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COVER STORY

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Roads To Riches

Why investors are clamoring to take over America's highways, bridges, and airports—and why the public should be nervous

COVER STORY PODCAST

Steve Hogan was in a bind. The executive director of Colorado's Northwest Parkway Public Highway Authority had run up $416 million in debt to build the 10-mile toll road between north Denver and the Boulder Turnpike, and he was starting to worry about the high payments. So he tried to refinance, asking bankers in late 2005 to pitch investors on new, lower-interest-rate bonds. But none of the hundreds of investors canvassed was interested.

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Then, one day last spring, Hogan got a letter from Morgan Stanley (**MS**) that promised to solve all of his problems. The bank suggested Hogan could lease the road to a private investor and raise enough money to pay off the whole chunk of debt. Now Hogan, after being inundated with proposals, is in hot-and-heavy negotiations with a team of bidders from Portugal and Brazil. "We literally got responses from around the world," he says.

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In the past year, banks and private investment firms have fallen in love with public infrastructure. They're smitten by the rich cash flows that roads, bridges, airports, parking garages, and shipping ports generate—and the monopolistic advantages that keep those cash flows as steady as a beating heart. Firms are so enamored, in fact, that they're beginning to consider infrastructure a brand new asset class in itself.

With state and local leaders scrambling for cash to solve short-term fiscal problems, the conditions are ripe for an unprecedented burst of buying and selling. All told, some $100 billion worth of public property could change hands in the next two years, up from less than $7 billion over the past two years; a lease for the Pennsylvania Turnpike could go for more than $30 billion all by itself. "There's a lot of value trapped in these assets," says Mark Florian, head of North American infrastructure banking at Goldman, Sachs & Co (**GS**).

There are some advantages to private control of roads, utilities, lotteries, parking garages, water systems, airports, and other properties. To pay for upkeep, private firms can raise rates at the tollbooth without fear of being penalized in the voting booth. Privateers are also freer to experiment with ideas like peak pricing, a market-based approach to relieving traffic jams. And governments are making use of the cash they're pulling in—balancing budgets, retiring debt, investing in social programs, and on and on.

But are investors getting an even better deal? It's a question with major policy implications as governments relinquish control of major public assets for years to come. The aggressive toll hikes embedded in deals all but guarantee pain for lower-income citizens—and enormous profits for the buyers. For example, the investors in the $3.8 billion deal for the Indiana Toll Road, struck in 2006, could break even in year 15 of the 75-year lease, on the way to reaping as much as $21 billion in profits, estimates Merrill Lynch & Co. (**MER**) What's more, some public interest groups complain that the revenue from the higher tolls inflicted on all citizens will benefit only a handful of private investors, not the commonweal (see BusinessWeek.com, 4/27/07, **"A Golden Gate for Investors"**).

There's also reason to worry about the quality of service on deals that can span 100 years. The newly private toll roads are being managed well now, but owners could sell them to other parties that might not operate them as capably in the future. Already, the experience outside of toll roads has been mixed: The Atlanta city water system, for example, was so poorly managed by private owners that the government reclaimed it.

Such concerns weigh on the minds of public officials like Hogan. He intends to negotiate aggressively with corporate suitors and has decreed that the buyer must share future toll-hike revenues with the local governments that built the highway. But with the market for infrastructure still in its infancy, every deal is different. The ideal blend of up-front payment, toll hikes, and revenue sharing hasn't been found.

FLOOD OF MONEY

The nascent market in roads and bridges in the U.S. follows the shift toward privatization in Europe and Australia that began with British Prime Minister Margaret Thatcher in the 1980s. It took longer to develop in the U.S. because of the $383 billion municipal bond market, which has been an efficient source of capital for governments over the years.

But with the explosion of money flowing into private investments recently, fund managers have been exploring the fringes of the investing world in search of fresh opportunities. Now a slew of Wall Street firms—Goldman, Morgan Stanley, the Carlyle Group, Citigroup, and many others—is piling into infrastructure, following the lead of pioneers like Australia's Macquarie Group. Rob Collins, head of infrastructure mergers and acquisitions at Morgan Stanley, estimates that 30 funds are being raised around the world that could wield as much as $500 billion in buying power for U.S. assets.

Many investors think of infrastructure investing as a natural extension of the private equity model, which is based on rich cash flows and lots of debt. But there are important differences. Private equity deals typically play out over 5 to 10 years; infrastructure deals run for decades. And the risk levels are vastly different. Infrastructure is ultra-low-risk because competition is limited by a host of forces that make it difficult to build, say, a rival toll road. With captive customers, the cash flows are virtually guaranteed. The only major variables are the initial prices paid, the amount of debt used for financing, and the pace and magnitude of toll hikes—easy things for Wall Street to model. "With each passing week, there are more parties expressing unsolicited interest in some kind of a financial transaction that will involve one of our assets directly or indirectly," says Anthony R. Coscia, chairman of the Port Authority of New York & New Jersey.

Firms are even beginning to market infrastructure to investors as a separate asset class, safe like high-grade bonds but with stock market-like returns—and no correlation with either. The Standard & Poor's 500-stock index has returned about 10% a year, counting dividends, since 1926. Bonds have returned about 5%. Firms say infrastructure will beat both, and without having to sweat out market dips along the way. That's a huge selling point at a time when stock, bond, and commodity markets around the world are becoming increasingly interconnected.

Investors can't get in fast enough. They recently deluged Goldman Sachs with $6.5 billion for its new infrastructure fund, more than twice the $3 billion it was seeking. "We're using [infrastructure] as a fixed-income proxy," says William R. Atwood, executive director of the Illinois State Board of Investment, who plans to invest $600 million to $650 million, or 5% of its portfolio, in infrastructure funds over the next three years. "We're hoping to get 11% to 12% returns and lower risk." Pension funds in particular like the long-term investment horizons, which match their funding needs well. Infrastructure "delivers similar yield expectations to high-yield bonds and real estate, with less risk," says Cynthia F. Steer, chief research strategist at pension consulting firm Rogerscasey.

On the other side of the bargaining table from the investment firms sit struggling governments suddenly amenable to the idea of selling control of assets to solve short-term problems. The burden of maintaining roads, bridges, and other facilities, many built during the 1950s, is becoming difficult to bear. Federal, state, and local governments need to spend an estimated $155.5 billion improving highways and bridges in 2007, according to transportation officials, up 50% over the past 10 years. And that's hardly the only obstacle they face. In 2006 alone, states increased their Medicaid spending by an estimated 7.7%, to $132 billion. And state and local governments could be on the hook for up to $1.5 trillion in retiree liabilities, estimates Credit Suisse. At the same time, politicians find it difficult to raise taxes. Chicago's former chief financial officer, Dana R. Levenson, sums up the situation: "There is money to be had, and cities need money." U.S. Representative Chaka Fattah, a Pennsylvania Democrat who is running for mayor of Philadelphia, proposes to privatize the Philadelphia International Airport and use the proceeds to fund poverty programs—a much easier sell than a tax increase.

The combination of eager sellers and hungry buyers is shaking loose public assets across the country. The 99-year lease of the Chicago Skyway that went for $1.8 billion in 2005 was the first major transaction. Last year came the Indiana deal. Now states and cities are exploring the sale of leases for the turnpikes in New Jersey and Pennsylvania, a toll road in Texas, Chicago Midway Airport, and several state lotteries. Suddenly politicians around the country are wondering how much cash they might be sitting on. Based on the going rate of about 40 times toll revenues, the iconic Golden Gate Bridge could probably fetch $3.4 billion were California interested in selling. The Brooklyn Bridge? If permission were granted by New York City to charge the same tolls as the George Washington Bridge, a private owner might shell out as much as $3.5 billion for it.

PAVEMENT PRICING

But there's a downside to the quick cash: planned toll hikes that are usually quite aggressive. Chicago's Skyway could see car tolls rise from $2 in 2005 to $5 by 2017. For some perspective, if a similar scheme were applied to the Pennsylvania Turnpike during its 67 years of existence, the toll for traveling from the Delaware River to the Ohio border would be as much as $553 now instead of $22.75. Macquarie, which teamed up with Spain's Cintra to purchase the Chicago Skyway and the Indiana Toll Road, underscored the governmental trade-off during a presentation at the recent White House Surface Transportation Legislative Leadership Summit: "More Money or Lower Tolls." In an extreme scenario, governments could begin to sell properties that aren't tolled to private owners who will impose fees.

Of course, tolls won't go to the moon if they result in dramatic reductions in traffic. For example, investment firm NW Financial Group estimates that if the Chicago Skyway pricing scheme were applied to New York's Holland Tunnel over its 80 years, it would cost $185 to travel through it instead of the current $6. "No one will pay that much," says Murray E. Bleach, president of Macquarie Holdings (USA) Inc. "It's just not going to happen."

Still, Indiana legislators became so alarmed by promised hikes that they changed the terms before the toll road lease was completed. The state set aside $60 million to pay the difference in tolls for up to two years or until the buyers install electronic tolling equipment. After that, the fee for cars with electronic toll cards will rise to $4.80 over the full 157 miles, while the fee for cars without the cards will soar to $8. After 2010, both rates will rise each year by 2%, the pace of inflation, or the rate of economic growth, whichever is highest.

The certainty of future toll hikes doesn't jibe with the uncertainty of service quality. Assets sold now could change hands many times over the next 50 years, with each new buyer feeling increasing pressure to make the deal work financially. It's hardly a stretch to imagine service suffering in such a scenario; already, the record in the U.S. has been spotty. In 2003 the city of Atlanta ended a lease of its water system after receiving complaints about everything from billing disputes to water-main breaks. The city wrestled with the owner, United Water Inc., over basics like the percentage of water meters it should monitor. Both parties acknowledge that the contract lacked specifics. In the end, "we didn't believe we were getting performance," says Robert Hunter, commissioner for Atlanta's Dept. of Watershed Management. "I don't believe the city will ever look at privatizing essential services again." United Water says the contract wasn't financially feasible because Atlanta's water system was in worse shape than the city had represented.

A CHAMPION'S PERSPECTIVE

States are wrestling with other public policy issues, too. Bankers say New York could reap a combined $70 billion for long-term leases on a bunch of assets, including the state's lottery, the Tappan Zee Bridge, and the New York State Thruway. New York state officials have looked into the option of leasing the lottery, which itself might command $35 billion—a sum that could substantially upgrade, say, New York's higher education system. The downside? The state would probably have to remove constraints on the lottery's marketing designed to discourage people from gambling more than they can afford. If the state insists on keeping the constraints in place, it could reduce the value of selling it.

Chicago's experience shows the possibilities and the pitfalls of privatization. Former CFO Levenson has been one of the movement's biggest champions. He was an architect of the Skyway deal, which kicked off the market. Then he sold control of parking garages to Morgan Stanley for $563 million. Next, he started shopping around a lease for Midway Airport that could fetch as much as $3 billion. And soon the city hopes to auction off rights to operate some recycling plants. Levenson dismisses critics who argue that he has dumped prized assets. "This is not like where a person goes in and buys a loaf of bread from a store and walks out with that loaf of bread," he says. "Some entity, we expect, will make an offer to lease the Midway Airport for 75 to 99 years, and the following day I'm pretty sure it will still be there."

Wearing a crisp suit and stylish eyeglasses, Levenson looks like the Wall Streeter he once was, working for Bank One Corp. and Bank of America Corp. (**BAC**) before taking the Chicago city job in 2004. In April he returned to banking: As a managing director at the Royal Bank of Scotland Group (**RBS**), he now beats the bushes for infrastructure deals. Levenson doesn't understand how local governments can afford not to put public works up for sale. Thanks to the 99-year lease for the Skyway, Chicago has paid off its debt and handed over $100 million to social programs like Meals on Wheels. Plus, says Levenson, it's earning as much in annual interest on the $500 million it has banked from the transaction as it used to earn from running the Skyway ($25 million).

In some ways, Levenson argues, the city still has control over the highway. The agreement with the new owners spells out guidelines in mind-numbing detail, dictating everything from how quickly potholes must be filled (24 hours) to how rapidly squirrel carcasses must be removed (8 hours). If Macquarie and Cintra violate those conditions, the city can take back the road.

So far, the buyers have strictly adhered to the rules. At 7 a.m. on a Wednesday in March, five workers begin another day at the Chicago Skyway's Snow Command. On their to-do list are potholes to be checked and cracks to be sealed. Juan Rodriguez used to patrol the freeway for Chicago city. Today, he cruises the road for private owners. He discovers some potholes have grown unacceptably large because of salt that was spread the previous night. There's some tire debris that must be removed, and a disabled vehicle holding up traffic.

A SMOOTH RIDE?

In the past, Rodriguez says, he had to write out a ticket for each problem, which would be added to a long list of chores. Addressing problems often took days, Rodriguez recalls. But by 10:25 a.m., all of this morning's issues on the Skyway's 7.8-mile stretch of pavement are resolved. "The new owners are taking the Skyway to a whole new level," he says.

They've certainly spent money on improvements. The message "a clean workplace is a happy workplace" is scrawled on a whiteboard in a freshly painted and ventilated garage where workers meet. There's electronic tolling, which didn't exist before. A bunch of new lanes are under construction. The investments seem to be paying off: Since taking over two years ago, the Skyway's operators estimate traffic has risen 5%.

It's all encouraging, except that Chicago "probably could have gotten more without privatizing," according to Dennis J. Enright, a principal and founder of NW Financial. His firm's analysis shows that Chicago could have done a lot better by handling the whole deal itself. It could have raised tolls and sold tax-exempt municipal bonds backed by the scheduled hikes. That would have given the city the up-front cash it needed while preserving some of the income from the toll hikes. Instead, that money will go to Macquarie and Cintra.

Meanwhile, the higher tolls will take a big bite out of lower-income people's wallets. "You have to ask yourself if you want roads that used to be considered a public service to be rationed by income class," says Princeton University economics professor Uwe E. Reinhardt. Chicago says it hasn't received any formal complaints from citizens, though two different drivers recently went to extremes to avoid tolls, says Skyway maintenance manager Michael S. Lowrey. When the new owners introduced free towing for broken-down vehicles, the drivers called the Skyway for help, claiming to be stranded. After workers hauled the vehicles past the tollbooths, they hopped in their cars and sped away.

For workers, the privatization wave has wrought many changes. Skyway toll takers used to be full-time city employees with rich benefits. Now most are part-time independent contractors without benefits. Brian Rainville, executive director of the Chicago Teamsters Joint Council 25, helps manage the union's pension fund. When he listened to a recent pitch from a pension consultant about infrastructure funds, it sparked a realization: The returns he might generate for his pensioners could be canceled out by the union's shrinking number of contributors. "It's pretty obvious that it's not sound fiscal policy for the [pension] fund to undercut the people it's serving," Rainville says.

Pushback against private investors is now playing out in different ways elsewhere. In Pennsylvania, the state turnpike commission is going head-to-head with private bidders for the right to operate the state's 537-mile toll road. Pennsylvania desperately needs cash to repair its nearly 6,000 structurally deficient bridges. Some pundits expected Pennsylvania Governor Edward G. Rendell to propose hikes in gas taxes and other fees to fund the projects. But in December, Rendell unexpectedly announced plans to privatize the turnpike. Timothy J. Carson, vice-chairman of the commission, scrambled to submit an expression of interest for the turnpike to continue to run itself. His proposal is being judged against many others, including those from big Wall Street firms.

Carson isn't dissuaded by arguments that investors are better qualified to run turnpikes profitably. "There's no magic here," he says. "These [deals] are largely driven by one factor: the permitted toll increases." Carson says the state doesn't need to hand over the turnpike to private owners. Historically, he says, the state wanted the turnpike to collect only enough money to break even. But it could just as easily adopt its own toll-hike schedule. The state could also charge tolls on more roads. In other words, the public could remain in control simply by changing the turnpike's mission. That would ensure that the benefits of the toll hikes were spread throughout the populace, says Carson.

Pennsylvania's isn't the only turnpike authority exploring the possibility of bidding for roads. The North Texas Tollway Authority calculated in March that it would have valued a partially constructed 25-mile stretch of highway near Dallas 26% more than a private investor had bid. Now it's considering making a formal bid. And on Apr. 11, the Texas House of Representatives passed an amendment by a vote of 134 to 5 to impose a two-year moratorium on privatizing state toll roads. "We need to put the brakes on these private toll contracts before we sign away half a century of future revenues," said representative Lois W. Kolkhorst, who proposed the bill. A similar bill was passed in the state senate on Apr. 19.

With so much money at stake and so many options available to states, it's impossible to know how the great infrastructure craze may play out. But this much is certain, says Pennsylvania's Carson: "People are willing to pay more than they are currently being charged. The only question is to what extent you're willing to take advantage of that."

Click **here** to join a debate about private ownership of roads and bridges.

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