For Stressed State and Local Governments, Is Privatization the Answer?

Ohio Governor John Kasich has a toll road to lease. Next door in Pennsylvania, Governor Tom Corbett is offering a deal on selling liquor. And the Port Authority of New York & New Jersey has a bridge if you're buying.

U.S. state budget deficits that may reach $125 billion in this fiscal year are forcing governors to turn to banks and builders including Macquarie Capital (USA) Inc. and Bouygues SA to help lease or sell assets ranging from turnpikes and lotteries to liquor stores while seeking investors in bridges, roads, and other public facilities.

While governments have been selling and leasing assets to investors for more than two decades, they have not always proved to be economic or political successes. Chicago Mayor Richard Daley received $1.15 billion from leasing parking operations to a Morgan Stanley-led partnership in 2008 and reaped criticism for malfunctioning meters and rising rates. Virginia and North Carolina turned back plans to sell off state liquor distribution. In California, Democratic California Governor Jerry Brown canceled what he called a "short-sighted proposal" from former Republican Governor Arnold Schwarzenegger to sell and lease back 11 state properties to raise $2.3 billion. Brown estimated that the annual payments of $56 million would cost $6 billion dollars more over 35 years than retaining ownership.

Corbett, a Republican elected in November, campaigned on a proposal to sell Pennsylvania's 643 state liquor stores to raise an estimated $1 billion to $2 billion. The stores generated $452.6 million in gross revenue from sales in fiscal 2009-10, according to the Pennsylvania Liquor Control Board. It's not just drinking. It's also driving: in Florida, Actividades de Construccion & Servicios SA, Spain's largest builder, leads a private group overseeing a $1.2 billion expansion of Interstate 595 in Broward County north of Miami, and Bouygues, France's second-biggest builder, is handling a $1.1 billion tunnel to Miami's port.

Former Ohio Governor Ted Strickland, a Democrat who lost to Kasich last year, said his administration considered leasing the Ohio Turnpike, handing the lottery to a private operator and selling buildings, then leasing them back. Strickland estimated the deals would not raise enough money or maintain adequate services. Kasich is undeterred. A Republican elected last year, Kasich promised to address an estimated shortfall of $8 billion in Ohio's fiscal 2012-13 budget without raising taxes. As many as five state assets or services might be turned over to private operators, including the Ohio Turnpike, prison operations, the lottery, and the state's liquor distribution as possibilities. Leasing the turnpike, which carried 48.9 million vehicles last year paying $232 million in tolls, might bring $3 billion, $600 million of which would retire bonds, Kasich claimed. The sale of the liquor-distribution system could net $1 billion to $1.5 billion.

Governor Kasich said he is convinced that leasing the Ohio Turnpike is "a winner," even as current and former governors in neighboring states say they doubt he would get as much as they did for their toll roads. Indiana Governor Mitch Daniels said it is "unreasonable" for Ohio to expect the $3.8 billion investors paid for his toll road in 2006. The $12.8 billion bid for Pennsylvania's turnpike in 2008, which was rejected by lawmakers, likely would be less today, former Governor Ed Rendell said. Kasich said it is wrong to compare past deals with what Ohio may get because they were done before the 2008

financial collapse weakened the market for private leases of state assets. Ohio, which is hiring advisers to explore a lease, can still tap the 241-mile toll road's underutilized value to pay for infrastructure projects it otherwise could not afford, and will walk away from a deal if the price is too low, he said.

The recent lease of two Puerto Rico toll roads covering 56 miles shows there is still private-sector interest. Puerto Rico announced June 20 it will receive $1.08 billion up front plus $356 million in improvements during a 40-year lease from Goldman Sachs Infrastructure Partners II and Abertis Infraestructuras SA, Spain's biggest toll-road operator. The Ohio Turnpike should get as much or more interest because other things equal, that would be a much more attractive asset to acquire than a road on an island. Still, it is unlikely Ohio would get offers comparable with what was received by Indiana, Pennsylvania, and Chicago's $1.8 billion lease of its Skyway in 2005 because they were highly leveraged deals with an expectation of economic growth that did not materialize. Ohio expects a lease term of about 40 years, compared with Indiana's 75-year deal and Chicago's 99-year agreement. It also would retain a percentage of the toll revenue over time, even if that reduces the upfront payment. Any lease contract also would restrict future fare increases and set requirements for road maintenance.

Last year, 21 states and the District of Columbia considered 52 legislative measures regarding public-private partnerships, and 11 in seven states were approved, according to the National Conference of State Legislatures. In 2009, 33 such bills were introduced in 18 states, the organization said.

Capital for partnerships is reported to outstrip available deals. New York's Port Authority received eight proposals for a venture in which an investor would provide an estimated $1.6 billion to reconstruct the Goethals Bridge, an 81-year-old span between Staten Island and Elizabeth (NJ). The investor would be repaid in installments. The Authority plans to award the contract during the first quarter of 2012. Just last week, the Authority approved a scaled-back toll increase offered by Governors Andrew Cuomo and Chris Christie that will raise bridge and tunnel fares by $4.50 over five years. The Authority board, whose members are appointed by the two governors, voted for the plan that includes a $1.50 toll increase effective next month for cars using E-ZPass during rush hour (for the George Washington Bridge, the Holland and Lincoln Tunnels, and the Goethals, Outerbridge, and Bayonne Bridges on State Island). The original proposal, which called for a $6 increase over four years, to $14 from $8, was revised after the governors deemed it "unacceptable."

Not all the privatization deals are a sure political sale. Most city workers, consumer advocates, and regulators do not like to see investors profit at public expense. Voters in Trenton (NJ), so poor it laid off more than 100 police last month, voted against a Water Department sale. In 2008, former New Jersey Governor Jon Corzine, a Democrat, proposed forming a nonprofit corporation to borrow $38 billion against toll revenue from the New Jersey Turnpike and Garden State Parkway to pay for road and bridge projects. Corzine abandoned the idea in the face of public opposition. This year, Governor Chris Christie, a first-term Republican, tried again to enlist businesses to help run the roads. His administration began soliciting bids in January to replace unionized toll collectors on the New Jersey Turnpike and Garden State Parkway to save as much as $43 million a year. Christie ran into opposition from Democrats in the Legislature and the newly formed New Jersey Coalition on Privatization, a group of labor, environmental, and community organizations. Jim Walsh, spokesman for the coalition, said his group wants to ensure the sale of public assets do not leave consumers paying more. Walsh's group is also looking to ensure such transactions do not weaken environmental safeguards, increase corruption, or use workers who earn less than those employed by governments. The Turnpike Authority board recently decided not to privatize toll collections, but only after turnpike and parkway toll collectors agreed to have their salaries -- which average $65,000 a year -- slashed as much as $20,000 over the next year.

The City of Philadelphia (PA), with more retired ex-employees than active workers, is struggling to fund their future pensions. The need to ease a multibillion-dollar budget shortfall threatens higher taxes, and leaves less for today's City needs. So Mayor Michael Nutter and two would-be mayors, Councilman Bill Green and Sam Katz, the state oversight board chairman, have revived suggestions that Philadelphia try a garage sale -- of assets the City has accumulated.

What does the City have to sell?

Philadelphia International Airport - Three years ago Citigroup Inc. and its clients offered $2.5 billion for Chicago's Midway Airport, half the size of Philadelphia's. But that plan stalled, and the Federal Aviation Administration is not making other deals easy.

Philadelphia Gas Works - PGW was run by UGI Corp. until the 1970s, when Mayor Frank Rizzo took it over, hired several former police officers, and stopped collecting bills. Debt zoomed to more than $1 billion. Under Mayor John Street and Nutter, PGW boosted collections to more than 98 percent; debt is down. What is a gas works worth? UGI paid $580 million for utilities serving 150,000 customers in Scranton-Wilkes-Barre five years ago, and $268 million for systems with 75,000 customers in 2008. The Philadelphia system has 500,000 customers.

Philadelphia Water Department - Private water operator Aqua America Inc., of Bryn Mawr (PA), recently agreed to pay $120 million for systems serving 51,000 Ohio customers. Philadelphia's system is 10 times that size. Plants and pipes are worth $1.8 billion, but the system's debt is almost as much.

Other assets the City owns include the Philadelphia Parking Authority which rolls in the cash, but it is state (and Republican) controlled, so Harrisburg has to approve a deal. The City's ports and the City's stadiums are weighed down by debt.

MTAM believes that municipal bond investors should remain highly skeptical of any supposed credit improvement from privatization proceeds. The situations where privatization dramatically improves the credit story are few and far between. But promises to sell assets can be a useful political bargaining-chip to secure or supplement other benefits such as the continued fiscal support of the official sector, such as support from the Commonwealth of Pennsylvania in the case of Harrisburg. Privatization appears to make sense in Harrisburg because the City is plagued by an out-sized debt burden that is too large to grow out of. The City and its authorities (water & sewer, parking, incinerator) have $594 million of total indebtedness, which is 30% of the area's GDP (excluding another $300 million of unfunded OPEBs and pensions). If they raise $260 million by privatizing their parking garage and incinerator, City authorities could collectively reduce their annual debt service from 41.5% of the three authorities' $125 million collective annual budget to only 23.5% of the budget.

The Commonwealth of Pennsylvania is concerned that a Harrisburg default or bankruptcy might unleash contagious ripples across Pennsylvania municipalities. That is why then Governor Rendell announced $4.4 million of liquidity support for the City last September when the Mayor was talking about defaulting on the City's general obligation debt. The official sector loans were extended to a borrower whose solvency was in question, so the Governor was presumably worried about the *liquidity* support eventually becoming *solvency* support. As such, the loans were shorter-term than the City's market debt and the Governor strongly advocated for privatization as a longer-term solution.

But while privatization might be the least bad option for Harrisburg, it is not a sustainable solution for states suffering from structural budget deficits. There is nothing magical about revenues found from privatization proceeds. If a private operator raises highway tolls or parking fees, how different is that than the state simply raising taxes? One difference is that privatization proceeds are often front-

loaded by selling to a private bidder the license to operate the concession. This is just a back-door way of bringing forward future revenues.

There are certain assets and market environments where privatizations can raise substantial proceeds, including $1.8 billion for the Chicago Skyway in 2005 and $3.8 billion for the Indiana Toll Road in 2006. This can be positive for the seller's credit if the proceeds are used to pay down debt and invest in infrastructure, as was the case with these two deals. But these two privatizations of well-established toll roads should also be distinguished from start-up toll road projects which are sometimes accompanied by high leverage, financial engineering, and steep and escalating tolls. These were contributing factors to the distressed outcomes for such roads as Connector 2000, Dulles Greenway, and the Garcon Point Bridge in Florida.

Privatizations can be useful in certain situations, but MTAM believes that investors should be particularly wary today when cities' and states' troubles are driven by both structural and cyclical budgetary shortfalls, rather than one-time problems looking for one-time solutions. Privatizations should not be a band-aid for structural budget shortfalls. Privatizations are not a cure-all since they do not typically create new economic value. Allowing a private operator to raise tolls or parking fees is politically difficult. However, at times, public-private partnerships can better align incentives. Private companies are sometimes better at paying, hiring, and firing employees in a way that is consistent with taxpayer interests. They also adopt technology and change inefficient rules more quickly. But it is still only a short-term solution. As a conservative municipal bond investor, MTAM would prefer to see longer-term solutions to today's problems.