Modernizing and Expanding Pennsylvania's Transportation Infrastructure through Public-Private Partnerships

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Reason Foundation respectfully submits written testimony to the Pennsylvania House Republican Policy Committee. Reason is a Los Angeles-based non-profit, non-partisan think tank that has researched and analyzed transportation policy for more than 35 years. Furthermore, we are among the leading national experts in public-private partnerships and privatization research.

A. Introduction

Like many states, Pennsylvania finds itself at the convergence of several intersecting trends that demand policymakers' attention. First, the state's growing transportation needs are outstripping available revenues—the state's current transportation funding gap will total tens of billions of dollars in coming decades—and the need for maintenance and renovation of existing systems is eating up available financial resources. Left unchecked, this will lead to even greater congestion in various forms and lowered relative reliability of service in the future.

The transportation challenges do not end there. As the state's population grows and expands, increased demands will continue to be placed on the aging network of roads and highways. At the same time, recession-hit state and local governments are faced with bleak fiscal conditions and the challenge of trying to do more with less for years to come. Further, there is little will among many politicians to support fuel tax or vehicle fee increases of any kind to fund infrastructure, especially in challenging economic times. With tax dollars already stretched thin, preventative maintenance is all too often put off for another day.

Altogether, Pennsylvania is facing a transportation crisis that threatens the state's economic competitiveness and its citizens' quality of life. Absent new funding and procurement mechanisms, Pennsylvania will be faced with having to close a multi-billion dollar infrastructure funding gap without some of the innovative procurement tools available to other states. The transportation challenges are confronting a state that is unable to deal with them outside of the traditional means of gas taxes, vehicle fees, and government subsidies, which challenge the ability of the state to keep the overall transportation system ahead of the curve.

To get Pennsylvania moving again, the state will need to "think outside the box." How? If we take a global perspective, the answer becomes more clear—government cannot do it alone, and we should seek greater private sector participation and investment in providing for our transportation needs.

Even though the vast majority of transportation projects around the country continue to be funded from traditional sources—taxes, fees, public debt and government subsidies—a new funding paradigm is rapidly emerging. State and local transportation agencies are increasingly looking to supplement these sources with private investment through public-private partnerships (PPPs). PPPs are just one "tool in the toolbox," but this promising and valuable procurement option has been relatively untapped in Pennsylvania.

PPPs offer a way to leverage private capital and expertise to provide a public service, and states are increasingly using them to deliver needed new transportation capacity while stretching limited taxpayer dollars. Although often thought of simply as "private toll roads", transportation PPPs actually allow for a variety options to finance, construct and/or maintain new and enhanced transportation facilities.

Opportunities for PPPs exist in Pennsylvania in many important facets of transportation, including constructing new highways, building new bridges, and competitive contracting for additional local and state road maintenance and operations. In fact, PPPs may offer a viable means of financing some of the state's large-scale capital improvement projects that currently lack a funding source, or perhaps even deliver more value for the road maintenance dollar.

PPPs are never going to completely replace the traditional means of funding transportation, but they are a very promising method in which to augment traditional transportation revenue sources and provide more project delivery options and cost-savings to the Commonwealth.

Pennsylvania currently lacks broad enabling legislation for these partnerships, which is generally needed to entice private sector investment. Over the last two decades, over half of the states have now adopted legislation authorizing the use of PPPs for the design, construction, financing, and operation and maintenance of transportation facilities. The reality is that transportation projects are going to states like Virginia, Florida, and Georgia that have created a solid legal foundation for PPPs—where the law facilitates PPPs and where private investment and participation is welcomed and embraced.

Pennsylvania policymakers should embrace the considerable potential of the emerging PPP paradigm for highway funding and operations. Policymakers are no longer forced to choose between increasing costs to taxpayers or reducing services to motorists. PPPs, when implemented properly and carefully, can help the state address its looming transportation funding shortfall in order to keep people and goods—and ultimately the state economy—moving forward.

B. What is a Public-Private Partnership?

Public-private partnerships are simply contracts formed between public agencies and private companies that facilitate greater private sector participation in the delivery of a public function. The private sector has long participated as a close partner with state and local governments in the design and construction of transportation assets. In fact, nearly all road construction in the United States is performed by private firms working under contracts with public sector entities. Given that, it would be reasonable to wonder how PPPs are any different from current state practices.

What's different is that PPPs expand private sector involvement beyond just the limited scope of simply designing and building transportation facilities. According to a 2009 report by the National Surface Transportation Infrastructure Financing Commission (emphasis added):

> *Today, the private sector is taking on far greater risk and responsibility through an emerging class of comprehensive contractual arrangements to* ***not only deliver projects but also to operate, maintain, and finance them****, thereby providing greater financial certainty and more efficient performance for the public sector. […] The private sector's participation in delivering surface transportation infrastructure* ***can be viewed as a continuum****, ranging from project delivery techniques (e.g., design-build contracting) to project maintenance (extended warranties) and long-term responsibility for financing and managing the operation of facilities (concession agreements).*

PPPs come in many forms and are increasingly being used for the development of new infrastructure, the modernization of existing roadways, the maintenance of existing infrastructure and the operation of existing services. Such partnerships often involve the investment of private risk capital to design, finance, construct, operate, and maintain a road or other transportation asset for a specific term during which a private toll company collects toll revenues from the users (or, in non-toll PPPs, collects an annual payment from the state). When the contract expires, the government can take over the facility at no cost.

PPPs leverage the capital and expertise of the private sector with the management and oversight of the government to provide public services, and they are an effective way of financing, managing and operating roads while minimizing taxpayer costs and public financial risks. Though relatively new to the United States, PPPs for complex, multi-billion dollar transportation projects have been used for decades in Europe, and more recently in Australia and Latin America.

In fact, PPPs have become the conventional way to provide major new highway capacity in many countries. The private sector is financing, building, and operating most of the major new highways in countries as diverse as Great Britain, France, Spain, Italy, Greece, Poland, China, India, Indonesia, South Africa, Australia, Argentina, Brazil, Chile, and Jamaica. Large urban toll projects in excess of $1 billion are in operation or under construction in Melbourne, Sydney, Paris, Israel, Santiago, and Toronto.

During the 1990s, PPPs began in the United States and Canada as well. PPP toll projects are currently in operation or in development in states like California, Florida, Texas, and Virginia (as well as several Canadian provinces), and over 25 states have passed specific legislation to authorize the use of PPPs in transportation projects. States that passed new PPP enabling legislation in 2009 alone included California, Arizona, and Massachusetts. Also in 2009, New York policymakers created the State Asset Maximization Commission to evaluate PPP opportunities in transportation, education and other areas, and Michigan Governor Jennifer Granholm created a new Office of Public-Private Partnerships to begin framing a new PPP program in that state. Major PPP initiatives are also currently underway in Puerto Rico and Guam.

C. Benefits of Public-Private Partnerships

Toll financing can help Pennsylvania close the financing gap for new infrastructure. In addition, the public-private partnership model has several advantages over the traditional model of transportation financing.

1. Access to large new sources of capital

PPPs can also allow the state to tap into new sources of capital never used before to deliver transportation infrastructure in Pennsylvania. For example, the concession model is attractive to many different types of investors, including private equity investors and institutional investors (such as pension funds and insurance companies). Probitas Research reported in early 2009 that there were over 70 new infrastructure equity funds in or coming to market that calendar year, seeking over $92 billion in new equity capital. Combined with the $84.5 billion raised by existing infrastructure funds between 2004 through 2008, that would mean a total of $176.5 billion in equity has been raised in the private capital markets to invest in infrastructure PPPs (assuming all $92 billion is raised in 2009). That figure is close to the $180 billion estimated as available in 2009 by Morgan Stanley.

Institutional investors are not just investing in infrastructure funds (which, like mutual funds, are designed to invest in and spread risk among many projects); some are investing directly in individual PPP projects. In 2009, the Dallas Police and Fire Pension System joined the mix of direct equity investors in two toll concession megaprojects ($6 billion total value) in the Dallas-Fort Worth area, making it the first direct pension fund investor in U.S. PPP projects.

2. Delivering tomorrow's infrastructure today

PPPs enable needed new capacity to be delivered much faster than is possible under the current pay-as-you-go funding system, which is often ill-suited to delivering large-scale projects in a timely manner. In a pay-as-you-go system, projects are held off until enough gas taxes have been collected to pay for the project—and this may take decades in the case of larger transportation projects.

PPPs offer a way to finance and build needed capacity now, when we need it, versus decades from now or possibly never. And it frees up resources to deliver other projects that will not have to wait for funding to become available. This is a win-win for taxpayers, drivers, and businesses as partnerships deliver projects to strategically connect the state and enable greater mobility of goods and people.

The contractual mechanism in PPPs increases the incentive to produce high-quality work and ensure high performance. Indeed, the level of performance is firmly established in the contract. Generally, contracts can (and should be) performance-based (focusing on outputs or outcomes) and can include quality assurances or quality control assurances. Enhancing accountability and performance also are prime considerations for many public officials in their role of protecting the public interest. Partnerships require strong contracts with performance requirements. In many cases, this adds an additional level of transparency into the operations.

3. Ability to raise larger sums for toll projects

New highway capacity is far more costly these days than it was when the Interstates were built. Hence, rebuilding and modernizing our freeways and Interstates will be far more costly than most people realize. There is growing evidence that the long-term concession model can raise significantly more funding for a given toll project than the traditional toll agency financing model.

For a new toll road in Texas (SH-130 segments 5 and 6), for example, a toll traffic and revenue study estimated the ability to finance $600 million, but the project's cost was $1.3 billion. Texas DOT turned to a long-term concession approach, in which the private sector will finance the entire $1.3 billion project, in exchange for a 50-year concession. Three factors seem to drive such results. First, the concession agreement adds certainty to future toll increases that we've never seen with toll agencies. Second, the private sector seems more aggressive in both attracting traffic and holding down costs. And third, the private sector can take depreciation as a tax write-off, like any other business, but toll agencies can't, since they pay no income taxes.

4. Transferring risk from taxpayers to investors

PPPs allow government agencies to shift major risks from taxpayers to the contractors, including such normally "unseen" risks like construction cost overruns, traffic and revenue shortfalls, and higher-than-expected life-cycle operations and maintenance costs. With the power of a contract at hand, governments can build quality assurance and/or quality controls into project delivery as a means to manage risk. An increasing trend is the employment of warranty concepts whereby the contractor places a long-term guarantee on their work. This further shields taxpayers from risk. The assumption of risk by the private partner is one of the most important aspects in a successful PPP.

In addition, PPPs get away from traditional procurement requirements, allowing the state and the private partner to use innovative financing to make additional capital readily available, as well as reduce the common delays in project completion. The traditional design-bid-build procurement process completely separates the planning of the project from the construction. The project is designed by an engineering contractor—or the highway department itself—and then put out for bid. Different construction contractors then put in their bids. The design-build model gaining popularity includes the same contractor team in both the design and construction work. The benefits are in the time and cost savings of having one contractor team responsible for the entire project.

5. More businesslike approach

The typical U.S. toll agency and the typical European or Australian toll road company are miles apart in their approach to everyday business. Private toll road companies are less constrained by political pressure and are more customer service oriented. They are quick to adopt cost-saving and customer-friendly technology and specialized products and services to meet customer needs.

6. Major innovations

One of the most important advantages of investor-owned toll road companies is their motivation to innovate, in order to solve difficult problems or improve their service to customers.

- Today, we know that variable pricing (also known as value pricing) works very well to eliminate traffic congestion during peak periods, actually maximizing throughput while maintaining high speeds. Electronic toll collection makes value pricing possible—but it was a private toll company in California that took the initiative to introduce and perfect value pricing; no state toll agency was willing to take the risk of doing so.
- Toll road companies are also good a value engineering—thinking outside the box to dramatically reduce the costs of new capacity. A case in point is the forthcoming HOT lanes project on the I-495 Capital Beltway in northern Virginia. Virginia DOT's plan to add two HOV lanes in each direction on that section of the Beltway would have cost $3 billion—money that VDOT did not have. The private sector team's unsolicited proposal called for adding two HOT lanes in each direction—the same amount of physical capacity—at roughly one-third of the cost, thanks to value engineering that reduced or eliminated many "bells and whistles" that added large costs but very little real benefit.
- In France, an unsolicited proposal from a private toll firm resolved a 30-year impasse over completing the missing link—through Versailles—of the A86 Paris ring road. The company is completing the link as a deep-bore tunnel underneath Versailles, and is financing the $2 billion project with value-priced tolls.

7. Flexibility

Governments seek PPPs for a myriad of reasons and to achieve a number of different goals. One of the undervalued benefits of PPPs and concession arrangements is that they are customizable to fit the needs, goals, and desired outcomes of a community. Put simply, governments can tailor each particular initiative or project to meet their goals.

The concession model has been adapted in a variety of ways to build new capacity and address difficult challenges. In Texas, for example, the private sector is developing a 40-mile extension of State Highway 130 from Austin to San Antonio and will share revenues with the state over the life of the 50-year agreement. Without the private sector, this road would not have been built—the state could have only financed half of the project's $1.35 billion cost on its own.

Similarly, a concession can be structured to add new capacity to an existing roadway. For example, in return for a 75-year concession, a private consortium is now adding the first new lanes to the I-495 Capital Beltway in Northern Virginia, which again is something government had been unable to implement through traditional funding approaches.

For the recently opened South Bay Expressway in San Diego, the concession was tailored to meet a number of environmental and economic development goals. This roadway has been on the books since the late 1950's, but the funding was not there to advance it. The state partnered with a private venture to deliver the road through a 35-year concession. Not only did the private partner finance the $635 million project, but they undertook an extensive public involvement process that led to the integration of features designed to meet a number of environmental and community goals, such as preserving 1,000 acres of habitat, restoring area wetlands, and building a number of parks and recreation facilities. Aside from its award-winning environmental innovations, the road delivers a much needed, north-south corridor to reduce congestion and improve mobility, filling in a major gap in the regional road network.

As another example of the flexibility of the PPP approach, several states are seeing increased interest in availability payment concessions, in which the private sector designs, builds, finances, and maintains the road, but the public sector actually collects all of the tolls and reimburses the private company over the life of the deal in return for having made the road "available." Some officials are seeing this as a more politically attractive structure than having the private partner collect tolls and retain revenues. The $1.6 billion I-595 express toll lane project in the Fort Lauderdale, Florida area—which reached commercial and financial close in 2009—is an example of an availability payment concession, as is the $1 billion Port of Miami tunnel project in Miami, Florida, which reached financial close in October 2009.

The above examples—all of which are underway today—offer just a few examples of the types of approaches being used by innovative policy makers to capitalize on the flexibility inherent in PPPs. These projects are excellent examples of the types of projects that might be able to greatly benefit Pennsylvania if it were to pass enabling legislation creating a solid legal framework for PPPs.

8. Efficiency and the Life-Cycle Approach

Some agencies seek PPPs to explicitly gain the maximum utility from tax dollars and improve overall system efficiency through competition and specialization. PPPs offer considerable opportunities for cost savings and efficiency improvements due to the proper alignment of incentives and greater flexibility to innovate. Private companies often bring in better and more specialized management and equipment that helps cut down expenses and improve operations. In long-term concessions, for example, contractors have the incentive to adopt life-cycle approaches to asset management that will minimize operations and maintenance costs and capital expenditures over the life of the lease.

Private contractors are also not burdened by government civil service rules and can hire a more flexible and specialized work force using lower wage or part time workers in conjunction with higher skilled workers when necessary. Also, private companies often have incentive pay packages that encourage managers to achieve their performance goals at lower costs.

D. How Do Public-Private Partnerships and Concessions Work?

Like anything else, public-private partnerships can be done well or poorly. This is true of each type of partnership, from simple operational contracts to concession agreements for new and existing roads. Fortunately, while these arrangements may be new to Pennsylvania, they are not new to the rest of the world. A long history has established best practices and guidelines to ensure that quality is delivered and that taxpayers are protected.

The model that has worked best around the world is to use a long-term concession agreement as the basis for protecting the interests of both parties in the partnership. And the issues that need to be addressed in a concession agreement are quite similar, whether the agreement concerns the leasing of an existing toll road or the development of a new one. Over the span of 50 or 75 years, major construction or reconstruction will be required in any case, so all such concession agreements must address the same set of issues. The only major differences between agreements for existing toll roads and those for new ones is that the former involve large new revenues for the states, while the latter involve much higher levels of initial risk for the private partner.

In any case, the concession should be structured to mitigate any concerns, and adequate protections for the public interest should be detailed in the terms of the agreement. These agreements tend to be several hundred pages long, spelling out all kinds of “what-ifs” and establishing well-defined performance levels that the contractor is legally required to meet or face penalty. These standards dictate everything from future maintenance and road condition expectations to the time it takes to remove dead animals. The contract also establishes toll rates and possible increases over the term—tolls are usually capped and indexed to some inflation measure—as well as any revenue sharing or limits on the concessionaire’s return on investment.

From a risk side, perhaps the most important aspect, the state can revoke the contract at any time. The concession agreement and lease sets the conditions for the state to cancel the contract and resume operations of the road should the contractor fail to perform. The structure of the agreement also spells out which risks are allocated to the contractor and which to the public sector.

The public sector's key role is setting the agenda—outlining expectations, goals, and desired outcomes. They set the standards and performance requirements. Once a private partner has been selected and a contract is signed, the role of the public sector shifts to that of oversight and evaluation. The government should never sign a contract and walk away. Rather, strong reporting, evaluation, and auditing components should be in place.

E. Responses to Common Concerns

Despite the increased utilization of PPPs in various states in recent years, a wave of new state PPP enabling legislation and the significant benefits to taxpayers and the public sector, reasonable concerns about PPPs have been expressed by policymakers and the general public. This section explores some of those concerns.

1. Infrastructure Investment in the Wake of the Financial Crisis

In the wake of the fall 2008 financial crisis, some observers have wondered whether the turmoil on the financial markets would dampen private investors' enthusiasm for PPPs and infrastructure asset leases. Broadly speaking, the answer is no. As the global financial markets experience a massive credit crunch, one of the few categories in which there appears to be increasing interest among investors is revenue-producing infrastructure. There is a general consensus in the finance community that infrastructure remains an attractive investment in the "flight to quality" seen in the markets more generally (capital flowing to solid, safe, and tangible investments with steadier returns and relatively lower risk profiles).

Despite economic ups and downs, people are still going to drive, fly and consume goods. That means roads, airports, water systems and other types of brick and mortar assets remain good investment prospects over the long term. Industry analysts expect that while debt is going to be more expensive and more conservatively invested, it will definitely be available for good projects. What is likely to change is the leverage in these deals. Instead of debt/equity ratios of 80/20 or 70/30 (as seen prior to the crisis), in the future we are likely to see much larger percentages of equity, at least in the near term.

There is strong evidence that the major providers of equity—infrastructure investment funds, insurance companies, and pension funds—continue to be strongly interested in infrastructure. Probitas Research reported in early 2009 that there were over 70 new infrastructure equity funds in or coming to market that calendar year, seeking over $92 billion in new equity capital. Swiss financial services giant UBS announced in November 2008 that its new International Infrastructure Fund had raised an unexpectedly high $1.5 billion in committed capital, and the company was considering launching another similar fund in 2009.

The proof is in the pudding though, and perhaps the most significant indicator of PPP market conditions in 2009 is that several high-dollar PPP deals have reached commercial and/or financial close, including:

- **I-595 Express Lanes project** (Fort Lauderdale area, Florida): This $1.6 billion project to add express toll lanes to I-595 reached both commercial and financial close in 2009. This is an example of an "availability payment" concession in which the concessionaire will finance, design, build, operate and maintain the lanes and will be repaid over 35 years through "availability payments" (or payments from the state based on delivering the lanes and keeping them "available" for users).
- **Port of Miami Tunnel** (Miami, Florida): In mid-October 2009, the state of Florida reached financial close with the Miami Access Tunnel Consortium on another availability payment concession project to deliver a long-sought, $1 billion pair of 3,900-foot tunnels to provide a direct link between Miami's seaport and I-395 and I-95 on the mainland, improving goods movement and eliminating major current chokepoints in the city.
- **North Tarrant Express** (Metroplex area, Texas): This $2 billion, 52-year concession project involves a combination of dynamically priced managed lanes & untolled lanes. The state is contributing $570 million in public funds; the concessionaire will bring the remainder of the financing. The project reached commercial close earlier this year, and financial close is anticipated by early 2010.
- **I-635 managed lanes project** (Metroplex area, Texas): Like the North Tarrant Express, this $4 billion, 52 year toll road concession project will deliver a technically complex mix of new "free" (untolled) lanes and managed express toll lanes. The state is contributing $445 million in public funds, while the concessionaire will bring the remainder of the financing to the table. The project reached commercial close earlier this year, and financial close is anticipated before summer 2010.
- **Chicago Parking Meter System lease**: In February 2009, the City of Chicago reached financial close with Morgan Stanley/LAZ Parking on a $1.1 billion, 75-year lease of its downtown parking meter system.

2. "Sale" vs. lease

PPPs do not involve the sale of any facilities. Some partnerships involve short-term contracts to design, build, and possibly finance a road or bridge. The most dramatic form—the long-term toll concession—still involves only a long-term lease, not a sale. The government remains the owner at all times, with the private sector partner carrying out only the tasks spelled out within the concession agreement and according to the terms set by the state. Done properly, these deals are truly partnerships, in which the state does what it does best (right of way, environmental permitting, policymaking, contract monitoring and enforcement, etc.) and the concession company does what it does best (design, finance, construction, operation, marketing, customer service, etc.).

3. Uncontrolled tolls

There are concerns that PPPs deals will lead to sky-high toll rates in future years, leaving the impression that tolls are uncontrolled. However, this is not the case. Most concession agreements to date have incorporated annual caps on the amount that toll rates can be increased, using various inflation indices. Put simply, future toll rates are a policy decision and are determined by state officials upfront before a concession agreement is signed. In fact, those pre-determined toll rate caps are generally established very early in the procurement process, as they are a critical input to potential bidders' financial models.

It is important to note that those caps are ceilings; the actual rates a company will charge depend on market conditions. Before entering into any toll road project, a company (or a toll agency) undertakes detailed and costly traffic and revenue studies. A major goal of such studies is to determine how many vehicles would use the toll road at what price; too high a toll rate means fewer choose to use the toll road, which generally means lower total revenue. So the toll road must select the rate that maximizes total revenue. That rate may well be lower than the caps provided in the concession agreement.

There are some cases, such as high-occupancy toll (HOT) lanes or express toll lanes, where the main purpose of value-priced tolling is to manage traffic flow. In those cases, pre-defined limits on toll rates defeat the purpose. Those rates must be allowed to vary, as needed, to keep traffic flowing freely at the performance level specified. When such value-priced lanes are operated under a concession agreement, instead of limiting the toll rates, the agreement should limit the rate of return the company is allowed to make, with any surplus revenues going into a state highway or transportation fund. That is how California's original pilot program for long-term concessions dealt with the issue, and similar deals have been done in Texas, Florida and Virginia.

4. Non-compete clauses

Whether public or privately-owned, bond investors will not buy bonds for assets with unregulated competition from entities with the power to tax, and build competing facilities. Contractual clauses designed to protect toll road operators from the construction of new, parallel "free" roads have evolved over the years. The approach has changed from an outright ban on competing facilities to a wider definition of what the state may build—generally, everything in its current long-range transportation plan—without compensating the toll road developer/operator. And for new roadways the state builds that are not in its existing plan and which do fall within a narrowly-defined competition zone, the current approach is to spell out a compensation formula. The idea is to achieve a balance between, on one hand, limiting the risk to toll road finance providers (of potentially unlimited competition from taxpayer-provided "free" roads) and, on the other hand, the public interest. All of Texas' PPP concessions have utilized this approach, as will any future projects under Arizona's new PPP enabling legislation.

Two recent long-term lease transactions provide a useful illustration. For the Chicago Skyway concession, there were no protections for the private-sector lessee. Given that the roadway is located in a highly-developed area of Chicago, it is highly unlikely that any competing, parallel freeways will be developed in the future. In the case of the Indiana Toll Road lease, the concession agreement set up a narrow competition zone alongside the toll road. The state may add short, limited-access parallel roads (e.g., local freeways), but if it builds a long-distance, freeway / expressway-standard road greater than 20 miles long within a 10-mile competition zone, there's a formula for compensating the private sector for lost toll revenue if the concessionaire can prove the new road is causing a financial loss.

5. Foreign Ownership

A common concern about any PPP is the likelihood that a foreign company will become the state's partner in operating a toll road, bridge or mass transit system. The potential is high that a foreign company would win the bid because foreign companies have the most experience with PPPs. Roads in countries like Australia, New Zealand, France, Italy, and Spain have utilized PPPs for years. Therefore, it is not surprising that the private-sector role in the provision of transportation services is more developed and mature outside of the United States.

In the early years of U.S. adaptation of the concession model, states want to deal with firms that have extensive experience as toll road providers. The simple fact is that the United States has no such industry yet, because we have used only public-sector agencies to build and operate toll roads. Meanwhile, European and Australian companies have decades of experience as world-class toll road providers. Thus, a responsible state government, wanting to ensure that the toll road is in experienced, professional hands, will weight prior experience very heavily in its selection criteria.

However, a domestic market is rapidly emerging in America. Investment firms including Goldman Sachs, Morgan Stanley, JP Morgan Chase and the Carlyle Group have created their own infrastructure investment funds, as have many of their foreign peers.

In addition, U.S. union pensions are attracted to investing in infrastructure because those investments create jobs for union members. Unions have already contributed to investment funds run by firms like the Australia-based Macquarie, blurring the line between foreign and domestic interests. Further, in 2009 the Dallas Police and Fire Pension System became the first public pension fund to serve as a direct equity partner with a private concessionaire in two concession megaprojects in the Dallas area valued at over $6 billion total.

Regardless, it would be unwise to ignore foreign operators—and their experience and expertise—simply because they are foreign. Pennsylvanians should not be too concerned if a foreign company from Australia or Spain (like the consortium currently operating the Indiana Toll Road) wins the bid to build a new, privately-operated highway in Pennsylvania. First, any potential roads would remain the property of the Commonwealth. Second, the terms and conditions of the contract would empower the state to seize control of the road should the company violate their contractual agreements. Third, a road is a fixed, nonmoveable asset. It is not as if a foreign company will be able to pack up this asset and ship it overseas. Finally, many foreign companies are part of the pension portfolios of many Pennsylvanians (including labor unions), so any attempt to limit the participation of international firms in state PPPs would be counterproductive to many workers right here at home.

Furthermore, it is important to remember that even deals that involve 100 percent non-U.S. companies are very good for our economy. Attracting billions of dollars in global capital (and expertise) to modernize vital highway infrastructure is a large net gain for this country. Rather than investments and jobs going overseas; foreign entities are willing to invest their money domestically, creating jobs here in the United States. The further build-out and investment in our transportation infrastructure only makes the U.S. more competitive in the global marketplace.

In effect, foreign investment in our nation's infrastructure represents the reverse of outsourcing—it's more properly viewed as "insourcing." The opportunity to "insource" significant amounts of foreign investment into Pennsylvania should be embraced rather than avoided.

6. Eminent domain

There is understandable concern that toll road privatization might lead to private companies acquiring the power to condemn land for right of way. To the best of my knowledge, none of the nearly two dozen state public-private partnership enabling acts has delegated any such power to private partner companies. The eminent domain power is always reserved by the state, in its traditional role of acquiring rights of way for public-use infrastructure.

7. Losing Public Sector Control of Assets?

One of the prevalent myths about PPPs is that somehow government would be "losing control" of the asset as part of the deal. This really involves a fundamental misunderstanding of the nature of PPPs—namely, that their entire legal foundation is a strong, performance-based contract that spells out all of the responsibilities and performance expectations that the government partner will require of the contractor. And the failure to meet any of thousands of performance standards specified in the contract exposes the contractor to financial penalties, and in the worst-case scenario, termination of the contract (with government keeping any upfront payment the contractor may have paid).

PPP contracts are often several hundred pages long and may incorporate a number of other documents (e.g., detailed performance standards) by reference. The public interest is protected by incorporating enforceable, detailed provisions and requirements into the contract to cover such things as:

- who pays for future expansions, repairs and maintenance;
- how decisions on the scope and timing of those projects will be reached;

- what performance will be required of the private company (i.e., operating standards, safety, maintenance, electrical and mechanical systems, and many other requirements);
- how the contract can be amended without unfairness to either party;
- how to deal with failures to comply with the agreement;
- and provisions for early termination of the agreement; and
- what limits on user fees/rates or company rate of return there will be.

So government never loses control—in fact, it can actually gain more control of outcomes—in well-crafted PPP arrangements. For example, state officials in Indiana have testified that they were able to require higher standards of performance from the concessionaire operating the Indiana Toll Road than the state itself could even provide, precisely because they specified the standards they wanted in the contract and can now hold the concessionaire financially accountable for meeting them.

8. Bankruptcy

What if the concessionaire goes bankrupt? In the event of a corporate bankruptcy on the part of a private sector investor-operator, the asset would revert back to the state, which could re-lease it again. Should the concessionaire need to sell, get out of, or modify the contract for any reason during the lease term, final approval would rest with the state.

F. Pennsylvania Needs Broad PPP Enabling Legislation

The modern use of PPPs in the transportation arena originated over 15 years ago with California's enactment of AB 680 and adoption by the Commonwealth of Virginia of its landmark Public-Private Transportation Act of 1995. Today, over two dozen states have adopted legislation authorizing the use of public-private agreements for the design, construction, financing, operation and maintenance of transportation facilities.

Workable legislation is generally needed to entice private sector investment. The reality is that transportation projects are going to those states that have created the right conditions—where the law facilitates PPPs and where private investment and participation is welcomed and embraced. States like Texas, Virginia, Georgia, and Florida are generally regarded as offering the best models, as evidenced by the fact that they are reaping the most private sector interest and investment. As long as Pennsylvania lacks the proper legal framework, these other states will continue to reap the benefits of private sector investment at the potential expense of Pennsylvania's economy and business climate.

If Pennsylvania policymakers seek to embrace PPPs, the legislature will need to pass a comprehensive PPP enabling statute, and there are many models to choose from. Arizona's House Bill 2396, passed in June 2009, offers a good example of cutting edge PPP legislation combining many of the key elements generally seen as desirable by PPP legal experts, such as:

- **No requirement for legislative approval of PPP contracts**: Perhaps the most important aspect of PPP legislation is what it should not have—a requirement for legislative approval of contracts. Put simply, legislative approval of contracts is generally a deal breaker for private investors, as it significantly increases political risk. Legislative approval would have the undesirable effect of limiting private sector interest in Pennsylvania projects; after all, the prospect of spending millions of dollars to navigate a competitive procurement process and then losing the project at the end in a legislative vote will be relatively unattractive to private bidders. The states that have been the most progressive in advancing PPPs to date—notably Virginia, Texas and Florida—have established strong procurement rules through comprehensive enabling legislation but have opted not to pursue legislative approval of individual PPP projects.

- **Broad flexibility in project delivery methods**: Arizona's new PPP statute allows the state to utilize a broad range of PPP project delivery methods--predevelopment agreements; design-build (DB) agreements; design-build-maintain (DBM) agreements; design-build-finance-operate (DBFO) agreements; design-build-operate-maintain (DBOM) agreements; design-build-finance-operate-maintain (DBFOM) agreements; concessions providing for the private partner to design, build, operate, maintain, manage or lease a facility; and any other project delivery method or agreement (or combination of methods or agreements) that the state determines will best serve the public. Essentially, Arizona now has as much flexibility as it could possibly need to craft creative PPP contracts well-tailored to each individual PPP project.

- **Allows for both solicited and unsolicited private sector project proposals**. The ability to accept outside ideas via unsolicited project proposals offers a means by which the state can "think outside the box" and pursue initiatives that might not have otherwise come forward from in-house staff tap creative proposals. Importantly, unsolicited bids that are ultimately advanced by the state would be required to be competitively bid so as to ensure maximum value for money.

- **Selection based on best value or qualifications**, as opposed to simply low bid. Bid costs are certainly an important consideration in selecting a contractor, but focusing on delivery costs alone ignores other considerations such as financing plan, total project life-cycle costs over its design life, risk transfer, expertise and experience, technological innovation, etc. Combining several of these factors into a "best value" or "value for money" analysis will ensure that the state is not sacrificing important aspects of the project in a single-minded pursuit of the lowest construction bid.

- **Authorizing the blending of public and private funds to finance projects**: For every PPP project that can be financed 100 percent by a private partner, there will be many more projects for which the private sector could provide some—in many cases, most—but not all of the financing at the toll rate schedule established by the public partner. For example, in Texas the state is contributing approximately $1 billion in public funds to leverage over $5 billion in private investment on two concession megaprojects that reached commercial close in 2009. As one observer noted, “for the price of a can, Texas got the whole six pack.” Similar projects that blend public funds to leverage private financing are underway in Virginia and Florida.

- **Authority for toll/user fee collection**: Legislation should give express authority for the private partner (and possibly the state, if it doesn’t already have it) to collect tolls or user fees. Also the legislation should require the state to establish in the agreement either (a) a toll rate schedule covering the life of the contract, or (b) provisions regulating the private partner’s return on investment.

- **No delegation of condemnation power**. To avoid fears of impropriety or concerns over private property rights, it should be explicitly stated in the legislation that the state never relinquishes its eminent domain authority in a PPP.

- **“Competing” facilities provisions**: The private sector needs some assurance that if it builds and operates a toll road over a multi-decade period that the state will not come along later and build nearby competing “free” roads. Without some assurance in this regard, investors would never purchase the toll revenue bonds. At the same time, outright bans on competing facilities would place too severe a restriction on the state’s ability to act in the public interest. To balance these competing concerns, PPP legislation should establish the public entity’s right to build the facilities of its choosing, but also allow the private partner to seek—but not guarantee—compensation for lost toll revenues due to construction of competing facilities. Further, Arizona and Texas included provisions exempting currently-planned projects from potential compensation claims; after all, if nearby projects are already on the books or in development at the time a PPP is signed, the private partner already knows it’s coming and can factor the potential toll revenue impacts into its financial models upfront.

G. Conclusion

Business as usual will not deliver the infrastructure Pennsylvania needs to meet the mobility and goods movement needs of the 21st century economy. Pennsylvania policymakers should embrace the considerable potential of the emerging PPP paradigm for highway funding and operations. PPPs have proven to be valuable tools in leveraging private capital, improving efficiencies, and managing and developing the transportation infrastructure and services that are the foundation of our economy. Thus far, Pennsylvania has failed to utilize the power of PPPs to help solve its transportation problems, as states like Florida, Virginia and Texas are doing. The choice for policymakers now is clear: higher taxes and fees, or partnerships with the private sector.

The success of existing private sector participation in transportation services highlights the potential benefits for many transportation projects needed in the Commonwealth. While not a panacea, these partnerships have proven successful when done properly with a strong contract, continual oversight and strict accountability. The potential for Pennsylvania is tremendous. As global capital is already flowing into Texas, California, Georgia, Florida and Virginia to invest in highways, why shouldn't Pennsylvania also benefit?

The Commonwealth is at a crossroads. It can choose to open its doors to this capital and a new way of doing business, or not. Policymakers should consider adopting PPP enabling legislation to encourage the aggressive pursuit of private sector participation in transportation services, because the private capital is flowing to those states that have created the right legal conditions for investment. Without the proper legal framework, other states will continue to reap these benefits at the expense of Pennsylvania's economy and business climate.

As the think tank that has done the most research on public-private partnerships and their applicability to transportation infrastructure, the Reason Foundation welcomes the opportunity to be of further assistance this committee as you learn more about these new approaches. Please feel free to call upon us.

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