TESTIMONY OF:

D.J. GRIBBIN
DIVISION DIRECTOR
MACQUARIE HOLDINGS (USA) INC.

BEFORE THE

HOUSE TRANSPORTATION AND INFRASTRUCTURE COMMITTEE SUBCOMMITTEE ON HIGHWAYS, TRANSIT, AND PIPELINES

"UNDERSTANDING CONTEMPORARY PUBLIC-PRIVATE HIGHWAY TRANSACTIONS: THE FUTURE OF INFRASTRUCTURE FINANCE"

MAY 24, 2006

TABLE OF CONTENTS

1. INTRODUCTION

Good morning, Mr. Chairman and members of the Committee. My name is D.J. Gribbin, and I am a Division Director for Macquarie Holdings (USA), Inc. Thank you for giving me the opportunity to join this panel discussion exploring the future of infrastructure finance.

For those who may not be familiar with Macquarie, we are a diversified global financial services organization. In particular, Macquarie is recognized as a leader in the ownership, management and development of important infrastructure assets around the world, including a growing number in the United States. Macquarie has operations in 24 countries, including a significant presence in North America. Over 500 of its 8,200 worldwide employees and approximately one quarter of Macquarie's 800 infrastructure professionals are located in North America. Macquarie has 16 offices in the United States.

Macquarie recognized as early as 1990 the potential of infrastructure as an emerging asset class that offers attractive long-term investment characteristics and benefits from a long-term active management philosophy. Macquarie is a committed, long-term investor in infrastructure. Our aim is to manage responsibly and profitably the assets in which we have investments. We take a partnership approach, adding value through specialist strategic, commercial, operational and financial expertise with proven ability to enhance the performance of assets over the long term.

The Infrastructure and Specialized Funds (ISF) division of Macquarie manages a US$24 billion global investment portfolio, which includes investments in over 90 assets in more than 20 countries. Major infrastructure sectors that Macquarie specializes in include toll roads, airports and airport-related assets, telecommunications, water, rail, port, energy generation, transmission and distribution assets as well as water & wastewater and, social infrastructure.

In my time here today, I will briefly outline some of what Macquarie has done here in the U.S. and how the private sector can play a role, and potentially a significant role, in helping overcome the lack of funding for highway infrastructure. As this Committee has explored in great detail, the financing gap for highway infrastructure is staggering. The Federal Highway Administration's Conditions and Performance Report estimates that this nation will need to invest an additional $118.9 billion to meet the needs for surface transportation.

Before I begin, however, let me thank this committee for the work it has done to encourage increased private sector involvement. The tools you provided under TEA-21 and SAFETEA-LU are helpful. Provisions expanding tolling opportunities, allowing private activity bonds, streamlining the environmental process, and reforming the design-build rules will facilitate private participation in funding transportation infrastructure. And as a result, the creative energy and finances of the private sector will have an opportunity to more fully influence this market.

2. CONCESSION AGREEMENTS – FINANCIAL BENEFITS

In a 2004 speech before the American Road and Transportation Builders Association, the former Chairman of this Committee and my former boss, Transportation Secretary Norman Y. Mineta noted, "the smart course for transportation's future requires a turn in the direction of public-private partnerships. . . Within the world of public-private partnerships, ventures can be structured to provide better incentives for innovation, cost reduction, faster project delivery, and improved management of new – and existing – facilities." Secretary Mineta was prescient. Less than two months after this speech, Indiana Governor Mitch Daniels announced Indiana was seeking financial investors interested in leasing the Indiana Toll Road. When completed, this one transaction will close Indiana's transportation funding gap and allow for construction of the State's 10-year transportation plan. As Governor Daniels noted earlier, few projects in this plan would be constructed had Indiana continued to rely on traditional funding mechanisms.

Allow me to use my time here today to focus on the public policy implications of this transaction and concession transactions in general. Macquarie has been involved in transportation concession transactions in eight countries around the world, including four agreements here in the United States.

Long-term leases of highway infrastructure have raised a number of questions. Notwithstanding the fact that this new model of highway financing liberates billions of dollars of investment, it has come under some criticism, which I will address later in this testimony.

Hernando de Soto, in his book *The Mystery of Capital*, explained how dead capital has contributed significantly to poverty in the developing world. Dead capital is comprised of investments made within a legal structure that prohibits those investments from being used as capital. For example, poor workers who build a home on land without clear title have created dead capital. They cannot borrow against their investment, and it is very difficult for them to sell their investment. The home has value, but that value is captive. Inadequate legal structures in developing countries have locked up $9.3 trillion in investments of this type, investments that could be used to develop businesses, create jobs, and lift people out of poverty. Instead, the legal structure surrounding these investments prevents them from being utilized as capital. Highway infrastructure here in the United States is analogous. Inadequate markets and legal systems in this country have locked up billions of taxpayer dollars in our transportation infrastructure, billions of dollars that could be used to create jobs and fuel economic growth. Fortunately, two recent transactions, the long-term leases of the Chicago Skyway and the Indiana Toll Road, have demonstrated that the captive capital invested in these assets can be freed.

The most notable aspect of the Indiana Toll Road concession is that this relatively simple transaction freed $2 billion in captive capital. As Governor Daniels noted, the State did a study of what the highway would have been worth had the State raised tolls and operated it according to the provisions of the concession agreement. The study found that it would be worth approximately $1.8 billion. Yet, Statewide Mobility Partners, a Macquarie-Cintra partnership, has signed a concession agreement offering $3.8 billion. So how did this transaction liberate $2 billion in captive capital, $2 billion that can now be spent for the benefit of Indiana citizens?

Simply put, the liberated $2 billion resulted from placing the Indiana Toll Road in a market environment. The Indiana Legislature created a legal construct under which the State of Indiana was able to transfer legal property rights to whatever entity in the world placed the highest value on the Indiana Toll Road, in this case a partnership of Macquarie and Cintra, Statewide Mobility Partners. This new legal construct liberated the captive capital allowing Statewide Mobility Partners to pay more than twice the value the State placed on the asset. The partnership was able to find additional value in this asset for two reasons:

1. A debt-equity financing model allowed the Partnership to pay more for the asset than a traditional bond financing approach; and
2. A private sector owner will be able to achieve more efficient operations through innovations and timely investment in operations and maintenance.

The debt-equity model used to finance the long-term lease of the Indiana Toll Road was quite innovative. Given the limited time I have, let me just briefly touch on why this approach to financing the Toll Road was able to liberate so much captive capital.

The traditional bond financing approach has layers of conservatism built into valuing the asset, and that conservatism tends to under-value the asset. In addition, bond covenants require a debt coverage ratio, i.e. that the revenues of the asset exceed debt payments by a defined percentage. This debt coverage ratio provides a cushion for investors, but it prevents that cushion from being used to help finance the asset. By contrast, a debt-equity model is able to use the equity investment as the cushion or assurance that those holding the debt will be repaid. As a result, the debt-equity financers are able to free up more capital than those using traditional bond financing, producing a greater payment to the owner of the asset.

Policy makers have asked whether an up-front payment is in the public interest. Some states have pursued a revenue sharing agreement instead of a lump sum payment up front. Which is a better deal? Like many public policy questions the answer is – it depends. In the case of highway concessions, the answer hinges on the financial needs of the state. In the case of Indiana, the Governor declared that proceeds from the Turnpike sale will be used for additional highway construction. When one considers the cost of construction cost inflation (from 8 to 19% last year depending on material) and the safety and economic benefits of having a facility built earlier, it was more cost effective to have a lump sum payment. For states in need of a steady revenue stream over years, a revenue sharing agreement may better meet their needs. Whatever the financial needs of the state, the concession model allows governments to unlock value trapped in assets.

3. CONCESSION AGREEMENTS – OTHER BENEFITS

In addition to liberating the capital locked in infrastructure assets, concession agreements provide a number of other benefits, including:

- Revenue risk transfer. Whenever government funds the construction of highway infrastructure through public debt, taxpayers are exposed to the risk that toll revenues may not be sufficient to cover the bonds issued. This is particularly true of new, greenfield projects. Funding via private investment shifts this revenue risk to the concessionaire.

- Operations and maintenance cost risk transfer. Operation costs and the liability for future maintenance are the responsibility of the concessionaire. For example, the concession agreement for the Chicago Skyway requires the Skyway Concession Company LLC, (SCC) to make improvements to the roadway and pay all operating costs. A similar provision was included in the Indiana Toll Road Concession agreement.

- Accelerated project delivery. Concession agreements can help accelerate project delivery in three ways: (1) concessionaires have incentives to complete projects on time or ahead of schedule, accelerating design and construction timetables; (2) concession agreements on existing facilities or new facilities with a great deal of traffic can provide an infusion of cash to accelerate the construction of other transportation projects by providing the funding they lack; and (3) concession agreements can help projects short of funding bridge the financing gap, and with the concession model, non-viable projects can become financially viable.

– Funding security for expansion and maintenance. Public authorities responsible for maintaining and improving facilities are subject to fluctuations in tax revenues and to uncertainty that comes with legislative appropriations. As a result, lack of funding or other priorities may prevent those responsible for maintaining the road from addressing the needs of the facility in a timely manner. Delayed routine maintenance can lead to more serious and costly maintenance problems, further exacerbating the funding shortage. Concessionaires, on the other hand, have the resources and incentives to provide maintenance when needed because that is when it is most cost-effective. Fundamentally, private operators provide a service to which there is a free alternative and are therefore incentivized to provide value for money in the form of a well-maintained facility.

– Economic development. By advancing projects not otherwise feasible or by generating cash payments, concession agreements can significantly further economic development. The United States Department of Transportation estimates that $1 billion in spending on road construction generates 47,500 new jobs. This Committee has estimated that $1 invested in highways delivers $4 in economic benefits and estimated that between 1980 and 1991, highway investments gave rise to almost one-fifth of the increase in productivity in the U.S. economy.

– Fiscal Solvency. A cash infusion from an upfront payment presents an opportunity to maintain or restore fiscal solvency. For example, in the fiscal year ending December 31, 2002 the Chicago Skyway generated revenues of $43.2 million and expenses of $34.8 million, for a profit of $8.4 million. According to Chicago's chief financial officer, the concession arrangement has increased the city's credit ratings, lowered its debts, and allowed the city to create three funds to meet various needs: a $500 million long-term, interest-generating reserve; a $375 million medium-term reserve to be drawn down over eight years in order to provide budgetary relief and reduce the need to raise taxes; and a $100 million neighborhood, human, and business infrastructure fund supplementing 20 city programs. Remaining funds paid off Skyway and other debts.

– Rational Pricing. Inflation forces all toll operators to increase tolls. Concessionaires, however, are free from the political pressures that government operators face. As a result, they can keep toll prices more stable. Prices under a concession agreement increase in a more gradual, less disruptive fashion than under government management where political pressure keeps tolls frozen until operational demands force sharp, sudden price increases.

– Investment opportunities. Currently, there are limited opportunities for those interested in investing in our nation's infrastructure. Under a concession model, pension funds and others interested in investing in infrastructure will be allowed to do so. Hundreds of billions of dollars are moving around world markets looking for long-term investments. For U.S. pension funds, especially those of labor unions, a concession agreement provides them with a great opportunity to invest in American infrastructure.

4. CONCESSION AGREEMENTS – POLICY CONCERNS

Notwithstanding the numerous benefits of a concession approach to financing and operating transportation infrastructure, a number of concerns have been raised about the ability of the private sector to meet public policy objectives under a concession model. These concerns include the following:

- Toll Increases. As mentioned above, all toll facilities have to increase tolls to cover the cost of inflation and the costs associated with expansion. The tolls in concession agreements are set by the public owner of the facility in the concession agreement, not the concessionaire. So whether a toll road is publicly owned or managed by a concessionaire, tolls are established by a public authority.

- Length of concession agreements. Concession agreements have spanned up to 99 years. The long-term nature of these agreements has caused some to express concern about the ability to adequately protect the public's interest over such a long term. The length of a concession agreement is driven by the need to mitigate revenue risk and the importance of giving the concessionaire enough property rights in the asset that the concessionaire views itself as a owner and not a renter. However, the length of the concession agreement will ultimately depend on the needs of the community in which the facility is located.

- Safety and security. Some have expressed concerns that a concessionaire will try to maximize revenue by skimping on maintenance and allowing unsafe road conditions to exist. Under a concession approach, these concerns are mitigated two ways. First, the concession agreement is a legally binding contract with clear performance standards and severe penalties for non-compliance. The Chicago Skyway agreement, for example, requires the concessionaire to: operate, maintain, repair, and toll the Skyway in material compliance with defined operating standards and all applicable laws; make defined capital improvements to the Skyway; and make periodic reports to the City on traffic, environmental issues, accidents, and finances. Violating the concession agreement can lead to forfeiture of the concession payment and the operating rights to the facility. Notwithstanding the concession agreement and its penalties, the concessionaire has a strong incentive to provide a safe facility for its customers. Drivers in this country always have a non-tolled alternative. Concessionaires understand that they have to keep their facility in a condition that will encourage drivers to pay for premium service. Privately operated toll roads are consistently seen as among the most safe roads for drivers to use, given their high standard of maintenance, design, and free-flowing nature.

- Operating characteristics. Concerns have been raised over how concessionaires will respond to a number of operating challenges, including issues as varied as landscaping, emergency vehicle operations, and free access for public transportation vehicles. Again, the concession agreement governs all these issues, and it is often in the private operator's interest to provide considerable amenities to maintain community support. For example, on the South Bay Expressway, Macquarie built trails, sports fields, camping grounds, and engineering berms, as well as doing extensive landscaping, all of which were of great interest to the community.

- Loss of toll revenue. The fact that future toll proceeds go to the concessionaire instead of a public toll entity has caused some to express concerns about how the facility will pay for future maintenance costs and the potential need for additional capacity. However, under the concession agreement, liabilities for operations and maintenance, in addition to future capacity needs, are the responsibility of the concessionaire. Thus, the loss of toll revenues does not inhibit the state's ability to maintain or expand the facility because those duties are the responsibility of the concessionaire.

As several of the points above indicate, the key to mitigating many of the concerns about a concession approach is the concession agreement itself. Reviews of the concession agreements for the Chicago Skyway and the Indiana Toll Road may be found at www.fhwa.dot.gov/ppp/agr_chic_skyway.htm and www.tollroadsnews.com/cgi-bin/a.cgi/0Ih.8pf8EdqcEIJ6InsxIA. A copy of the Indiana Toll Road Concession Agreements and its amendments may be found at http://www.in.gov/ifa/tollroad.html.

5. PUBLIC-PRIVATE PARTNERSHIPS

Concessions, however, are just one form of public-private partnership (PPP). In addition to bringing much-needed capital to transportation infrastructure projects, PPP contracting methods have been shown to save substantial amounts of time and money. For example, a Battelle report found that performance-based contracting can result in savings of 6 to 40 percent and increase on-time delivery by up to 50 percent. The State of Florida has found that non-traditional methods were more timely and cost-efficient than traditional low-bid contracting. In 2004, the United States Department of Transportation sent a report to Congress detailing many of the benefits that have been realized under PPP procurement approaches. A copy of that report may be found at www.fhwa.dot.gov/reports/pppdec2004/index.htm.

6. PRE-DEVELOPMENT AGREEMENTS

While several states and quite a few countries have found significant value in the use of concessions and PPPs, many state DOTs do not have the staff resources to fully explore this new procurement approach. For this reason, the Oregon Department of Transportation (ODOT) has teamed up with Macquarie under a procurement agreement similar to that used by Texas on their Trans-Texas program.

Under the Oregon Innovative Partnerships Program agreement, the Oregon Transportation Improvement Group (OTIG), led by Macquarie Infrastructure Group, is partnered with ODOT to determine the feasibility of developing three PPP projects in Oregon. The predevelopment agreements (PDAs) between the ODOT and OTIG allow either party to halt the development process if the projects are not financially, technically or politically feasible. Should this occur, the financial arrangements between the parties are clearly defined, and Macquarie will receive a discounted fee for its investment. If the project moves forward, all costs will carry forward and be rolled into the final project financing.

Under this procurement approach, ODOT will only be required to reimburse OTIG for costs incurred if projects do not reach implementation—no funds will be paid from ODOT to OTIG if the projects move successfully into implementation. The pre-development costs for the three projects are estimated at over $26.5 million. If the projects do not proceed, ODOT's contribution to costs is capped at $20 million.

The total estimated cost to develop, design, and construct these three projects is more than $1 billion. Procurement costs will be controlled through competitive bidding. Both design and construction work will be selected through a competitive bidding process to ensure taxpayers get the best price for this project. Over the last seven years, ODOT has secured less than $100 million for two of the projects, and sufficient public funding is not expected to be available for a considerable period into the future. If this experimental process is successful and the projects reach implementation, OTIG will provide the funding necessary to develop the projects.

The PDA structure encourages a strong commercial focus on developing successful projects. The early involvement of the private sector limits the risk of pursuing technically feasible but commercially unviable project alternatives. In addition, this process allows

ODOT to harness the creative energy of the private sector to seek out innovative ways to construct a project, or series of projects, that stand virtually no chance of being built under the traditional procurement model.

7. THE ADMINISTRATION, CONGRESS AND THE FUTURE OF PPP'S

Secretary Mineta deserves to be commended for his willingness to aggressively challenge traditional approaches to congestion relief. His 6-point National Strategy to Reduce Congestion on America's Transportation Network is well reasoned and founded on a premise that bears repeating – "Congestion is not a fact of life." In too many communities across America, policy leaders have given up trying to reduce congestion and are just focusing on trying to manage it. In his plan, the Secretary declares his intention to educate policy leaders around the nation on the options available to them to reduce congestion. Hearings, similar to the one this Committee is holding today, are an excellent first step in that education process.

Even with the Administration's National Strategy to Reduce Congestion on America's Transportation Network and the successful passage of SAFETEA-LU, there is a considerable amount of assistance this Committee and the Administration can lend states interested in pursuing PPPs. Listed below are a few ideas we would suggest to encourage those states interested in pursuing alternative procurement methods, methods which can provide drivers in their states with higher quality transportation infrastructure, quicker delivery times, and lower costs.

- Encourage the continued use of the SEP-15 program. Governments are excellent at reaching a public consensus, but they can be slow to change and innovate. Innovations involving procurement of transportation infrastructure can be particularly challenging because local, state, and federal rules can all come into play. SEP-15 is a program created by the FHWA to address this reality. SEP-15 allows states to be creative in their procurement processes and move forward with procurements that may not fall within the FHWA's traditional guidelines. Yet, SEP-15 allows the FWHA to protect the federal interest in projects by requiring increased federal oversight of the project and by allowing flexibility only on a case-by-case basis. Some of the experiments being performed under SEP-15 could result in new rules shaving years and millions of dollars off the development of highway projects.

- Streamline TIFIA Program reviews and awards. TIFIA can play a crucial role in project financing for projects seeking non-traditional financing options. Yet the length and complexity of the TIFIA process has dampened its use. Providing TIFIA with more flexibility to support innovative projects would be helpful.

- Streamline environmental permitting. As this committee is aware, the environmental permitting process takes far longer than is necessary to protect the environment and build community consensus around a project. This committee provided strong leadership in this area during the debate and drafting of SAFETEA-LU. Continuing efforts along these lines will help communities provide much needed transportation infrastructure in a more timely manner.

- Consider the federal interest in a project. Traditional highway procurement has a federal funding component of 80 to 100 percent. As such, it makes a great deal of policy sense for federal procurement rules to apply to protect the federal interest. With a slackening of federal revenue and increased funding from state, local and private sources, this Committee should consider whether one dollar of federal revenue should still federalize a project or whether a de minimis federal contribution would be allowed without all federal rules attaching.

– Encourage states to experiment with private sector investment. One of the larger barriers to increased private sector financing is the lack of authority under state law to allow such participation. Congress could help breach this barrier by providing greater incentives for states to be less reliant on federal funding by using private capital. For example, the administration has previously proposed requiring that for any federal-aid project estimated to cost $50 million or more, the state would have to study the feasibility of a toll road and the financial advisability of privatizing its construction, maintenance, and operation. This is similar to an approach taken by Texas and would provide much-needed impetus to States that currently do not authorize private participation in highway construction or operations.

8. CONCLUSION

Mr. Chairman and Members of the Committee, thank you again for holding this hearing today and affording me the opportunity to speak on this important topic. Concession agreements have the potential of unlocking capital trapped in assets and making non-viable projects viable. Utilizing improved financing and asset management techniques, the private sector can help bridge the highway infrastructure gap. As Secretary Mineta has stated, "…we don't have to put our lives on hold any longer. We have the tools, the technology, and the plan to make today's congestion a thing of the past." We need only make modest changes to our legal structure to unlock tens of billions of dollars in captive capital.