What Public Officials Should Know about Public–Private Partnerships

By Jack Lettiere

Editor's Note: While this article makes frequent use of the term "public private partnerships" (PPPs), the main focus of the article is on long-term leases of existing highways.

As the American transportation system ventures further into establishing public–private partnerships (PPPs), the nature of these buyer–seller transactions continues to evolve. This relatively new type of business arrangement marries buyers eager to enter the U.S. market with governments anxious to exploit burgeoning new infrastructure investment funds needed to help resolve fiscal crises.

Buyers, because of their experience in structuring PPPs to benefit shareholders, currently seem to have the advantage in arranging these transactions. As is the case with any growing market, however, conditions will change as more buyers (generally corporate entities) and sellers (generally public officials) enter the marketplace and become more sophisticated in its workings. Consequently, a more refined approach on the part of both the buyer and the seller will be needed to conduct future privatization transactions.

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Sellers, in particular, will be compelled to ask two critical questions as they gain refinement in the PPP process: (1) What are we trying to achieve and why? and (2) How would privatization fit into the overall operation of the region's transportation network? State and regional governments must be ever mindful that they don't run an isolated roadway or transit system, but rather a network. Understanding the answers to these queries is pivotal for evaluating and proceeding with the transaction, and determining how a PPP fits in the management of an asset portfolio is essential to the decision-making process.

Due Diligence

We currently have few examples of transportation PPPs to reference. As a result, due diligence in preparing for such transactions has centered primarily on the traditional technical issues of finance, traffic, and law. In this process, public officials and buyers alike pore over traffic and revenue projections; review the physical condition of the asset infrastructure, which will affect future capital expenditures; and dissect the facility's operations to determine economies and savings that could be derived from changing the owner's business methods. Existing statutes, tax laws, and court decisions are scrutinized to determine legal impediments to both the proposed transaction and future net revenues. In addition, polls are taken to gauge public reaction to the PPP and to help assess potential political difficulties that could arise.

The due diligence process should answer several questions, including: Has this process yielded the highest expected return to the public and to the investors? Has the law review in the process, which examines legal impediments to and requirements for executing a PPP, diverted attention from other potential impediments to ratification, such as public acceptance and legislative approval? What kind of public reaction has polling uncovered regarding the proposed PPP, a superficial response or a more considered opinion?

These questions should prompt public officials to consider other critical points, as well: In the PPP, will the

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public receive the fair value of the asset? How can we measure the return? How can the public participate in the facility's profitability? Will the transaction solve any area transportation problems and fit into the overall transportation network? Are the public and the legislature(s) sufficiently knowledgeable about the entire transaction to form educated opinions about it?

thing as an ideal purchase price. Theoretically, the price determined will give the buyer excellent value and the seller an excellent return, but even that price point can't be considered ideal. In the marketplace, even the ideal price may be a compromise, because it can be the result of negotiation and an appropriate (given the market) lowering of expectation.

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The answers to these questions may be inconclusive, judging from the few transportation-based PPPs that have been created in the United States thus far, but they can serve as a foundation for further developing these partnerships to benefit the transportation industry in the future.

Obtaining the Best Sale Value

Many critics have questioned the prices paid for the Chicago Skyway ($1.83 billion) and the Indiana Toll Road ($3.85 billion), two public roadways that were recently privatized. Yet, theorists can argue that the market itself determined the value of these facilities.

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In a PPP, it is important that the public agency determine what it considers to be the fair selling price. In the end, that may drive the decision of whether to move ahead with the transaction. Public officials should establish a price similar to the "reserve price" used in auctions; that is, a minimum bid the seller is willing to accept for its asset. Conducting such a price analysis is crucial in completing a successful public–private transaction.

Base asset value. During the due diligence, financial advisors and engineers undertake a rigorous process to establish the value of the facility being sold. This evaluation, though highly technical, is completed with great proficiency by the private sector. As alluded to earlier, the finance/engineering team reviews traffic-output models to determine the toll revenue potential over the lease period given periodic toll increases. Likewise, the physical condition of the facility is evaluated to determine the capital-expenditure ("cap ex") distribution needed over the length of the lease.

Depending on the objectives and conditions in the lease agreement, cap ex may include the costs of toll-road expansion and facility preservation. Additionally, the team calculates operating-cost projections that include all costs incurred by the facility, such as labor, utilities, and insurance. Essentially, the present value of revenues less expenditures forms the assumed base value of the asset. These considerations should constitute just the preliminary steps to a more comprehensive asset valuation. The same team should conduct this more comprehensive evaluation, which should be done during the due diligence process.

Revenue and value-added enhancements. It is well known that the market value of a home exceeds the value of the physical structure. The location of the home, surrounding neighborhoods, schools, proximity to businesses and shopping, and property taxes are all factors that can add to the perceived value of the property. Thus, one must look beyond the house's walls to determine the home's true value. Similarly, if one were to look "beyond the pavement" of a toll facility, one could derive additional value by considering the total facility footprint and leveraging adjoining business and community needs, as illustrated in the following examples.

Utility placement: For more than a century, public utilities—water, electric, and natural gas—have been accommodated on roadways and bridges for little or no cost to the utility companies. With the decade-long boom of the microelectronics and telecommunications industries, placement of new infrastructure to meet consumer demand has been a major concern of the utilities industry.

Many toll roads have already embarked on programs that take advantage of the placement of cellular towers and fiber-optic cable within their rights of way. Nonetheless, toll operators should take care to evaluate these opportunities systemically so as to optimize their value. For example, significant value may lie in increasing fiber-optic cable capacity to connect businesses to disaster recovery sites along a toll facility. Following the events of September 11, 2001, businesses began feverishly locating backup data centers many miles from their business centers to ensure continuity in the event of a disaster. With fiber-optic cable running along the

right of way, companies can, for a fee, "tap into" the trunk line located within the toll facility and, for an annual fee, maintain connectivity.

Furthermore, opportunities exist for servicing commercial and public television stations and multimedia companies that seek to provide enhanced programming and diverse services via fiber optics and microwave/cellular towers. The value ascribed to their ease of placement and subsequently lower costs is significant.

Visitor centers/rest areas: Traditional visitor and rest area services have revolved around food services, fuel, and lodging. On some toll roads, public markets and novelty shops, as well, have achieved success with motorists. Visitor centers and rest areas also offer commercial value for the location of entities such as towing services and mechanical repair shops. Consideration should also be given to locating other small businesses, such as branch offices and government offices, on visitor and rest sites to increase their value.

Billboards: Using fiber optics, billboards can evolve from static, one-message media to dynamic electronic communication vehicles capable of bringing in significant advertising revenues. Modern electronic billboards can also be integrated into the toll road's emergency and operations centers to display traffic and weather conditions, detours, and other emergency notices.

Real estate development: As noted above, looking beyond the pavement can add to a toll facility's value, but looking beyond the facility itself can reap even greater rewards. By identifying and meeting adjacent development and business needs, toll officials can reveal opportunities that not only

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add to the facility's value base but also solve area transportation problems. Reviewing scenarios of this type helps to determine the value of transportation assets beyond tolls.

Although commuters and visitors usually have other roadway choices for travel, toll roads become the route of choice as nearby growth and congestion lead to longer and longer commute times. The key to uncovering value-added opportunities, then, is to identify and create demand on the toll road during low-volume or nonpeak travel times. For example, high-volume, rush-hour traffic may occur westbound in the morning and eastbound in the evening. The result is that a significant amount of capacity exists on the toll road in the opposite directions, both a.m. and p.m.

The value-added option here would be to develop office parks and transportation villages along interchanges and on mainline rights of way in the nonpeak direction. Transportation officials could work with real estate developers to determine the feasibility of locating office complexes in high-growth areas with established labor forces. Businesses would benefit from being located near a major transportation facility where property might not currently be used at its maximum potential. Such businesses could lower their office costs while affording their employees and customers briefer commutes. The private toll-road owner, in turn, would benefit from both the development and the increased toll revenues.

Paid parking facilities could also be located on these sites. This could help alleviate traffic congestion by encouraging ride sharing while providing the facility owner with revenue from new customers taking advantage of this commuting option as well as from those who choose to park at the site. Furthermore, congestion-easing initiatives would assist private owners in meeting performance measures derived from travel times and travel delays, hence eliminating or deferring the need for facility capacity expansion.

Multimodal development: Though rarely considered a value enhancement on toll roads, developing or expanding public transportation on the toll-road right of way can greatly benefit facility owners. Transportation net worth is significantly increased when limited-access tolled highways are joined with public transportation. Customers who normally would avoid both tolls and public transportation might very well be induced to take advantage of shorter commute times and ease of use to improve their quality of life. Commuters could drive the toll road to the transit station located along the right of way, park their vehicles, and take a train, light rail line, or bus to their final destinations. The entire trip, including parking, could be paid via an electronic toll/fare collection system, making the commute even more convenient.

Private owners, assumed to be averse to operating public transportation systems, could provide the capital needed to construct an interconnected transit system that could be leased back to the operators with periodic "availability" or lease payments. In so doing, the private owner could increase its revenues while enhancing the transportation system. This in turn would add to the calculated value of the facility for current public owners.

All of the examples noted above are meant to expand the view that

public officials take when determining the estimated value of a toll road. To reiterate—current owners shouldn't conduct a "toll only" based analysis in calculating the true value of their facility. Rather, they should look beyond the pavement and a single mode of transportation when assessing true asset value.

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Communication and Education: Critical Links

Good communication is often extolled as the critical success element in matters ranging from happy marriages to corporate profitability. Our failure to communicate effectively with one another has been part of our human frailty since we began inhabiting the earth. We know we should take time to communicate clearly, but we fail to make the effort required. Indeed, everyone wants to go to heaven, but not everyone wants to do what they have to do to get there! Public–private ventures are no exception to this shortcoming.

Public officials and other participants in PPPs—from financial advisors to transportation engineers—tend to get so immersed in the technical pursuit of the PPP that they fail to consider how crucial it is to develop an effective communication plan to gain acceptance of the transaction.

Think of the thousands of new products launched every year that haven't been accepted by consumers because they've been advertised—or communicated—ineffectively. Products that do catch the public's eye, conversely, are those whose benefits are well explained. Indeed, technically superior products are often dismissed in favor of less proficient products that are more effectively advertised. Consumers buy what they believe to be a good product despite having a limited understanding of its technical complexity. New-product ad campaigns can spend extraordinary sums of money overcoming consumer skepticism by describing the product from the buyer's perspective at the expense of touting the product's technical superiority. New-car buyers, for example, rarely make a purchase based on their understanding of the physics of the internal combustion engine. Instead, they focus on the vehicle's horsepower, acceleration, and fuel efficiency.

Communicating with the public. PPPs are inherently complex. They involve complicated financial, legal, and engineering requirements that must be explained clearly to the public in layman's terms. Consequently, those involved in the due diligence process must be sure to have a well-crafted public information campaign ready to launch at the same time that the request for proposals for the PPP is announced. It is crucial that the public understand what a public–private venture is, how it will affect them, and what the long-term benefits and consequences of the transaction will be. Public officials should be out in front of the issue and be articulate enough to counter any misinformation that might cloud the debate. The key function of public officials in this endeavor is to make the public feel comfortable with the government's decision to undertake a PPP.

With a patient, reassuring, and ongoing approach, officials should explain factors such as the difference between a sale and a lease; provisions in the contract that will protect the public from undue toll increases; the enforcement of performance standards that will protect the facility from deterioration and crippling congestion; the potential sharing of profits with the public; and the manner by which a fair price has been established for the public asset.

The major aspects of the expected contract must be clearly articulated to the public to assure them that they aren't simply being subjected to "spin doctoring." If such discussions don't occur, public debate will more likely center on misinformation and unsubstantiated claims that will put public officials in a defensive position and obscure the essential aspects, both positive and negative, of the PPP.

In his book *Mobility: America's Transportation Mess and How to Fix It*, Joseph M. Giglio wisely advises that

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we focus not on what we are paying, but rather on what we are buying. This can only be accomplished, he says, if there is a clear explanation of how the proceeds of a transaction will be spent. Will the funds be reinvested in the transportation system or other public capital assets, and, if so, what improvements should the public expect? If officials demonstrate clear and lasting benefits to the public, then acceptance will be won. If not, one can easily imagine the cynical thoughts the public might hold of its government frivolously wasting public funds on projects of questionable or little lasting value. This negative outcome must be avoided if private capital is to become a critical component in transportation funding.

Winning the support of legislators. Strong communication and educational efforts must also be used to win the support of the legislative bodies that approve public–private ventures and contracts. The information conveyed must be carefully composed so that legislators understand the intricacies of private ventures, including legal issues, contractual obligations of the parties, financial analyses, protections and guarantees, toll provisions, performance measures, development abilities, length-of-term options, profit sharing, personnel and union contracts, wage provisions, and so on. Like the public, legislators should be made fully aware of how the PPP proceeds might be spent.

Full understanding of the PPP not only will stimulate proper discussion and debate, but it can also address and allay many fears that elected officials might have about these transactions. Confusion and misinformation about the PPP could lead an otherwise supportive vote to be cast against it.

It would be naïve to think that this process will be a purely analytical one. Political give-and-take will be necessary, Lease agreements of 50 to 75 years will need to generate more than toll revenue to support the true value of transportation facilities.

but such reciprocity can be constructive if it is based on the effective communication of reliable information.

Beyond Tradition

As mentioned earlier, public–private ventures are a relatively new means of financing transportation in the United States. We've already witnessed that they can become constructive parts of infrastructure financing. (Examples include S.R. 125 in California, I-895/ Pocahontas Parkway in Virginia, and the Dulles Greenway in Virginia.) As sellers become more aware of the true value of their asset and buyers become more sophisticated in understanding the long-term value that asset can afford, PPPs will gain more widespread acceptance. In the process, public officials and private companies alike must look beyond the traditional toll-based valuations of such assets. Lease agreements of 50 to 75 years will need to generate more than toll revenue to support the true value of transportation facilities. Over such a protracted period, it is essential that buyers employ, in addition to tolls, supplementary means for financial success such as those described above. Public officials must properly assess the value of their asset while appreciating the value of communication and education in establishing a PPP contract.

Although there is tremendous apprehension at the mere mention of "privatizing a toll road," the anxiety in the marketplace will necessarily arouse American ingenuity and creativity. This fundamental change in how we view and manage our assets can provide us and future generations with a transportation system fit for the 21st century. Our lives, and our livelihoods, depend upon it.

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