Squeezing Cash From Concrete:
Navigating the Perils of Turnpike Privatization

by

Steve A. Steckler
Chairman, Infrastructure Management Group, Inc.

In 2005, the City of Chicago leased its 3.6 mile Chicago Skyway toll road to an Australian-Spanish consortium for $1.8 billion. Last year, the State of Indiana leased the Indiana Toll Road to a similar group for $3.8 billion. The size of the winning bids on both projects stunned both the distant second-place finishers and caught the attention of state treasurers everywhere. Now, as Chicago prepares to move forward with the leasing of Midway Airport in hopes of another multi-billion-dollar payday, New Jersey and Pennsylvania are among those looking at leasing transportation assets in their own states.

They have plenty of company in the financial community. The Chicago and Indiana deals have set off a stampede by the major US investment banks, ranging from Goldman Sachs and Citibank to the Washington-based power money firm, the Carlyle Group, to create and invest new, multi-billion dollar infrastructure equity funds. Firms with municipal bond departments that had previously struggled to even pronounce “privatization” are now establishing new investment units in anticipation of a new market of ten-digit deals.

Imported Dreams of a Public Payday

In the early 1980’s, when British Prime Minister Thatcher’s privatization policies were emigrating to America via the think tanks advising the Reagan Administration, young policy wonks (including this one) dreamed of billions in new infrastructure investment from private equity funds. We were certain that pension funds and other retirement-oriented money pools would be eager for long-term investments that matched the participants’ life cycle. We tinkered with Federal transportation grant programs and talked up the investment houses, certain they would see the opportunity. We were wrong on both counts. Twenty years later, the US’s three major airport privatizations – Indianapolis, Stewart (Newburg, New York), and the JFK airport international arrivals terminal -- stood out like islands in a sea of public ownership. The private lessees of the country’s one sizeable private toll road, California’s State Road 91, sold out to the government, and the Stewart airport lease was headed in the same direction (and recently did so).

Then came the Chicago Skyway deal and with it a seismic shift in the US privatization market. A money-losing punch line of a road, a glorified exit ramp in a bad part of town, fetched $1.8 billion from an Australian equity fund with billions of pension dollars burning a hole in its pocket. A year later, Indiana proved that bigger and better assets could draw even larger paydays when it leased its northern interstate conduit (I-80) for $3.8 billion. It is easy to understand why Pennsylvania and New Jersey, with bigger turnpikes, might try to improve on even those numbers.

"Delawared"

Pennsylvania's and New Jersey's leaders should note what most distinguishes the Skyway and Indiana road from their own turnpikes: the majority of the tollway's users do not vote in the owner's jurisdiction. The Skyway is used mostly by northwestern Indiana suburbanites commuting to downtown Chicago, while most of the Indiana Toll Road's revenues come from thru-traffic originating outside of the state. To use a term that southbound New Jersey and Pennsylvania drivers on I-95 will understand, the deals "Delawared" out-of-state drivers.

The politics of the deals are also telling, if not foreboding. Mayor Richard Daley, probably the most powerful big-city mayor in the country, easily pushed the Skyway deal through a desperate city council, while the Indiana deal, crafted by Republican Governor Mitch Daniels, barely squeaked through a Republican-controlled state legislature despite the billions it made available for its favorite transportation projects. It is hard to imagine that any governor trying to emulate them would have easier politics.

On both roads, tolls will increase beyond what they would have under continued government control; after all, the size of the check paid by the winning bidder is directly related to how much the bidder can increase tolls. In the case of the Skyway and Indiana Toll Road, they can increase roughly by the rate of inflation or GDP growth. One analyst ruefully noted that if the same regulation negotiated for the Chicago Skyway had been applied to New York's Holland Tunnel back in the 1920's, the toll rate could now be $185 each way. Of course that won't happen, but it does provide some perspective on what kind of regulatory structure it takes to get to a multi-billion dollar payday.

Extraction Versus Enhancement

The other frontier of privatization leases is Texas, where the state has awarded billions of dollars worth of concessions (franchises) for the construction and operation of *new* toll roads. There, with the assistance of my own company, among others, state officials plan to harness business-like construction and operating efficiencies, along with private capital, to satisfy some of its largest highway needs. The deals there are examples of "value added" leases.

The Chicago and Indiana deals, by contrast, are "value extraction" leases, where the leasing government taps some of the value created by its local transportation monopoly. Their officials are mainly interested in the size of the up-front check they can get by renting the road – or more importantly, the toll booths -- for between 50 and 99 years. Texas, on the other hand, is more interested in getting new roads and not just a check, although in some cases they have gotten both.

For the investment banks, value-added leases are just not as much fun as value extraction leases because the equity portion of the financing (when there is one) is usually smaller or non-existent, and the financial risks somewhat greater. They're not as much fun for governors either: the former means pitching a skeptical legislature on behalf of a particular project delivery method, while the latter can mean brandishing a giant check for the state school system. Of course, some state legislators will argue (as they did in Indiana) that the state could itself raise the billions by upping tolls and issuing bonds backed by them, but they won't. *That* kind of extraction is just too obvious.

Lessons for Pennsylvania and New Jersey

The US targets most talked about among the infrastructure funds right now include Midway Airport in Chicago, the Pennsylvania Turnpike (or a portion of it), and the New Jersey Turnpike. The numbers bandied about range from $2.5 billion for Midway to more than $15 billion for the New Jersey Turnpike. All three have some of the "thru-traffic" characteristics of the Skyway and Indiana Toll Road, but only some: a solid majority of Pennsylvania and New Jersey turnpike users are state residents, and the majority of the trips begin and end within the state. Midway Airport may have an even harder time, where the airlines, which must approve any such deal, have long since dug in against the proposal.

All governors know that the greater good is rarely a successful argument for pinching a minority constituency. The only sure way to appease road users who also vote is to give them something in return: a vastly superior road, for example, or to fund the up-front check via new revenue sources or cost savings rather than higher tolls. Accordingly, state officials would be wise to heed some lessons learned from previous value extraction leases:

- **It's Tolls, Tolls, Tolls:** My firm's experience is that the private sector can do wonders on the maintenance and operations efficiency front, as demonstrated by the success of several full-service highway maintenance contracts in Virginia, and there may also be savings in how private firms bundle design and construction compared to the government, but there are limits. The New Jersey Turnpike and Pennsylvania Turnpike are in the upper half of the operating efficiency scale for public turnpikes, according to the available data, but even if they weren't, a halving of variable maintenance costs would barely budge the valuation needle. Savings during expansion and re-construction might be greater, but the debate among transportation engineers on that topic is as fierce as any in the industry.

- **Toll Roads Are Not Airports:** It might also be possible to sell more hamburgers and caffeine to turnpike drivers, and the success of the Pittsburgh airport terminal's Airmall and the new concessions at Philadelphia's airport show how lucrative catering to traveling shoppers can be, but unlike airports, tollway food and retail revenue is negligible compared to toll revenue, and most of the sales are rung up by retailers lying just outside of authority-owned land. Non-toll revenues were not a major part of the Skyway and Indiana Toll Road bidders' calculations, or for that matter any other major toll road privatization in the world. Even a tripling of the "capturable" revenue might contribute less than a tenth of what tolls do.

- **Roadway Real Estate Is A Very Wild Card:** There is also potential in the real estate development rights at the interchanges and above the roadway in urban areas. The value of these rights could be huge, and it begs for a more detailed analysis, but once again there are limits. The trade association representing highway service station owners and related retailers is as powerful as any group in Washington or the state capitols, and they have proven to be both watchful and tenacious regarding any government-supported competition. Moreover, the toll authorities have generally acquired no more land around interchanges than is necessary for safety or future capacity expansion. Finally, the opportunities for building shopping or offices *over* urban roadway segments are numbered, and they are often expensive and technically challenging to execute.

None of this is to say there aren't more non-toll revenues in the turnpikes or that they aren't worth pursuing: the interest level among potential investors is demonstrably *higher* for infrastructure with developable real estate (e.g., airport and transit station land) than without it. But valuing the opportunities for an entire turnpike system is challenging for both lessor and lessee. Especially for real estate, the issues are very site-specific, and properly analyzing each site is simply too time-consuming and expensive to be performed at the bidding stage. Moreover, each site will have many permitting, design, access and competition contingencies that will not be resolved ahead of time. For these reasons and others, bidders on previous infrastructure privatizations with secondary land development have tended to steeply discount the future real estate-related revenues in sizing their offers.

Half a Loaf Can Still Be Huge

Infrastructure-specific funds have declared their preference for acquiring *existing* facilities, with solid local service monopolies and demonstrable cash flow, compared to financing new ones. This bodes well for any state considering an infrastructure lease. Still, the interest of the major banks is so intense that state decision makers would be wise to temper their enthusiasm a bit with the realities of local toll politics. That said, there is a reasonable tradeoff to be made in the case of the turnpikes.

- First, the combination of maintenance, operations and construction efficiency gains, along with increased non-toll revenue and the value of real estate rights (however discounted) could conceivably exceed a quarter of the value of new toll revenue. That number alone is worth pondering.

- Second, turnpike user-voters will accept at least *some* toll rate increases before burning politicians in effigy, and that level is probably not too far under the rate of inflation. As we are discovering in Texas and elsewhere, even that level of toll rate growth can provide bidders with enough room to generate solid value in a lease deal.

- Finally, officials in Illinois, Indiana and Texas have all been pleasantly surprised by the size of the winning bids in the latest transactions. One reason is that a few bidders are taking even longer-term views than state transportation officials typically do, valuing distant toll revenues that are ignored in state financial analyses. The other is that the bulging purses of the investment funds (not to mention the fees the fund managers earn for placing them) appear to have driven down the "acceptable" long-term return on toll road leases, resulting in higher lease bids. And compared to corporate stocks, infrastructure investments are very long-term bets, which could separate fund managers from the consequences of any mistakes.

Pennsylvania and New Jersey might be wise to make their decision sooner rather than later. There is a risk that the investment fund feeding frenzy may be short-lived if the forecasted returns on the newest lease deals continue to drop and if few new US lease opportunities arise. There is enormous inertia in state highway policy, strong Federal tax and funding biases against private project financing and control, and each project has its own fragile politics. Texas is already hearing noises from potential lessees that the bid prices, risks and prospective returns are moving out of line with alternative investments. Moreover, the winning bids in Chicago, Indiana and some recent new-facility leases were so much larger than the second-place bids that it's hard to be sure just how broad and deep the appetite for US infrastructure really is. One thing is certain, however: the Pennsylvania and New Jersey turnpikes would be the truest tests of that appetite to date.

Steve A. Steckler is the chairman of Bethesda, Maryland-based Infrastructure Management Group, Inc. He has served as the chief financial advisor and transaction manager for numerous airport and highway privatizations in the US and around the world. He can be reached at ssteckler@IMGgroup.com.