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Leasing the Indiana Toll Road: Reviewing the First Six Years Under Private Operation

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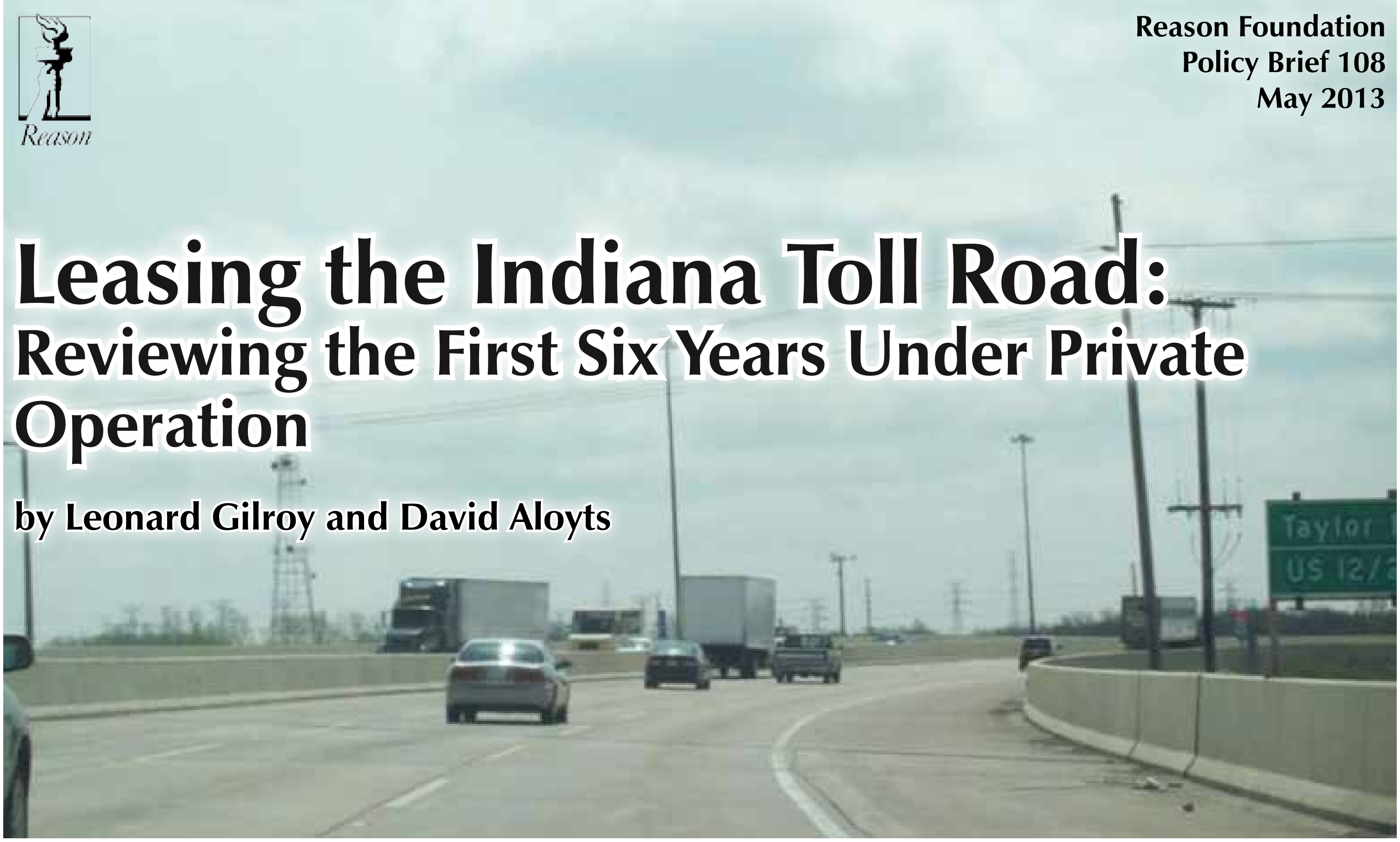

Many states currently face a major challenge in transportation infrastructure funding, given the growing gap between identified transportation needs and available funding. Across the nation, the revenues derived from fuel taxes and other traditional transportation funding sources are increasingly falling short of what is needed to maintain existing highways and bridges, much less deliver the new or modernized transportation infrastructure to support the 21st century economy. In recent years, some state and local governments—including Indiana, Colorado and Puerto Rico, among others—have taken steps to turn over the operation of public sector toll roads to private sector investor-operator teams in order to improve their financial and operational performance and stretch traditional transportation dollars further.

Shifting any public asset to private management requires careful due diligence, and in contemplating such a step it is useful for policymakers and taxpayers to examine the results of similar transactions elsewhere. Though long-term leases of public sector toll roads have occurred in several jurisdictions in recent years, the largest and most notable example comes from Indiana, which in 2006 leased its 157-mile Indiana Toll Road to a private concessionaire for 75 years in return for $3.8 billion, which the state has dedicated to transportation investment statewide.

To help policymakers elsewhere understand the potential opportunity a lease of public sector toll roads could offer to their jurisdictions, this policy brief examines the results from the Indiana Toll Road (ITR) lease thus far.

UNDERSTANDING THE INDIANA TOLL ROAD LEASE

Like many states today, prior to the ITR lease in 2006, Indiana was facing a multibillion-dollar gap between statewide transportation project needs and projected revenues (approximately $3 billion in Indiana's case). The ITR was also losing money at the time, with toll rates not having increased in 20 years, resulting in deferred maintenance and under-investment in the roadway.

For Indiana, this changed on June 29, 2006, when the state reached financial close on a 75-year concession (lease) agreement with the Indiana Toll Road Concession Company (ITRCC)—a joint venture between Spanish toll road operator Cintra and an infrastructure investment unit of Australian bank Macquarie—for the operation and management of the Indiana Toll Road (ITR). In return for a $3.8 billion upfront payment to the state by ITRCC, the concessionaire was granted the rights to operate, maintain and collect revenue from the 156-mile toll road for 75 years.

Similar to other commercial leases, the state retains the ultimate ownership of the roadway in the concession and negotiated a detailed, performance-based contract outlining the state's requirements of the concessionaire in terms of maintenance, emergency response, toll rate caps and a range of other operational factors.

Hence, Indiana did not "sell" its toll road; rather, it leased the road's operation to a concessionaire for 75 years in return for billions of dollars the state has invested into new and upgraded transportation infrastructure statewide. Indiana governor Mitch Daniels described the rationale behind the ITR lease in a 2006 article:

[The] 40-year-old Indiana Toll Road across the northern part of our state continued losing money and deferring maintenance and expansion, while charging the lowest tolls of any comparable highway. Tolls had not been raised in twenty years; at some booths the charge was 15 cents. (As the new governor, I innocently inquired what it cost us to collect each toll. This being government, no one knew, but after a few days of study the answer came back: "34 cents. We think." I replied, only half in jest, that we'd be better off going to the honor system.) With politicians in charge, neither sensible pricing nor businesslike operational practices were likely, ever.

[...] Without knowing what level of interest to expect, we offered to lease our toll road long-term to any interested operator willing to pay for the privilege.

Independent estimates of the road's net present value in state hands ranged from $1.1 billion to $1.6 billion, the latter figure aggressively presuming that all future politicians, unlike all their predecessors, would raise tolls at least in line with inflation. I had resolved that only a bid far in excess of that range would be worth advocating to my fellow citizens.

In the event, we received a best bid of $3.8 billion. Upon closing, we will cash a check in this amount and commence the largest building program in our state's history, while transferring the burden and the risk of running the toll road to the private firm. At one stroke our seemingly insurmountable transportation gap will be closed. Needed projects that have sat around in blueprint stage for years will now become reality. The jobs generated by the construction alone will be measured in the tens of thousands, and the permanent payoff in incremental economic activity should far exceed that.

In short, the state took advantage of a powerful opportunity to leverage an asset that was underperforming in the state's hands, unlocking the economic value previously trapped within it as a government-run asset and investing it into new capital assets with long-term value in delivering needed new infrastructure to improve the movement of people and goods statewide.

Use of Lease Proceeds

To ensure that the proceeds from leasing a long-term revenue stream would be invested to ensure long-lived benefits to Hoosiers, the state invested the bulk of the $3.8 billion lease payment into new and upgraded transportation infrastructure. Approximately $2.8 billion was dedicated to Major Moves, a new, statewide highway construction program that has since delivered hundreds of road and bridge projects across the state, many of which had previously been identified as needs but lacked dedicated funding. The state also repaid $200 million in outstanding ITR debt, resulting in the state no longer having any indebtedness related to the toll road for the first time in its half-century of existence.

Local governments also received funding from the ITR lease proceeds, apart from Major Moves:

- The state distributed $150 million in lease proceeds to each of Indiana's 92 counties for local road improvements.
- The state distributed an additional $240 million in proceeds to the seven counties the ITR traverses for local infrastructure and economic development projects.

- The state has committed $120 million over ten years to the Northwest Regional Development Authority for local economic development uses.

The state also anticipated the long-term maintenance of its expanded road and bridge capacity, allocating $500 million in lease proceeds to a new Next Generation Trust Fund created to generate interest income to provide stable, long-term maintenance funding for the new assets delivered as a result of Major Moves.

Investment earnings from the Trust Fund are transferred to the separate Major Moves Construction Fund every five years, with the first $124 million transfer having occurred in April 2011.

Looking across both funds in which the state invested a majority of ITR lease proceeds, the state had generated $755.4 million in interest income as of April 2011, with an overall rate of return of 6.8%. In essence, the ITR lease has allowed the state to turn a revenue-losing asset into an asset that is funding billions in transportation investment now and generating hundreds of millions of dollars for the state's long-term transportation infrastructure needs—*even though the state is no longer operating it*.

ITR Operations and Maintenance

During the initial debate on leasing the ITR, some opponents feared that privatization would involve a loss of state control and that the state would no longer be able to protect the public interest if it did not directly operate the asset. However, this perception is based on a fundamental misunderstanding of the nature of long-term toll road concessions.

Like other types of long-term concessions for public infrastructure assets, the ITR contract is built on a performance-based contract that is several hundred pages long and incorporates a number of other documents (e.g., detailed performance standards) by reference. Enforceable provisions and performance standards were built into the ITR contract to protect the public interest, including:

- Requirements for the concessionaire to fund future repairs and maintenance, as well as required expansions of the roadway in the event that traffic levels reach certain targets.
- Limits on the amount that toll rates can be increased by the concessionaire without prior state approval (capped by inflation, in ITR's case).
- Performance standards in operations, safety, maintenance, and electrical and mechanical systems. As an example, the ITR contract goes so far as to specify the maximum amount of time that the concessionaire has to respond to vehicle incidents (15 minutes), remove snow (4 hours after storm), remove roadkill (8 hours), remove graffiti (24 hours) and respond to hazardous incidents (immediate).
- Provisions for contract amendment in the future, as well as provisions for early termination of the agreement.
- A requirement that at the conclusion of the 75-year lease, that the concessionaire turn the ITR back over to the state in like-new condition, which creates a strong incentive for the concessionaire to perform proper asset management over the life of the contract.
- A requirement that the concessionaire reimburse the state for the annual costs of law enforcement to patrol the ITR, removing this long-term cost from the state's books.
- A requirement that the concessionaire reimburse the state for its annual costs of monitoring the contract.

Indiana Governor Mitch Daniels summarized the ITR concession in a May 2012 *Washington Post* opinion article by noting that the Indiana Toll Road lease "has a 432-page agreement that tightly controls everything from toll rates to how long the operator has to remove dead animals from the roadway." Beyond contract provisions, the state also created a seven-member Indiana Toll Road Oversight Board to monitor the concessionaire's compliance with the terms of the contract and advise policymakers on ITR operational and finance issues.

To further mitigate risk for the state, the contract is structured such that the concessionaire would face penalties, fines and ultimately, the potential voiding of the contract in the event of under-performance. Further, in the worst-case scenario—such as the state seeking to void the contract for poor performance, or in the event the concessionaire goes bankrupt—Indiana ultimately gets to keep the upfront concession payment, transferring significant risks to the concessionaire, not taxpayers.

Major Moves

The $2.8 billion portion of upfront proceeds from the ITR concession allocated to the Major Moves program allowed Indiana to become the only state with a fully-funded 10-year transportation plan—without incurring additional debt or tax increases—which is noteworthy at a time when many other states are deferring transportation projects amid declining revenues from traditional transportation funding sources, like state and federal fuel taxes.

Indiana was able to combine the ITR lease proceeds with planned federal transportation dollars and other transportation revenue streams to generate over $11 billion in total Major Moves funding through 2015 (or an average of over $1 billion per year in transportation investment). In essence, the ITR lease allowed the state to fund hundreds of road and bridge preservation/reconstruction projects and dozens of new highway projects that had been planned for years but which lacked dedicated funding, allowing these projects to move from concept to completion and accelerating them by years, if not decades.

After five years in operation, Indiana's Major Moves program tallied some noteworthy accomplishments through the end of 2011, including 50 new roadway projects, over 600 bridges repaired or replaced and $6.5 billion in total transportation investment, as shown in Table 1 below. By 2015, the state expects to have completed 87 new roadway corridors, delivered over 400 centerline miles of new road construction, upgraded pavements for nearly half of the state's road inventory, and rehabilitated or replaced over 1,000 bridges statewide. Further, over 93% of Major Moves contracts have been awarded to Indiana companies, a significant boon to the local construction industry.

Overall, as other states suffered in the wake of the 2008 recession and dozens have raised taxes or taken on new bonded debt to pay for transportation projects, Indiana has been investing over $1 billion annually in road and bridge projects, in large part a result of leasing the ITR.

Investment in the ITR

One of the more overlooked aspects of the ITR lease is that in addition to the $3.8 billion upfront payment to the state, the concessionaire also committed to over $4.4 billion in improvements to the road itself over the life of the deal. Hence, the real overall value of the ITR transaction—combining the cash up front and the required capital investment over the 75-year term—is on the order of $8 billion. The ITR's modernization is well underway, with the concessionaire having already installed electronic tolling technology, upgraded toll

Table 1: Major Moves Program Accomplishments, 2011–2015

	2011 (actual)	2012 (actual)	2015 (projected)
Roadway projects completed or substantially under construction	50	65	87
Centerline miles* of new roadway constructed	160	375	413
New or reconstructed interchanges	n/a	48	65
Centerline miles of pavement preservation projects completed	4,450	5,030 (40% of state inventory)	6,350 (49% of state inventory)
Bridges rehabilitated or replaced	615	720	1,070
Total investment in construction, preservation	$6.5 billion (through FY2011)	$7.5 billion (through FY2012)	$11 billion

* A "centerline mile" is defined as the length of a roadway in miles. A roadway ten miles in length has ten centerline miles, regardless of the number of lanes. By contrast, a "lane mile" is defined as the number of centerline miles multiplied by the total number of lanes in the roadway. For example, a four-lane divided highway that is 10 miles in length totals 40 lane miles.

Note: For the year 2015, the projected accomplishment listed is expected by the end of the calendar year.

Source: Indiana Department of Transportation, Major Moves homepage, http://www.in.gov/indot/2407.htm (accessed May 24, 2013).

plazas, added new lanes to reduce congestion and made other key investments that were stipulated contractual requirements in the concession agreement.

According to ITRCC CEO Fernando Redondo, "We have invested around $300 million in the road—$175 million has been for the mandatory expansion work; $25 million on maintenance projects we do every year; about $45 million on IT; that would cover the implementation of the electronic tolling, the replacement of the manual system, the new equipment. Around $35 million would be the rehabilitation of the structures, the bridges and such, and the other $20 million would be the work on the (toll) plazas."[5] According to Gov. Daniels, the concessionaire has brought the ITR "to the best condition and service levels in its history."[6]

POLITICAL CONTEXT OF THE ITR LEASE

The ITR lease represented what was to become a paradigm shift in the way Indiana finances major transportation infrastructure, and some policymakers and taxpayers expressed skepticism or "buyer's remorse" in the immediate aftermath of the deal. This second-guessing waned over time. After the ITR lease, there was little political impact on state legislators that had originally approved it, and Gov. Daniels was re-elected with nearly 58% of the vote. Daniels's approval rating actually increased following the lease, up to 63% in 2012 from the low 50s in his first term.[7]

What is more notable is that the more time that has passed since the ITR lease, the more comfortable Indiana policymakers have become with the private operation of public infrastructure. Examples include:

- In 2010, both Indiana and Illinois enacted enabling legislation to allow private sector financing and operation of the proposed Illiana Expressway toll road, a $1 billion project connecting I-65 in Indiana to I-57 in Illinois.
- In 2010, Indiana policymakers approved using private financing for a $4.1 billion bi-state project with Kentucky to develop two new toll bridges across the Ohio River in Louisville.
- In 2011, the Indiana legislature passed legislation granting the governor and the Indiana Department of Transportation broad authority to designate projects as candidates for private financing and solicit proposals from the private sector, without having to go back to the legislature for approval. The legislature had previously only authorized the use of private financing for specific projects on a case-by-case basis. The legislation also explicitly permits the addition of toll lanes to existing non-tolled highways.

In short, rather than shun private infrastructure finance and operation after the ITR lease, Indiana policymakers have embraced it by broadening the state's ability to use that approach. This suggests that once state policymakers actually had direct experience with private infrastructure management via the ITR lease, they increasingly realized that concerns and fears raised prior to the ITR lease regarding private management were overblown. Given such demonstrable support after the Indiana Toll Road lease, the reality is that Hoosier State policymakers are increasingly embracing private infrastructure deals, not rejecting them.

RESPONDING TO COMMON ITR LEASE CRITIQUES

Despite the overwhelming success of the ITR lease, opponents continue to criticize the deal, largely to dampen enthusiasm for similar efforts in other states. Often, these concerns are the result of misinformation and/or a lack of understanding of how complex toll road lease transactions work. Some common criticisms include:

"Indiana sold its toll road"

Critics have tried to equate a 75-year lease with a "sale" of the ITR, but as noted earlier, the state still holds title to the asset throughout the lease. Further, at the end of the lease, the ITR will transfer back to state operation, unless the state chooses to seek another private lease and major investments during the term of the lease. Indiana did not sell its toll road; it simply leased the revenue stream to a private concessionaire in return for a lump-sum payment.

"The ITR concessionaire paid too much for the lease and is defaulting."

Recent media reports have suggested that the concessionaire may be in danger of defaulting on its ITR debt due to traffic declines and other impacts related to the larger economic malaise, which prompted a faster-than-expected drawdown of a $150 million interest reserve account established to help ensure the maintenance of debt service in the event of revenue shortfalls.[8] However, from the state's vantage point, taxpayers are protected regardless of what happens with the concessionaire's future financial condition because the lease transferred the ITR's financial risk to the concessionaire. In the event of a default, bondholders would ensure the ongoing operation of the ITR while debt was restructured or another operator found, and the state would keep its upfront concession payment. In that scenario, the only way bondholders would get repaid is through the continued operation—and revenue collection—of the ITR at the levels and conditions required under the lease agreement, lest they would face having the contract voided (and the accompanying loss of their investment).

According to Indiana Finance Authority Chairman Christopher Ruhl, "We've known since 2006 that the $3.8 billion lease payment was financed primarily through debt, that the debt came due in 2015 and that the amount of debt could place a significant burden on the capital structure," adding that even in a concessionaire default the state has already received the full $3.8 billion lease payment and taxpayers are thus protected.[9]

"Indiana mortgaged its future and will have nothing left once lease proceeds are spent"

First, it is important to recognize that the toll road was losing money prior to the lease. In addition, prior to the lease, all toll proceeds were used by the state to finance the operations and maintenance of the toll road; under the lease, the private sector is responsible for paying these costs. Finally, at the end of the lease, the toll road has to be handed back to the state in like-new condition, giving future generations a new revenue stream after all the proceeds have been spent.

The proceeds of the ITR lease were invested in long-lived infrastructure in line with the basic public finance principle that if a government is divesting out of a long-lived asset, the proceeds should ideally be invested for long-term benefit, not short-term uses. According to Gov. Daniels, "Every penny of the bonanza we reaped goes into long-term investments in new capital projects. Not a cent went to current operations; we balanced Indiana's budget, cut taxes, built a sizable surplus and achieved a AAA credit rating through old-fashioned frugality."

Additionally, several media articles published during the 2012 Indiana gubernatorial campaign have suggested that the next governor will face a problem of long-term transportation funding as Major Moves funds are ultimately spent. However, this has nothing to do with the ITR lease; rather, this is the same situation that most states are in—and that Indiana was in before the ITR lease—as a result of the steady erosion in the power of the gas tax as an infrastructure funding mechanism amid a trend toward increasing fuel efficiency. But this is a national problem that rises above any one state. In fact, the ITR lease and Major Moves were designed as a means to drive a burst of transportation construction despite the larger transportation funding crisis, a creative solution at a time when fuel tax revenues are not even sufficient to fully fund maintenance of the existing highway system, much less new projects.

According to Adam Horst, director of the Indiana Office on Management and Budget, "when the lease's proceeds have all been reinvested, Indiana will rejoin the other 49 states in the dilemma of inadequate gas tax receipts. But Indiana will do so with more than 200 new road projects that otherwise never would have been built, with at least a third of our bridges rebuilt, and with a permanent half-billion dollar trust fund that will continue to generate earnings to augment future highway budgets. Other states can only dream of such a situation."[10]

"The ITR lease contains a noncompete clause inhibiting the state's ability to build roads"

Investors in toll road projects—public or private sector—typically seek some assurance that the financial viability of their projects will not be harmed from the construction of new, parallel "free" roads by government entities in the future. However, the nature of these so-called "noncompete agreements" has evolved over the years from outright bans on competing facilities to a more robust structure that clarifies what the state may build—generally, everything already envisioned in its current long-range transportation plan—without compensating the toll road developer/operator. The goal is to balance the state's goal of protecting the public interest with financiers' interest in avoiding potentially unlimited competition from taxpayer-provided "free" roads that draw traffic—and thus, revenues—away from toll roads.

In the case of the ITR lease, the concession agreement set up a narrow competition zone alongside the toll road of five miles in each direction. Within this 10-mile wide zone, the state may add short, limited-access parallel highways at its own discretion, but if it builds a long-distance, expressway-standard road longer than 20 miles within the competition zone, the concession outlines a formula for compensating the private sector for lost toll revenue if the concessionaire can prove the new road is causing a financial loss. However, it should be noted that this provision has not been a constraint on road building more generally, as Indiana is investing hundreds of millions of dollars from the proceeds of the lease transaction into new and expanded transportation infrastructure in the counties traversed by the Indiana Toll Road. In other words, the competing facilities provisions in the lease agreement are not preventing the state from making needed transportation investments across the state, as demonstrated by Major Moves itself.

"Toll road leases hurt public sector labor"

Public sector unions often attempt to frame leases of publicly owned and operated assets as hostile to government employment, but no public employees were made worse off by the ITR lease. The state structured the concession such that all of its 550 public sector employees were offered positions with no reduction in pay and benefits, either with the concessionaire or through a transfer to other state positions. Approximately 85% transitioned to the concessionaire, with another 115 transferring to other state positions, and those that left state employment were paid for accrued vacation time and will retain their pension plan contributions and vested retirement benefits.[11] Further, under state operation, ITR employees were not unionized, but after the ITR lease, the 244 ITR toll collectors narrowly approved unionization in 2007 and are now represented by four different Teamsters Locals.[12] Earlier that year, ITR maintenance workers also voted on—but rejected—a similar unionization effort.

Criticisms and misperceptions notwithstanding, Gov. Daniels succinctly summarized the state's overall perspective on the ITR lease in a 2006 Reason Foundation article:

However obvious from a business and economic standpoint, this proposal touched off enormous controversy and opposition when proposed in the political realm. Many citizens, with a sincere sense of responsibility, misperceived that value was simply being pulled forward from future years. Many have not yet understood that the state is being paid more than $2 billion more than the road conceivably would have been worth in public hands. Far from "stealing from our children," we have acted to leave our children billions in new public assets—roads, bridges, airports—that they would otherwise not have enjoyed. Turning down this deal would have been the real theft from the future.[13]

CONCLUSION

Given the overwhelming benefits that Indiana has reaped from leasing its toll road to a private operator, it makes sense for policymakers in jurisdictions with public sector toll roads to explore the potential value of leasing those assets as they develop strategies for closing a long-term mismatch between transportation needs and available funding. The ITR lease allowed the state to invest billions in transportation infrastructure during a major recession, taking advantage of competitive pricing and robust contractor competition in a down economy to modernize the state's transportation system for decades to come.

The ITR lease has been a major boon for the state of Indiana overall, leaving it in a far stronger position than it otherwise would have been. The state had previously paid interest on an asset that was costing more to operate than it generated in revenue, and now it is collecting interest on that asset without the operational or financial risks associated with operation. With the $3.85 billion the state received to invest in infrastructure, the billions of dollars the concessionaire is investing in the toll road, and the hundreds of millions of dollars the state has already received in interest—as well as the lack of dire consequences predicted by critics early on—it is hard to argue that Indiana made the wrong choice. The ITR lease has paved the way for transportation enhancements statewide and serves as an exemplary model of how the public and private sectors can partner together for mutual benefit.

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ENDNOTES

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