The Road to Privatization: Implications of Public-Private Partnerships for Transportation Projects

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Chapter 1. Introduction

Beginning with the construction of the highway interstate network, highways and transit have typically been funded by federal and state aid derived from the motor fuel tax. However, given the national reluctance to increase the motor fuel tax coupled with more fuel efficient automobiles, motor fuel tax revenue growth has not kept pace with construction costs. In addition, there has been an increasing demand for transportation system preservation and new projects to meet the increasing demands of congestion. To address the needs of residents and the relative static growth in the motor fuel tax, a new national trend appears to be developing in financing transportation projects.

Specifically, a growing national interest is developing in partnering with the private sector to access cash and equity that might not otherwise be available for transportation projects. The relationship between the public and private sector is commonly known as a public-private partnership (P3). The partnership can take several forms, including the State leasing an existing revenue generating State asset to a private entity for operation in exchange for a lump sum payment. Alternatively, the private sector can construct a transportation infrastructure project, generally a toll road, for the right to collect future revenues.

The Maryland Department of Transportation (MDOT) is evaluating several projects currently in the *Consolidated Transportation Program* for a P3 as a way to initiate projects that might not otherwise be developed due to limited resources. For example, in the fall of 2006, a Request for Expressions of Interest was issued by the Maryland Transportation Authority (MdTA) for the Corridor Cities Transitway project. Since 1997, MdTA has administered a P3 program for non-highway projects for MDOT. Under regulations adopted by MdTA, along with guidance found in a 1996 Attorney General's opinion, the P3 program has been used for a variety of non-highway transportation projects, including port, transit, and airport facilities. MdTA and MDOT have broadly defined P3 arrangements to include transit-oriented development, design-build contracts, and other relationships with the private sector. This paper will focus on P3 arrangements where the private sector invests large amounts of equity to develop mega-transportation infrastructure projects, mainly highways.

In considering P3s and the role of private finance in transportation infrastructure, there are a number of issues for the State to consider, including the role of the legislature, the legal framework for such an agreement, and how the State should engage the private sector. The Department of Legislative Services has prepared the following document as background on P3s, including national and international examples, and a number of issues for the General Assembly to consider regarding these partnerships. **Appendices 1** through **3** provide case studies of other P3 arrangements.

Chapter 2. What Is a Public-Private Partnership?

A public-private partnership (P3) is an agreement between the State and a private entity whereby the private entity undertakes the construction of a project (*e.g.*, a highway) or responsibility for the operation of an asset (*e.g.*, toll roads) on the State's behalf. In doing so, the private entity assumes some, but not all, of the responsibilities and risks associated with the project or asset. The agreements typically involve large, complex, and expensive projects.

In 2004, the Maryland Transportation Authority (MdTA), in conjunction with the Maryland Department of Transportation and the State Highway Administration, conducted a research project and issued a Request for Information on P3s for highways. The findings of these studies showed that the factors a private partner considers when deciding whether or not to compete for a P3 agreement include:

- the level of investment and technical risk associated with the project;
- the allocation of risk between the public and private sector;
- the perceived trustworthiness of the State's procurement process;
- the strength of the public sector project management;
- the strength of the State's commitment to the project;
- the clarity of enabling legislation; and
- the project size (private entities prefer projects that exceed $200 million).

P3s typically fall under two types of agreements, with variations possible:

Concession Agreements: A concession agreement involves the leasing of an existing, publicly financed transportation facility to a private entity to operate and maintain for a set period of time in exchange for an upfront lump sum payment. Furthermore, the private entity collects and retains the revenues from that facility for the length of the lease. The two most publicized examples of this type of partnership are the City of Chicago signing a 99-year lease with a private entity for a lump sum payment of $1.82 billion for a toll road, and Indiana signing a 75-year lease for a toll road totaling $3.85 billion. In both of these examples, the private entity is responsible for maintaining the toll road for the length of the lease as well as a number of capital improvements, such as installing electronic toll collection. In Maryland, this type of P3 agreement would most likely involve leasing existing assets operated by MdTA, such as the Chesapeake Bay Bridge, the Fort McHenry Tunnel, or the John F. Kennedy Memorial Highway

(I-95), assuming provision could be made under the Authority's outstanding agreements with bondholders. Alternatively, leasing could be applied to presently untolled properties of the Department of Transportation.

Design, Build, Operate, Maintain: Under this arrangement, a private entity contracts to finance, design, build, operate, and maintain a transportation infrastructure project. The private sector partner may own or lease the project, assumes some of the risk, and may collect all the revenue.

Possible Advantages of a Public-Private Partnership

There are several reasons why states are turning to private entities to assist in the development of transportation infrastructure.

Cash Influx to Advance Projects: States are leasing existing state assets for large lump sums of cash which in turn can be used to advance transportation projects that may not otherwise be constructed immediately. For example, Indiana's P3 agreement enabled the state to use the proceeds from the project to advance other transportation needs.

The issue of congestion is increasingly an issue state and local governments are looking to address. However, state sourced revenues for transportation, largely derived from the motor fuel tax, have not kept pace with inflation and have lost purchasing power. Given the national reluctance to raise the motor fuel tax, governments have turned to other revenue sources to move ahead transportation projects. Partnering with private entities allows a state to access other revenue streams outside of state sourced revenues to close the gap between what is needed and what is available in terms of revenues. By accessing private dollars, partnerships can also prevent the need for additional state bond indebtedness.

Risk Distribution: P3 arrangements allow at least some of the risk for cost overruns and anticipated future revenues to be transferred to the private sector.

Efficiency in Operations and Maintenance: Public entities have turned to the private sector to either perform or learn how to perform certain services in a more efficient and less expensive manner. A P3 arrangement allows for a private entity to operate and maintain a transportation facility. There is an assumption that greater efficiency will develop since market factors encourage innovation, and the private sector is better suited to respond more quickly to changes, utilize technology, focus on customer service, and learn how to reduce costs more effectively than the public sector. For example, the introduction of electronic tolling by private entities has contributed to the efficiency in the operation and collection of revenue for toll roads.

Developer Benefits: Private contractors can also reap benefits from P3 projects. Toll roads in particular provide a relatively stable and predictable stream of revenue which is important to investors and developers. Large pension funds are particularly interested in the

investment opportunities provided by P3 agreements. The federal government has also provided incentives for these types of agreements. Specifically, in the recently passed transportation reauthorization bill (SAFETEA-LU), $15 billion was authorized for tax-exempt private activity bonds to be used for the construction of eligible transportation facilities nationwide. Utilizing these bonds, a private entity can issue tax-exempt debt as part of its financing plan for a P3 project.

Possible Disadvantages of a Public-Private Partnership

Long-term Lease Risks: There will always be economic downturns and recessions in the future. Whether state governments, with aid from the federal government, can weather these financial storms better than the private sector is unknown. Clearly, when a state experiences a budget crisis, it cannot abandon its responsibilities, such as providing a functioning transportation system. Should a private company fall victim to bankruptcy, it is unclear how its abandoned responsibilities will be dealt with and allocated. Appendix 1 details a case study from Virginia where traffic volumes were below estimates and, as a result, the private entity sold the toll road to another private entity.

Enforcing a P3 Agreement: Because the private sector inherently places its own financial interest above all other interests, there is a risk that the agreement to provide a certain level of service will be called into question as the private entity seeks to maximize its return. In such a case, a state could incur significant legal expenses to enforce a contract that may have been written as long as 75 years ago.

Lost Revenue: While selling or leasing a transportation facility can create a huge influx of money for a state at first, the long-term revenue stream that would normally be provided by a revenue-generating facility is lost. This can result in less money for future capital projects, or a situation where a state is more cash-strapped once upfront payments are depleted and must therefore be dependent on the private sector to perform traditional public services. Another important consideration is that an asset may be undervalued when a concession agreement is reached. Under this scenario, the state will not fully realize the value of the asset.

Unions and the Use of Local Labor: Unions may object to P3 agreements, on the belief that privatization is a threat to state jobs. Alternatively, local trade unions may be concerned that the Davis-Bacon Act (requiring specific wage levels on federal projects) will not apply or that labor may be brought in from outside the area to complete the project. Finally, local contractors may worry that they cannot compete with national and international firms for very large projects.

Environmental Concerns: P3 projects also may raise environmental concerns. The National Environmental Policy Act (NEPA) requires the development of an environmental impact statement for "major federal actions," which usually includes actions taken using federal funds. If a P3 project is privately financed in its entirety, then the application of NEPA would

depend on whether another major federal action, such as the requirement for a wetlands permit or the connection of the P3 project to a federal highway, is involved in the project.

Impact on Taxpayers: Finally, another important policy consideration is to what extent a state wants to implement a user fee system to pay for transportation infrastructure. Typically, a P3 arrangement involves a revenue-producing facility such as a toll facility. By entering into a P3 agreement, a state is adding another revenue-producing facility to the transportation infrastructure inventory and in essence moving toward a user fee system. Policy concerns regarding double taxation, the appropriate role of toll roads, and the extent and impact of toll increases may arise.

Chapter 3. Legal Framework for P3 Agreements in Maryland

Legal Authority

In Maryland, there is no formal statutory framework governing public-private partnership (P3) agreements. Currently, P3 arrangements are governed by the Maryland Transportation Authority's (MdTA) general statutory authority relating to transportation facilities and regulations adopted under this authority, and – in certain instances – State procurement law. A 1996 Opinion of the Attorney General provides additional guidance with respect to this governing authority. Under regulations adopted in 1997, MdTA administers the Transportation Public-Private Partnership program on behalf of the Maryland Department of Transportation (MDOT). Legal authority for the MdTA to adopt the P3 program regulations is provided in Title 4 of the Transportation Article, Annotated Code of Maryland. Under § 4-204, MdTA "has those powers and duties relating to the supervision, financing, construction, operation, maintenance, and repair of transportation facilities[1] projects." Section 4-205 authorizes MdTA to set and collect tolls with regard to transportation facilities, and to enter into any contracts or agreements "necessary or incidental to the exercise of its powers and performance of its duties."

To date, the P3 program has been used for non-highway transportation projects, including port and airport support facilities and transit oriented development. All toll roads, bridges, and tunnels are currently owned and operated by MdTA. However, according to the Attorney General, "nothing in the law precludes a private entity from contracting with MdTA to participate in the construction of a toll road, [bridge, or tunnel]."[2] Furthermore, based on the exclusive authority to fix and collect tolls and to enter into contracts relating to an MdTA function, the Attorney General has opined that "to the extent that a private entity provides the financing for a State-owned toll road, the MdTA would be authorized to permit tolls to be charged by the private party [to finance the project]."[3]

Current MdTA P3 Regulations

Under the P3 program, MdTA may select a private entity to acquire, finance, construct, or operate a new transportation facility, or to perform major rehabilitation or expansion of an existing facility. Proposals for a P3 project may either be in response to a request for proposal issued by MdTA, or unsolicited. Regulations currently allow unsolicited proposals only for new transportation facility projects. However, the regulatory definition of "transportation facility" differs from the statutory definition. Under the P3 regulations, a transportation facility only

[1] A "transportation facility" includes airport facilities, highway facilities, port facilities, railroad facilities, and transit facilities. TR, 3-101(l).

[2] 81 Opinions of the Attorney General 261, 265 (1996).

[3] *Id.* at 264.

includes a "port, airport, railroad, or transit facility…and structures related to transportation facilities, as described in Transportation Article, Annotated Code of Maryland." Under this definition, the P3 regulations preclude unsolicited P3 proposals for a new highway project. In addition, the P3 regulations do not allow unsolicited proposals for the sale of assets or the procurement of operational or maintenance services.

Once a private entity is chosen by MdTA for a project, regulations require the private entity to enter into a comprehensive agreement addressing the rights and obligations of MdTA and the private partner. Noteworthy requirements include:

- the duration of a right to acquire, construct, finance or operate a transportation facility;
- how any user fees will be established;
- performance milestones;
- responsibilities for acquiring environmental approvals and other permits;
- the terms for reimbursement of State services; and
- that the maximum rate of return to the private partner be negotiated as part of the agreement for the project.

Applicability of State Procurement Law

State law establishes MDOT and MdTA as primary procurement units with exclusive jurisdiction over specified procurements, subject to the authority of the Board of Public Works. The Board of Public Works does not, however, have authority over capital expenditures by MDOT or MdTA in connection with State roads, bridges, or highways. Whether State procurement laws apply to a contract between a State agency and a private entity depends on whether the contract reflects a "procurement."[4] Under § 11-101(m)(1)(ii) of the State Finance and Procurement Article, a procurement involves "buying or otherwise obtaining supplies, services, construction, construction-related services, architectural, [or] engineering services…" Procurement includes a State agency's leasing real or personal property as the lessee; however, it does not include a State agency leasing property as the lessor.[5] Therefore, a contract between the State and a private entity to lease a transportation facility to the private entity would not, in and of itself, expose the contract to State procurement laws. Moreover, pursuant to a regulation adopted by the Board of Public Works, State procurement regulations do not apply to

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[4] *Id.* at 265.
[5] *Id.*

revenue-producing contracts involving a license, permit, or similar permission to use a transportation facility, or a lease of a transportation facility.[6]

While State procurement laws and regulations may not apply to specific P3 agreements, MdTA regulations do provide that a project selected under the MdTA P3 program is subject to Board of Public Works approval. Furthermore, under § 12-204 of the Transportation Article, the terms of any lease of real or personal property of the State to a private entity is subject to Board of Public Works approval.

Legislative Oversight

Chapter 472 of 2005 provides 45 days for legislative review and comment on any MdTA contract or agreement to acquire or construct a revenue-producing transportation facility. Specifically, under § 4-205(c), MdTA must provide to the Senate Budget and Taxation Committee, the House Committee on Ways and Means, and the House Committee on Appropriations, for review and comment, "a description of the proposed project, a summary of the contract or agreement, a financing plan that details the estimated annual revenue from the issuance of bonds to finance the project, and the estimated impact…on the bonding capacity of the [MdTA]." While this requirement provides legislative review and comment for P3 agreements to construct new revenue-producing transportation facilities, it does not apply to P3 agreements pertaining to existing transportation facilities; nor does it require legislative review and comment before MdTA issues a request for P3 proposals from the private sector.

[6] COMAR 21.01.03.03

Chapter 4. Issues

Before the State continues with its public-private partnership (P3) transportation projects and embarks on new P3 highway projects, there are several fundamental issues that need to be addressed. These are discussed below:

Weak Statutory Framework

As mentioned above in the Legal Framework section, there is no formal statutory framework governing P3 agreements in Maryland. Currently, P3 agreements are governed by Maryland Transportation Authority (MdTA) regulations. As such, the General Assembly has not established the appropriate scope of P3 projects. While there is limited legislative review of any regulation proposed by an executive agency, the process of adopting or altering regulations occurs with less legislative deliberation than does the process of enacting a statute. In fact, review by the legislative body charged with reviewing executive regulations – the Joint Committee on Administrative, Executive, and Legislative Review – is limited to whether statutory authority exists for adopting the regulation and whether it complies with legislative intent while also considering the fiscal impact. Furthermore, despite legislative objection to a proposed regulation, the Governor may instruct an agency to adopt a regulation over the legislature's objections. Because of the complex and enduring policy issues relating to P3 agreements, a statutory framework would provide the necessary structure to govern P3 projects in a manner that is fully vetted and agreed upon.

There are currently 21 states with laws authorizing some form of P3s for transportation projects.[7] Of those states, Arizona, Missouri, Indiana, North Carolina, and Alaska limit authorization to only one or more "pilot" projects. For states that have actually utilized a P3 agreement for a transportation project, such as California,[8] Indiana,[9] Texas, and Virginia,[10] the respective legislatures have enacted comprehensive statutory frameworks governing P3 agreements.

The lack of a comprehensive statutory framework governing all forms of P3 projects raises issues relating to the oversight role of the legislature. Currently, only limited legislative

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[7] These states are Alaska, Alabama, Arizona, California, Colorado, Delaware, Florida, Georgia, Indiana, Louisiana, Maryland, Minnesota, Missouri, Nevada, North Carolina, Oregon, South Carolina, Texas, Utah, Virginia, and Washington.

[8] California authorizes P3 agreements for a range of "fee-producing infrastructure projects" but explicitly excludes the use of toll roads on state highways.

[9] Indiana's enabling statutes were meant to implement a particular P3 project and specifically prohibit future P3 agreements without legislative approval.

[10] Although Texas and Virginia laws do not prohibit particular P3 projects, both states have enacted detailed requirements for any P3 agreement.

oversight for contracts or agreements entered into by MdTA to acquire or construct a revenue-producing transportation facility is granted through the 45 days of review and comment by the above mentioned Senate and House committees. Documents that must be submitted for review include a description of the proposed project, a summary of the contract or agreement, a financing plan, and the estimated impact on MdTA's bonding capacity. This requirement does not apply to any contract or agreement pertaining to existing transportation facilities, nor does it apply to request for proposals (RFPs) issued by the MdTA.

House Bill 1555 of 2006 (failed) was introduced in an effort to extend legislative oversight of P3 agreements. In addition to the existing requirements for acquiring or constructing a revenue-producing transportation facility, this legislation, as amended in the House, would have required a 45-day legislative review and comment period for any RFP issued by MdTA for a P3 project, a description of the proposed lease, and a summary of the proposed P3 arrangement, including the estimated length of the lease, a cost benefit analysis, the scope of any toll-setting authority to be granted to the private entity, and the estimated scope of payments to MdTA from the proposed arrangement. While House Bill 1555 would have been a step toward legislative oversight for P3 projects, it did not address unsolicited P3 proposals, nor did it provide a statutory framework for P3 agreements. Without a comprehensive statutory framework addressing all forms of P3 projects that provides notice and critical information during all stages of a P3 project, the General Assembly's oversight role is greatly diminished.

One role of the legislature is to serve as a check and balance to the Executive Branch. Given the length and financial commitment involved in a P3 arrangement, legislative involvement would provide an additional level of oversight. In addition, as the body charged with enacting a balanced State budget, the General Assembly should play a central role in any long-term financial commitment that will impact the ability of the General Assembly to affect appropriations. This issue is compounded by the fact that MdTA is a nonbudgeted agency; as such, the General Assembly has little control over the funds and expenditures of MdTA. Moreover, with varying expertise, members of the General Assembly may add value to the process of determining the most appropriate financing plan and P3 agreement for a particular project.

Currently, a P3 project is subject to approval by the Board of Public Works. While the board has the expertise and experience in determining the merits of a contract, board members do not represent specific jurisdictions of the State. As legislators representing their respective districts, members of the General Assembly are better suited in protecting the interests of a jurisdiction in which a P3 project is proposed. Although MdTA regulations provide for local agencies and affected jurisdictions to submit comments on P3 projects, these comments are not binding on MdTA. Therefore, any concern that is not adequately addressed during the comment phase essentially leaves the General Assembly or a local jurisdiction with no immediate recourse – except ad hoc legislation.

Long-term Implications

While there can be great benefit to states from entering into P3s, there are also several long-term effects that must be considered. These long-term effects can vary according to what type of partnership is entered into. Many of these effects can be mitigated by a well-constructed contract with the private partner. Some of the long-term effects which can be mitigated through a contract include:

Toll Rate Increases: The contract should include provisions about toll rate increases. This may include how often tolls are increased, a cap on total increases over a certain time frame, limits on yearly increases (often tied to inflation), and whether or not tolls should stop being collected at some point (*i.e.*, once the private entity has received a specified return on its investment). Without these provisions stipulated ahead of time, drivers may be faced with large, unexpected increases in tolls, or toll roads may see a decrease in usage.

Long-term Maintenance: The contract should also include provisions regarding who has responsibility for long-term road maintenance, what road standards are to be maintained, and who will have responsibility for repairing the road after a catastrophic event (*i.e.*, road ruined by earthquake). Long-term maintenance is especially important if the road will be turned back over to the State at some point in the future, as the State does not want to take ownership of an asset that has long been neglected. To combat this, the State may include a provision that allows for monitoring of road conditions throughout the life of the contract.

Ability to Allow for Revisions and Modifications to the Contract: Over the life of the contract, any number of events or changes in circumstances could happen which could necessitate a change in the contract. It is important that both parties be able to revisit the contract when necessary. Many states also include a provision that any changes to the contract may not adversely affect either party. For example, if the State wants a new interchange and the private partner does not believe that the additional toll revenue will be sufficient to cover the cost, the State and partner may enter into a cost sharing agreement to build the additional interchange.

Threat of Bankruptcy: With any private partner, there is always the chance of bankruptcy. If the partnership involves a concession agreement, in order to prevent disruption of service, there should be a provision in the contract that ownership of the road will revert to the State, without any refunding of the concession payment. This will allow the State to retain all proceeds of the lease as well as ownership of the project. However, this also means that the State will suddenly need to again provide service and maintenance for the facility. If the partnership involves a Design, Build, Operate, Maintain agreement, the State should decide during contract negotiations if it wants the potential liability of operating the road should its private partner go bankrupt. This could place an unexpected burden on the State’s finances. However, this can be mitigated by securing a new contract for operation through an expedited procurement process.

Non-compete Clause: In various types of P3 agreements, the private partner may sometimes request a non-compete clause to be included in the contract. This specifies that the State may not build a road within a certain proximity to the toll road. This ensures that the road that the private partner built or leased will not suffer from a decrease in ridership and revenues due to the availability of a free alternative route that drivers could use. In previous contracts containing non-compete clauses that were not carefully worded, states were actually prohibited from making improvements to existing roads in the vicinity of the toll road. Careful consideration should be given to this factor.

Other Outstanding Issues

One consideration that cannot be negotiated through a contract relates to the appropriate role of the private sector in the construction and delivery of public goods. In a P3 arrangement, the public sector cedes some, if not all, control of an asset to the private sector. The public sector is motivated by providing goods and services to the public whereas the private sector is motivated by market and economic forces. Whether or not these differing motivations can work together is an important consideration.

Financial Implications

MdTA is a nonbudgeted agency; therefore, the General Assembly has little control over its budget. MdTA pays for its operations through toll revenue collected from seven bridges, tunnels and highways, lease payments from the Maryland Port Administration for improvements at the Helen Delich Bentley Port of Baltimore (Port), food concessions on the John F. Kennedy Memorial Highway, payments for police services at the Baltimore/Washington International Thurgood Marshall Airport and the Port, and investment income. MdTA also issues revenue bonds to pay for its capital program and to help finance transportation related projects such as the InterCounty Connector. The revenue bonds are governed by a trust agreement which specifies that funds can be transferred from the Transportation Authority Fund (TAF) for transportation-related projects. It is unclear as to whether the trust agreement specifically prohibits transfers for non-transportation projects; however, MdTA's stance is that non-transportation transfers are prohibited.

Effect of a P3 Agreement on Existing MdTA Operations

Concession Agreement: If MdTA were to enter into a concession agreement or revenue sharing agreement to operate one of its existing facilities, it would have to refund or defease its existing revenue bonds, which now include the future revenue from six of MdTA's toll facilities as backing. In addition to the administrative costs associated with the refunding or defeasement, money to pay for the bonds would have to be put into escrow until it could be paid to the bondholders. Part of the strength of MdTA's credit rating and attractiveness of its bonds is based on the pool of shared revenues, in that bonds are backed by many toll facilities and not just one.

Reducing the number of toll facilities included in the revenue pool could potentially weaken MdTA's credit rating and make its bonds less attractive.

A concession agreement typically involves a lump sum payment for the right to collect future tolls. To determine the amount of the concession payment, an evaluation of the present value of all of the future toll revenues over the length of the contract would need to be completed. The risk of a concession agreement is that the valuation of an asset and the future revenues may not be accurate or truly reflect the actual value of an asset. If the facility is more profitable than expected, MdTA would not have captured the full value of the asset in its evaluation, and would essentially lose income as a result of being underpaid for the agreement. If the facility is less profitable than expected, then the private entity would have overpaid for the facility. Under that scenario, the private entity would be seeking to generate more revenue through toll increases, by cutting costs (possibly by deferring maintenance or capital improvements), or by walking away through a sale to another firm. The case study of Ontario in Appendix 3 provides an example of an occurrence where an asset may have been undervalued.

Design, Build, Operate, Maintain: If MdTA were to enter into a Design, Build, Operate, Maintain project for a new facility, operational control could eventually revert to MdTA. Existing bonds would not be affected by this, as they are dependent on the revenues of the current facilities; however, future bonds could potentially include the new project as a revenue source. Depending on whether or not the facility was projected to earn more than its expenses once operational control reverted, this could be a positive or negative development for MdTA. However, it is important to note that eventually the facility would revert to MdTA, not the Maryland Department of Transportation (MDOT).

Effect of a P3 Agreement on the Budget

When entering into a P3 agreement, there exist a number of budgetary implications that need to be considered.

Concession Payments: When a State agrees to lease a toll facility to a private partner, it gets a large influx of cash; however, in doing so, it also gives up its right to future revenues for the term of the contract. Because this future annual revenue will not be coming in, states must ensure that they use the upfront payment wisely. Ideally, the proceeds of the upfront payment will be used to pay off debt or for one-time projects, rather than ongoing expenses. By using the payment for debt service, there will be future benefits as the effects of the lesser debt burden move forward.

Although it was a pioneer of large concessions agreements in the United States, Chicago set a relatively good example of what to do with the proceeds. The $1.83 billion in proceeds it received from the lease of the Skyway is being distributed in the following way:

- $436 million to pay off outstanding debt for the Skyway;

- $258 million to pay down city owned short-term debt;
- $134 million to pay off other city owned long-term debt;
- $500 million to be invested as a reserve fund (earning an additional $25 million in interest each year);
- $325 million for an annuity to provide budget relief over the next several years; and,
- $100 million for various one time neighborhood improvement projects, including homeless shelters, seniors' facilities, libraries, and welfare services.

These are all what may be referred to as "balance sheet" transactions, in that they all improve the city's fiscal position. These types of transactions are vastly better than using the money for operating expenses, which would only serve to postpone addressing operating budget problems.

If MdTA leases or enters into a revenue sharing agreement for one of its facilities, the question is what would become of the initial payment. The first obligation would be to put money into an escrow account to defease existing MdTA bonds. Given that the current amount of MdTA debt outstanding is $264.4 million, and the deals discussed are often in the billions of dollars, there would be money left over. Since P3s would be implemented through MdTA, the concession payment would be transferred to MdTA, unless legislation specified otherwise. There are no other existing guidelines as to where the net proceeds of a P3 should be distributed, or whether to consider them as general fund revenue or Transportation Trust Fund revenue. Consequently, without specific legislation, MdTA would have ultimate authority to decide what to do with the net proceeds.

If the General Assembly wished to use the proceeds of a concession agreement for projects such as school construction, or other general fund purposes, it would include that provision in the contract with the private entity, or pass legislation transferring a portion of that income to the general fund after the fact. MdTA would need to be compensated for the loss of the projected toll revenue without the full benefit accruing to it. The loss of that revenue negatively impacts MdTA's operating budget and capital plan, as well as MDOT's capital plan.

If the General Assembly took no action, MdTA could use the concession proceeds for its capital program or to help fund MDOT's capital plan. Alternatively, in order to maintain interest in its bond products, MdTA could keep the funds in the TAF to generate interest for debt service. That would compensate MdTA for the loss of the projected toll revenue in the future; however, it would not help the State meet non-transportation goals.

Design, Build, Operate, Maintain: While the State's overall involvement on a design, build, operate, maintain project may be limited in terms of the total cost of the project, it is not

necessarily without capital outlays. As Virginia recently learned from its P3 project involving I-495, sometimes in order to complete a P3, federal highway money or even state money is required. Virginia is adding high occupancy toll lanes on the Capital Beltway. The Virginia Secretary of Transportation recently announced that completing the project could require as much as $100 million in public money in addition to the funding provided by the private partners.

Tax Payer Perception

Currently, there is no way of knowing what kind of toll rates may result from a P3 agreement. Most P3 agreements that have been implemented include some type of formula that determines what the toll rate will be and how often it will increase. Regardless, the private sector is motivated by profit and as such, the toll rate and associated increases are likely to be greater than what the public sector provides. Whether or not taxpayers will pay to travel a road or are willing to pay a potentially higher toll is an important consideration that directly impacts the viability of a P3 agreement.

In addition, Design, Build, Operate, Maintain projects that involve highways are typically done as toll roads. In moving ahead with P3 agreements, a policy decision is simultaneously being made to move toward a user fee system to pay for transportation infrastructure. This policy decision represents a departure from how highways have been funded previously, through federal and state aid derived from the motor fuel tax and other state revenues. To what extent the State wants to develop a network of toll roads and how much taxpayers will tolerate such a network, both financially and philosophically, is an important consideration.

Chapter 5. Conclusion

Although the Maryland Transportation Authority (MdTA) has administered a public-private partnership (P3) transportation program for nearly a decade, the program must be reevaluated in response to new conditions that are changing the scope of P3s. Some of the issues that need to be revaluated include:

- **What Is the Role of the Legislature?:** Currently there exists little legislative oversight over P3 agreements. To what extent the legislature wants to or should have oversight over such arrangements is an important consideration. In addition, when the legislature should assert oversight, either at the beginning of the request for proposal process or once an agreement has been reached, should also be addressed. There are a number of important statewide policy considerations the legislature should consider regarding P3 agreements such as environmental impacts, the impact on unions, and non-compete clauses for other State roads. An important financial consideration as well is to what extent the legislature has control over the use of funds resulting from a concession agreement.

- **Impact on the Taxpayer:** P3 agreements typically involve toll roads. To what extent tax payers will accept paying a toll to traverse a road given other financial obligations is a concern. In addition, toll rate increases and the frequency of such increases is an issue that should be considered. Finally, P3 agreements, and by proxy toll roads, represent a shift to a user fee system for transportation finance that is different than the current financial model.

- **Operational Considerations:** There are a number of operational considerations that need to be considered regarding P3 agreements. Most of these issues can be addressed in the contract itself; however, the legislature may want to provide some input. Issues that need to be considered include who is responsible for the operation and maintenance of the facility, how to resolve disputes or to modify the contract based upon unforeseen developments, how to address a firm's bankruptcy, and any law enforcement responsibilities.

Given the policy implications surrounding P3 agreements, the Department of Legislative Services recommends that either legislation be introduced or that a task force be created to address the following issues:

- **the role of the legislature in reviewing proposed P3 projects and any associated financing plans;**

- **the use of funds received from a P3 agreement and who receives the funds;**

- **what impact a P3 agreement may have on the Transportation Trust Fund, MdTA, and bonding;**

- **the impact of a P3 agreement on taxpayers;**

- **how tolls may be charged or increased;**

- **long-term facility maintenance, taking into consideration State procurement law;**

- **the implications on the State budget of a P3 agreement (including law enforcement, contract oversight, bankruptcy, and other incidental operating obligations);**

- **the future need for contract modifications; and**

- **environmental concerns.**

Appendix 1
Case Study of Pocahontas Parkway

The Pocahontas Parkway (Route 895) is an 8.8-mile tolled highway seven miles south of Richmond, Virginia. The current toll is $2.25 for both electronic tolling and cash receipts.

The project was initially a design build project that connects Chippenham Parkway at I-95 in Chesterfield County with Interstate 295 south of the Richmond International Airport in Henrico County. The design build partner was a joint venture of Fluor Enterprise and Morrison Knudsen (now Washington Group) with oversight from the Virginia Department of Transportation (VDOT). Construction began in the fall of 1998, and the parkway was opened to traffic in stages beginning in May 2002. VDOT was responsible for operations and maintenance.

The project was authorized using the Virginia Public-Private Partnership Act of 1995. It originally cost $381 million, using $354 million in 63-20 corporation tax exempt toll revenue bonds, $9 million in federal funds for design costs, and $18 million in State Infrastructure Bank loans. In addition, VDOT assumed subordinate loans to provide operations and maintenance.

A 63-20 corporation is a non-profit organization organized by a state or local government that may issue tax-exempt revenue bonds. In this case, the corporation was the Pocahontas Parkway Association (PPA), established for the sole purpose of funding the project. A State Infrastructure Bank is a revolving fund mechanism for financing highway and transit projects through loans and credit enhancement, originally capitalized with federal dollars.

Although traffic has been growing on the parkway, traffic volumes on the Pocahontas Parkway have historically been 50 percent below projections. Unable to generate enough revenue, the PPA was forced to draw down reserves and eventually seek to divest itself of its financial responsibility for the road. Transurban, a private Australian toll road operator with subsidiaries in the United States, executed an Asset Purchase Agreement with the PPA and entered into the Amended and Restated Comprehensive Agreement with VDOT on June 29, 2006. Under the terms of those agreements, Transurban has acquired the sole rights to enhance, manage, operate, maintain and collect tolls on the parkway for a period of 99 years. Transurban has also repaid all of PPA's underlying debt.

The lease amount was for $611 million, which went to repay the debt ($487 million), make operational enhancements, and establish a reserve and contingent funding ($92 million). A consortium of three banks provided $420 million in long term senior loans, and Transurban provided $191 million in equity ($136 million at the close, and $55 million over the next six years). The split between the total debt and equity provided was 70/30. In addition, the lease required Transurban to construct an additional 1.58-mile extension to Richmond Airport, if it could obtain a Transportation Infrastructure and Finance and Innovation Act loan. If it could not, VDOT would build the road.

There is a fixed rate of toll increase until 2016. After that, tolls can be adjusted by whichever is greatest: (1) a rate of 2.8 percent annually; (2) the Consumer Price Index; or (3) the annual change in real gross domestic product.

Instead of an upfront concession fee to the State of Virginia, Transurban and Virginia entered into a profit sharing agreement after the net internal rate of return on capital and debt exceeds 6.5 percent, or 14.5 percent of a nominal rate of return on equity (adjusted for inflation and other factors). After that point, Virginia will receive 40.0 percent of the revenues. This amount would increase to 80.0 percent if the net internal rate of return exceeds 8.0 percent. Transurban estimates a 12.6 percent internal rate of return on its equity. Transurban has also projected a growth in traffic on the parkway to nearly 35,000 vehicles per day in 2012 due to nearby construction and population growth.

Transurban views this project as a way to gain experience in Virginia, as it is seeking to enter into agreements to build and operate the Capital Beltway High Occupancy Toll (HOT) lanes and HOT lanes on I-95 and I-395.

Appendix 2
Case Study of the Indiana Toll Road

The Indiana Toll Road is a 157-mile road constructed in the 1950s that runs from the Chicago area to the Ohio state border. Its current toll is $4.65 to travel the entire road. Currently, a coin system is used on the western half of the road, while a ticket system is used on the eastern half. In 2006, the Indiana Financing Authority leased the Indiana Toll Road to ITR Concession Company, a joint venture between Cintra Concessiones de Infraestructuras de Transporte, S.A. of Spain and Macquarie Infrastructure Group of Australia.

The lease term is 75 years. ITR Concession Company will be responsible for both operating and maintaining the toll road. The Indiana Financing Authority, which worked to secure the lease for approximately one year before it was signed, will maintain oversight of the road and will be responsible for enforcing the lease.

Indiana received a lump sum payment of $3.8 billion for the concession agreement. The majority of the payment has been designated for transportation funding for new and existing roads and bridges in the state. Approximately $200.0 million will be used to retire the existing toll road bonds, and $200.0 million to $250.0 million will be used to subsidize passenger vehicle toll road rates, which will help shift any increase in tolls to commercial traffic.

ITR Concession Company is required to put in place an electronic tolling system that covers the entire road in the first two years, and to expand one stretch of the road to three lanes. ITR Concession Company has stated that it will make approximately $4.4 billion in capital improvements over the life of the lease. In addition, the concession agreement spells out the rate of toll increases and limits the rate of return that the partnership can earn on the toll road. Further, if the contractor fails to meet its obligations, Indiana has the option to resume operations.

At the time of the lease, Indiana's legislature had not passed legislation authorizing the Indiana Department of Transportation or the Indiana Financing Authority to enter into a public-private partnership (P3). It passed House Bill 1008 in the 2006 session in order to specifically authorize the lease of the Indiana Toll Road.

Opponents argued that ITR Concession Company would likely increase tolls on the road beyond what the state would, and that maintenance would suffer. The Governor of Indiana had already proposed raising tolls as an alternative to a P3. If the state raised tolls, opponents argued that the state could generate more revenue from operating the road than it would from the lease agreement. There was also a legal challenge arguing that the lease was unconstitutional. Proponents of the legislation argued that leasing the road would enable Indiana to fund transportation projects that it might not have been able to complete otherwise, or which would

have been delayed due to a lack of funding. In addition, after the lease was signed, proponents pointed out that the lump sum payment will generate interest even while being spent down, benefiting the state.

Appendix 3
Case Study of Ontario Highway 407

Ontario Highway 407 has been involved in two public-private partnerships (P3s).

P3 # 1: Design Build

Although construction began on Highway 407 in the mid-1980s, the road was nowhere near complete when it was re-conceived as a design, build, operate maintain P3 in the early 1990s. The Ontario Ministry of Transportation (MTO) established a government chartered corporation, the Ontario Transportation Construction Corporation (OTCC), to handle governmental responsibilities for the road and solicited bids from a private consortium to finish construction and operate the road. In order to pay for the cost of the road, OTCC anticipated tolls being collected for 30 years.

A consortium named CHIC, consisting primarily of local firms, was selected to design, build and operate 69 kilometers of the road; however, instead of using private financing, the Ontario government decided to finance the road itself, issuing approximately $1.4 billion Canadian dollars (CAD) in short- and long-term debt, to be repaid from future toll revenues. The government assessed the value of the road as completed in 1997 at $1.5 billion CAD.

The financing and construction of the road was a departure from typical Ontario road financing where roads are financed from MTO's annual operating budget. Issuing debt allowed Highway 407 to be constructed by 1997, rather than 2020 as otherwise projected. In addition, privatizing the project using a design-build mechanism enabled its construction at a lower cost than had been anticipated if MTO's traditional road construction mechanisms were used.

However, there has been some speculation that the reduction in price was due to changes in design practice and could have been achieved by MTO. For instance, some costs savings were achieved by:

- strictly adhering to MTO safety and engineering standards (MTO had been exceeding those standards on individual projects for several years, which increases costs);
- delaying the construction of several interchanges until traffic volumes increased; and
- shortening the length of merging lanes. When Ontario used the imperial measurement system (inches and miles), merging lanes had been a minimum of 500 yards (446 meters). When Ontario switched to the metric system, the design standard was rounded up to 500 meters, a standard which was relaxed to 446 meters for Highway 407.

P3 # 2: Concession Agreement

In 1998, the Ontario government sought bids to pay off the debt associated with Highway 407's construction. Legislation enacted in 1998, Bill 70, allowed the government to lease Highway 407 to 407 International, a consortium consisting of Cintra Concesiones de Infrastructuras de Transporte S.A., a Spanish company, and SNC-Lavalin, a Quebec-based engineering firm.

The term of the lease was 99 years (nonbinding bids had also been solicited for 55 and 199 years) and 407 International paid $3.1 billion CAD in 1999 for the project. In addition, 407 International was required to construct 39 km of additional toll sections. 407 International constructed those segments from 1999 to 2001 for $507.1 million CAD.

After the $1.5 billion book value of the highway was deducted and used to retire the existing debt, the Ontario budget showed a net profit of $1.6 billion CAD. The funds were included in the general budget to help pay off the existing debt and offset a budget deficit and were not dedicated specifically to transportation purposes.

In 2001, the value of the highway was established at $6.3 billion when SNC Lavelin sold their share to Grupo Ferrovial, Cintra's parent company. This drastic increase in price over a two-year period (from $3.1 billion CAD to $6.3 billion) caused public controversy over whether the road was under-priced at the time of initial sale.