 years after Margaret



Thatcher's ideas hit U.S. shores, the country's three major airport privatizations still stand out like remote islands in a sea of public management. IND, SWF, and Terminal 4 at JFK were each supposed to set off a wave of similar projects, but the march of the clones never happened. Then came the Chicago Skyway deal.

Imagine that you own a driveway that is the only way for the residents of your cul-de-sac to get out of the neighborhood. You're nice about it, and year after year you charge them only the cost of maintenance. Then one day you decide to rent out your house for the next century, including the driveway. A bidding war ensues, and your house that might otherwise have rented for, say, $500 million, goes for $1.8 billion because the bidders know that your driveway could be a goldmine. The bidders place a big time bet on their ability to raise tolls, increase the number of users, and reduce costs over the next century, and give you the resulting check. That's pretty much the Chicago Skyway and Indiana Toll Road deals. One analyst recently noted sarcastically that if the same regulation negotiated for the Chicago Skyway deal had been applied to New York's Holland Tunnel back in the 1920's, the toll rate could now be $185 each way. At least Indiana had the grace to sink its lease proceeds into other state transportation projects.

The allure of a gargantuan government payday cannot be denied, both for leasing governments and major investment banks. It has prompted the intense interest of U.S. investment banks, many of which have stooped to working for consulting fees just to learn the ins and outs of public-private partnerships. They are following a trail blazed by Australian bank Macquarie, which manages billions of dollars from the Australian equivalent of mandatory 401(k) retirement accounts. Armed with these resources and prodded by healthy placement fees, Macquarie bested the offer of every other bidder in the two tollway deals, by far.

Maybe a Baby Boom

As for any impending boom in equity investment in U.S. public-use infrastructure, there is hope among privatization advocates that Secretary Mineta's successors, his counterparts at the U.S. Department of Treasury, and his former colleagues in Congress will continue to advance the cause of blending federal grants and tax-exempt bonds with private equity, or at least level the playing field for private equity versus municipal bonds. Private investment and operation can have real public benefits. Recent changes in the federal highway program offer hope, and the number of resulting highway public-private partnership deals is accelerating rapidly. Unfortunately, while airports have always enjoyed more flexibility than highways in mixing public and private capital, the Airport Improvement Program (AIP) is still heavily biased toward pure public ownership and control.

The federal tax treatment of municipal bonds and the institutional mindset of U.S. public officials will be much slower to change than federal grant programs. Moreover, the number of value extraction opportunities where users vote elsewhere is small. Leasing the New Jersey Turnpike or MDW will be much harder if the only goal is a big up-front check, and without a big payday, few elected officials may be willing to run the gauntlet. With politically viable value extraction opportunities so rare, most private investment deals will be all-new projects that must stand alone financially and somewhat apart from the existing network, or major additions to existing facilities, such as a new airport terminal.

Stand alone projects are riskier than investing in a system of facilities, and if mitigating those risks requires some measure of government co-investment or revenue guarantees, the government will almost surely insist on limiting the investors' returns more directly than did the Skyway or Indiana Toll Road deals. Accordingly, the next two years are likely to see a lot of new money (some of it pension money), chasing a relatively small number of low-risk U.S. projects with often unrealistic hopes of investment return, followed by a modest but more realistic market for new equity-assisted infrastructure.

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