

US Concessions: What happens when the music stops?

The game of musical chairs is played with a number of persons sitting in chairs and when the music begins the participants rise from their chair and walk or dance around the chairs until the music stops, whereupon everyone scrambles for a seat. The catch is that each time the music starts, one chair is removed. Consequently, one person in the group is left standing without a seat and is removed from the game.

Parallels may exist with some of us in the recent concession activities in the U.S. Long term agreements are being concluded that have experts in the industry and the public at large wondering about the details of these agreements. How can such large sums be offered for existing facilities or the right to develop new facilities, especially when the competing bids have such a large range? Who is likely to left without a chair when the music stops? Once the project has fully matured and all costs and revenues are known, who will be the winners and losers. Recent articles by financial experts have projected that the original equity investment in some US "Brownfield" projects will be returned in just over a decade of operation as original equity is replaced with increasing debt and new equity investors. Does this mean that the original investor is interested in something other than long term returns?

Greenfield projects are also under public pressure. A recent public audit was quite critical of the negotiations process for a major US project. The audit was critical of the lack of public knowledge of the negotiations and the "true cost" of the project in interest cost and equity return. Without adequate protection of the public agenda are US concessions doomed to a short history?

Concession investments tend to be somewhat complex and for most citizens, it is difficult to understand what is lost or gained when political leaders negotiate on a long term basis in pursuit of a large payment or when large Greenfield projects are negotiated behind closed doors. Since these projects have traditionally been in the public domain, it is difficult to understand these new approaches to transportation infrastructure development. Understandably the public may be concerned about being the last person standing when the music stops.

Who are the stakeholders likely to be left out? Will it be the company that paid too much for a property, the investors who put money into the project last or will it be the public paying much higher toll rates? Partial answers to this question are becoming evident.

To understand the public concerns, we must understand the history of transportation in the US. Since 1916 transportation has been funded by the gasoline tax. It paid for the massive "hard road" construction of the 1920s and 30s and the interstate highway system that is still the envy of economically developing countries. That infrastructure now has to be maintained from gas tax funding. In addition, new capacity has to be built to relieve congestion and compete with China, India and the EU.

Gasoline tax as a funding source has however "hit the wall" politically. There is little support for further increases in that source. It is a nonstarter in most if not all political circles and there is a trend toward direct user fees.

Another solution is for government to borrow the money needed. For the last half of the 20th century the U.S. did just that. The Pennsylvania

turnpike showed the way as a precursor to the interstate system and was followed by New Jersey, New York, Florida and other states during the 1950s and 60s. In addition to turnpikes, urban expressways began to appear especially in states where growth occurred mostly in the last half of the twentieth century. The federal government has only recently begun to consider the option of borrowing to build infrastructure. The federal policy has been one of “cash on the barrel head” until recently.

The attraction of private capital as a partial solution to the transportation funding gap is a relatively recent development. From discussion in the 1990s, Public Private Partnerships, PPP have become the solution of choice. New York investment banks traditionally engaged in supporting the sale of tax exempt debt for the toll industry are now engaged in accumulating private equity commitments for infrastructure investment. Most have raised \$3-4 billion in commitments. Considering the rule of thumb that concession investments are structured with 25% equity and 75% debt, considerable U.S. infrastructure funds are available for the US market and this excludes the considerable funds available from Europe and Australia. If \$100 billion in equity commitments have been raised in the US and a similar amount is available outside the US, there is nearly \$1 trillion available for transportation investment in the US.

There is a large funding gap in the US and there appears to be a large source of private capital available to fill the gap, so what is the problem?

The first major concessions in the US have been long term leases of existing toll facilities, Brownfield projects. These long term leases lead to many questions. The term of the lease is well beyond any reasonable planning horizon where some level of predictability exists and there is assurance that the public agenda will be properly managed over the term

of the concession. Lease amounts have been surprisingly high and there has been concern about foreign ownership of public assets and a general loss of public input.

The financial structure may provide some answers to who is left without a chair. First, each project has its own corporate structure. This limits the risk to the concessionaire to the amount of the original investment. Large fees are extracted from the new project corporation up front for constructing the deal and as the project matures, rates are raised, efficiencies are implemented and profits are maximized. Accordingly, the return on investment increases. It is the old story of using other people's money to make money. As original equity funds are reduced, they are replaced by a commensurate amount of debt and second tier equity ownership.

If the rate increases contemplated in the original agreement begin to slow revenue growth and it becomes difficult to support the dividend expectations for equity investors, the music will stop and someone will be without a chair. It will not be the creditors holding the debt but the equity owners.

Since public agencies have been unwilling to increase toll rates over long periods, there is a considerable amount of toll rate elasticity built into Brownfield concession projects. However, as the rates increase and the net revenue begins to level, there will be a gradual realization that the project can not sustain growth indefinitely. Since this will likely not occur until some time after the closing of the lease, the original investors will more than likely have refinanced the debt and resold major portions of the equity interests. The blank space where a chair once set seems to be reserved for those who purchase a share of the equity late in the game and the public

who are strapped with an agreement that has no provision for renegotiations and is priced beyond a reasonable rate.

This is not to say that all concessions or Brownfield leases should be avoided. To the contrary there have some concessions negotiated that seem motivated as much by good public policy as profit motive. The lesson to be learned is that we must learn to balance public policy needs with profit motive and develop projects that leave no one without a chair because the music never stops. The return on investment is competitive with other global investments of the same class and the agenda of the public is maintained as well. These interests are balanced initially and when they become unbalanced with change over time, a renegotiation occurs which establishes the balance once more. What may appear initially as a excellent deal, may be less so over time. Renegotiation provisions and maintaining financial and operations risk with the primary investor should be an inherent consideration.

