

Special Report

**U.S. Toll Road Privatizations:
Seeking The Right Balance**

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■ Summary

Since the development of the interstate system in the 1950s, the U.S. highway system has been improved and expanded primarily through gas tax-funded sources. User-fee sources have played a more marginal role. The significant growth in vehicle miles traveled on the interstate highway system over the last two decades has accelerated the expenditure demands on gas taxes. Combined with the increasing fuel economy of vehicles and subinflationary hikes in gas tax rates, this has progressively resulted in decreases in available resources to maintain and improve highway infrastructure. Although some states and local governments have identified additional tax funded sources (through general obligation bond issuances and approved sales and dedicated taxes) to help meet their needs, the increased congestion on many major intercity corridors and large metropolitan population centers confronts policymakers with tough choices in the future given the continued resistance to tax hikes. This has precipitated the search for alternative methods of funding highway improvements that do not involve tax revenue, particularly tolls. Viable alternatives include user-paid tolls and government-paid shadow toll and availability payment schemes. The growing development of toll roads by private companies across the globe and the potential for privatizations to not only reduce public sector investment, but also generate financial resources for state and local governments make these options attractive in the U.S.

There is a considerable history of private ownership of transportation in the U.S. Toll roads and bridges, urban transit and passenger rail systems, and ferry services were largely owned and operated by private firms for many years in the 18th, 19th, and 20th centuries. As states and the federal government increased their direct investment in road construction to improve access to parts of the country and facilitate economic development, private investment declined and the existing facilities were taken over by the government. The increased use of the automobile and public rate regulation adversely affected passenger transportation systems, ultimately resulting in transit, rail, and ferry systems falling into public hands.

The well-publicized sales of long-term leases for the Chicago Skyway and, most recently, the proposed Indiana Toll Road transaction have again drawn attention to these types of transactions. While recently they have been more prevalent outside the U.S., they will undoubtedly be increasingly considered in this country. The importance of the assets, particularly transportation assets, that are being effectively sold by governmental entities and the financial scale of these and potentially other such transactions could have long-term credit implications for both the debt of the government entity and that of the concession. Importantly, the impact may not be felt or fully known for years to come. As such, there are major questions and issues that Fitch believes both governmental and private sector entities need to consider as they enter into these transactions.

Toll roads are good candidates for privatization. While their past revenue-generating record is somewhat checkered, toll road financings with sound long-term economic fundamentals have proven that they can ultimately perform successfully. Given the subsidies a number of toll road systems provide to new segments, such as those that serve the rapidly growing cities of Orlando, Dallas, and Houston, and the subsidies provided for nonsystem needs, such as transit in New York and municipal budgets in portions of Texas, mature toll road assets have demonstrated that they are able to generate even greater value than required to support their own needs. The desire by governments to extract that value is in part driving the current privatization trend.

Governmental entities and users can benefit from privatizations. A private operator's willingness to take advantage of rate-setting authority goes hand in hand with public sector requirements of maintaining high standards of customer service, operations, and facility maintenance; these are sometimes standards that the public sector may be unable to maintain under its own stewardship. In return for the tolls users pay, the expectation is that the private operator will provide a well-maintained, safe, and reliable roadway, user-friendly traveler service facilities, and timely emergency roadside assistance. Of note, privatization strategies that consider the viewpoint of the user and incorporate corridorwide and regional solutions will tend to maximize benefits to government through more optimal public investment. To the extent that solutions are confined to specific jurisdictions, the overall benefit to users will likely be limited.

Privatization historically has been used to accelerate the delivery and improve the efficiency and quality of public services; it has often been a response to specific performance problems or the legal or practical inability of governments to financially support new investment. Governments worldwide have done so through service contracts, operations and maintenance (O&M) contracts, and a combination of finance, building, and O&M contracts. The private sector has proven that in certain circumstances and with the right incentives, it can provide added value to users at a reasonable cost while generating an acceptable profit margin. The key to achieving such a balance has been the development of tailored agreements that seek to appropriately share risks and reward and take a long-term, balanced view of benefit for both the public and the private sectors. Privatizations in a number of countries outside the U.S. tend not to be very long term or require large up-front payments nor have very aggressive toll rate regimes. Certain European countries have transferred operational

control of their toll road assets through the sale of equity stakes to private investors in their formerly state-owned corporations. However, concession tenors generally are not very long term, and toll rates are linked to inflation.

Privatization is not a panacea given the numerous economic, financial, legal, and public policy issues at hand, but it can generate benefits if the right balance is struck. Given the potential ramifications for credit quality, some of the key issues associated with privatization that Fitch believes need to be considered in the decision-making process include: the nature of the project (greenfield versus brownfield); the primary basis for the decision (transportation solutions versus budgetary relief); the nature of the approved toll rate regime; the approach to garnering best value given the lack of adequate experience with comparable asset valuation over very long periods; the impact of the transaction on local needs; the flexibility that is retained within long-term arrangements to meet unknown future needs; the fact that governmental liability may not be completely transferable; and the approach taken to temper the perception of double-taxation. The considerations in each particular instance will likely be complex and the choices may not have clear credit implications. Fitch will assess each transaction on a case-by-case basis and incorporate its assessment of risk into its ratings.

Fitch notes that the extent of government services that may benefit from privatization goes well beyond toll roads. A natural evolution of this concept to government-managed services that require large public subsidies, such as transit, can reasonably be seen as an area of potential in the future. While the efficiencies the private sector can offer may result in sizable savings, these deals also tend to be more difficult to structure and manage. To the extent a workable risk-reward relationship is established, the benefits could be meaningful.

■ Privatizations — Credit Angle

The rationale for and method of implementation of any privatization effort is important as it can have a direct bearing on the credit quality of governmental and private entities. Nevertheless, privatizations that strike the right risk-reward balance should result in the generation of long-term value to governmental entities through accelerated project delivery and/or more efficient service delivery and equity investors through predictable and stable rates of return. However, the balance may change over time. For example, while still government-owned, the quasi-

Chicago Skyway Privatization

In 2005, the City of Chicago entered into a 99-year lease arrangement with a Spanish-Australian joint-venture between Cintra Concesiones de Infraestructuras de Transporte, S.A. and Macquarie Investment Holdings in return for a \$1.8 billion up-front payment. The large payment was obtained because of the length of the arrangement and the aggressive toll rate structure, which permits the joint venture to set rates at any level within a predetermined schedule between 2005 and 2017 and then at the greater of 2% per year, inflation, or nominal gross domestic product (GDP) per capita. Through 2017, the arrangement permits a 7.9% average annual increase in the toll rate cap, which Fitch believes will likely be implemented. Beyond 2017, assuming growing regional congestion, it is Fitch's opinion that toll rates could increase at rates at or close to the prescribed limits; based on historical data, these could average between 4.3% (1980–2000) and 7.4% (1940–2000). Fitch has identified the strengths and risks associated with this transaction, as listed below.

Strengths

- Eliminated a noncore city function.
- Improved operations, maintenance, and reinvestment.
- Strong concession agreement that identifies concessionaire's performance obligations and lender rights.
- Distances city from toll increases.
- Predictable toll hikes for foreseeable future.
- Lack of a noncompete clause.
- Large payment stabilizes city's near-term fiscal position.
- Prepayment of city debt provides some longer term benefit.

Risks

- Long-term arrangement limits future flexibility for changes in public needs.
- Not a corridor solution.
- Aggressive toll rate regime could result in high toll rates and diversions to congested state-run network.
- Choice of up-front payment may prove inadvisable, as the facility may be considered more valuable over time.
- Greater equity returns than expected may raise public concerns.
- Political risk may be manifested, forcing the city to act to solve the problem.
- Early termination could be forced in the long term and prove expensive, leaving the city with difficult choices.
- Reserves not locked up forever and may not be adequate or available if needed in a termination.

privatization of the U.S. Postal Service (USPS), which began with the Postal Reorganization Act of 1970 that converted it from a troubled tax-supported agency to a semi-independent federal agency that was mandated to be revenue-neutral, can be considered a success. Although USPS still has its issues and has been criticized as a monopoly, it has since increased productivity and improved service quality, generating net surpluses used to reinvest in itself. However, times are changing and the long-term implications for the USPS are unclear. Though it has a monopoly on regular mail service, it has had to adjust to the decline in first class mail with the onset and rapid expansion of email communication. It also operates in a competitive environment with FedEx and UPS in the express mail and parcel service area. As a result, despite its success to date, it faces future challenges.

The example of the USPS illustrates the long-term issues related to a relatively successful endeavor to increase efficiency. Similar issues can reasonably be expected with most such initiatives, including well-planned efforts to privatize portions of the highway network. As a result, a decision made by government to solve today's challenges, particularly budgetary or other short-term issues, through privatization efforts may prove more costly or problematic than anticipated. To the extent it does, sudden changes to public policy may be required in response to current events or public pressure. Should such arrangements need modification or termination, some accommodation between the parties must be reached. While this can be achieved, it will take time, possibly include litigation, and likely involve some form of taxpayer and/or equity investor impact through tax or cost increases and dilution of asset value. Consequently, bond investors in concession and

Indiana Toll Road Privatization

Earlier this year, the State of Indiana put its 157-mile toll road out for bid for privatization for a 75-year period. The winning bidder is the same consortium that won the Chicago Skyway privatization, the Spanish-Australian joint-venture between Cintra Concesiones de Infraestructuras de Transporte, S.A. and Macquarie Investment Holdings. Their bid was a \$3.9 billion up-front payment. The strength of the toll road as an important corridor between the East Coast and Midwest, combined with the length of the arrangement and the aggressive toll rate structure, represented key factors in the size of the bid. The toll rate structure is similar to the Chicago Skyway arrangement, except that the predetermined schedule of increases is for a shorter period, until 2010. The transaction has been approved by the state legislature and is pending final execution. Fitch has identified the strengths and risks associated with this transaction, as listed below.

Strengths

- Strong concession agreement that identifies concessionaire’s performance obligations and lender rights.
- Distances state from toll increases.
- Large payment provides state with adequate resources for near-term needs.
- Use of proceeds for related transportation purposes, including construction of new roads and bridges.
- Requirement for concessionaire to improve and expand toll road in the near term.
- Requirement for future toll road expansions at concessionaire’s cost to meet minimum levels of service.

Risks

- Long-term arrangement limits future flexibility for changes in public needs.
- Limited noncompete clause could prove problematic in the future and require economic compensation.
- Aggressive toll rate regime could result in high toll rates and diversions to congested state-run network.
- Impact from diversions could extend into neighboring states.
- No solution identified to avoid repeat transportation funding gap once proceeds are spent.
- Choice of up-front payment may prove inadvisable as facility may be seen to be more valuable over time.
- Greater equity returns than expected may raise public concerns.
- Political risk may be manifested, forcing the state to act to solve the problem.
- Early termination could be forced in the long term and prove expensive, leaving the state with difficult choices.
- Large share of proceeds will be spent in the near term and will not be available if needed in a termination.

municipal debt need to be cognizant of these hidden risks that, in time, could erode credit quality. Therefore, governmental and private entities must carefully implement major initiatives given the potential for material credit impact over the long term.

From the standpoint of government (tax-supported) credits, Fitch will positively view concessions that maintain the government’s flexibility to meet the transportation and public policy needs of future generations and adequately retain the public sector’s long-term value in toll road assets. Consequently, very long-term deals, aggressive tolling regimes, and large up-front payments that could prove restrictive or inadvisable in the future will be viewed negatively. However, arrangements that generate large up-front payments could be viewed more positively by Fitch if proceeds are invested in comparable long-term assets that provide lasting economic benefits. Fitch will negatively view the use of proceeds for short-term

operating needs of governments. Strategies meant to mitigate this risk will be considered more positively, such as the establishment of long-term trust funds that largely coexist along with obligations under a concession arrangement.

In evaluating the debt of a concessionaire, Fitch will positively view: the long-term track record of the concessionaire in successfully managing toll road projects; the appropriate balance of financial flexibility to the amount of leverage; the lack of ambiguity in performance requirements under the concession (O&M and mandatory capital improvement); complete independence in implementing the prescribed tolling regime; presence of historical and projected equity distribution tests; adequacy of remedies to events of default; and the ability to receive adequate value to repay debt if the agreement were terminated by the government for convenience. Aggressive traffic and revenue growth assumptions, high amounts of leverage, inadequate equity, potential for

Most Recent Ratings for Previously Defaulted Toll Facilities

Toll Facility	Bond Type/(Rating)	Period of Default
Chesapeake Bay Bridge and Tunnel District	Senior/junior lien revenue bonds (rated 'A' and 'BBB', respectively)	1970–1985
Chicago Skyway Toll Bridge System	City of Chicago toll revenue bonds (rated 'A-')*	1959–1976
Dulles Greenway	Toll Road Investor Partnership II revenue bonds (rated 'BBB')	1996–1999
Houston Ship Channel Bridge (part of the Harris County Toll Road Authority system)	Revenue bonds (rated 'A+')	N.A.**
West Virginia Turnpike	Revenues bonds (not rated by Fitch)	1958–1979

*Prior to privatization. **N.A. – Not applicable; bonds were in technical default. Payments were made from reserve funds and new bond proceeds.

change of control over time, and the manifestation of political risk will be viewed negatively. Fitch anticipates issuing more detailed credit rating criteria for the evaluation of concession debt later this year.

■ **Toll Roads: Good Candidates for Privatization**

Over the mid to latter part of the 20th century, many of the major components of today’s highway systems were developed and constructed. Initial segments of the Pennsylvania, Oklahoma, and West Virginia turnpikes, which are now parts of major systems, began with much weaker economic and financial profiles than they have today. The inability to accurately forecast traffic and revenue, the current issue with start-up projects, was a factor even then, as some of those projects faced lower than expected traffic and revenue levels. A few of the projects built during that era, such as the Chicago Skyway and the West Virginia Turnpike, were unable to fully support debt service and entered default. Importantly, they were all able to increase revenues over time and repay principal, current interest, and accrued interest.

Several common threads existed with these bond defaults. There was a heavy dependence on economic development to generate traffic. Political risk was manifested in a number of cases, as commitments or expectations from governments to add important connections to the highway network were delayed or improvements to competing routes were accelerated, undermining the economics of the new road. While the construction of these projects provided better access and increased the value of surrounding land, the pace of development, which is dependent on both microeconomic and macroeconomic factors, determined their ability to strengthen financial performance. In almost every case, the projects were subjected to long periods of subpar performance. However, they all demonstrated strong ultimate recovery potential after a couple of decades, and investors were eventually repaid interest (including accrued interest) and principal. Of note, initial investors lost considerable value through

nonpayment of timely interest and principal, reduced valuations on the bonds, and lack of liquidity in the secondary market, while subsequent investors in the distressed bonds saw gains.

In spite of their troubled credit history, these toll facilities have demonstrated a strong ability to move up the credit scale and, in many cases, have achieved high investment-grade ratings. Today’s ratings largely reflect their stable and growing base of traffic, congestion on competing routes, latent economic rate-making flexibility, and strong projected financial profiles. As a result, these assets have proven their economic and financial ability to support long-term privatization arrangements that include life cycle asset replacement and expansion.

■ **Potential Benefits From Privatization**

The private sector has played a useful role in the development of U.S. highways, primarily through the provision of engineering planning, design and construction services for state departments of transportation (DOT), and toll road agencies. Some DOTs and toll road agencies have extended the role of the private sector to include comprehensive operations, regular maintenance, and long-term capital maintenance services. The benefits from privatizations of all aspects of a toll road, including financing, may potentially be greater as they can help governments achieve budgetary efficiencies, which is a positive factor for the credit quality of governmental entities. In certain situations, the ability of the private sector to effectively mitigate project risks, like completion, traffic forecasting, debt management, operations, and capital reinvestment, also has positive credit implications for the stability of toll road ratings; this is particularly true for start-ups, which have had a rather poor credit history in the U.S. Since the public sector owns these assets, some of the savings in financing costs should accrue back to the related governments.

Specific Expected Benefits from Privatization

Cost-Effective and Timely Project Delivery: Studies, such as one performed by the Florida DOT, indicate that nontraditional contracting methods with appropriate incentives for on-time and on-budget completion tend to deliver projects closer to budget on both a time and cost basis than traditional low-bid contracts. Projects in other states, such as northern Virginia's Route 28 project and segments of Colorado's E-470 toll road, garnered meaningful savings from the use of design-build techniques. Variations of innovative contracting practices, like design-build, are used more widely by private sector companies than state DOTs and often facilitate more timely and cost-effective project completion; this is particularly true in the current high construction cost inflation environment. The benefits are particularly meaningful to the credit quality of stand-alone projects.

Efficient Operations, Maintenance, and Life Cycle Asset Management:

The private sector is not often constrained by restrictions such as statutory bidding requirements, administrative processes, and labor contracts with union pay scales and restrictive work rules. It consequently may be able to react more quickly to changing conditions and proactively manage O&M costs. New Mexico's Corridor 44, which serves trade and tourist activity in the northwestern part of the state, is projected to avoid almost \$90 million in maintenance costs due to a 20-year warranty built into the construction contract with the private party. It also eliminates the issue of deferred maintenance for a period. While public toll roads tend to be better maintained than the free network, they are also affected by external pressures that may limit the ability to reinvest when needed. Though O&M efficiencies can generate some savings, the bigger benefit from the private sector may very well come from timely reinvestment in the facility that lowers overall life cycle costs. By establishing appropriate incentives in agreements, the private sector can be induced to ensure that the facility remains in good shape through the life of the arrangement. A better maintained facility is a positive for credit quality.

Lower Government Investment/Subsidy: By transferring responsibility to the private sector, public sector capital can be more efficiently allocated. There may even be instances where public-private partnerships can be implemented with the goal of public subsidy minimization, similar to the Project Finance Initiative in the U.K. While it has not been without its problems, this is an innovation seen in some mass transit agreements in Europe. O&M agreements are

awarded to qualified bidders that require the lowest government subsidy. Credit quality can be enhanced through lower costs to the taxpayer over time.

Generate Excess Value to Support Other Government Investment:

Toll roads have proven the ability to not only be self-supporting, but also to generate excess value that can be used for other government purposes. While privatizations will result in some of that value resulting in profits, excess value above the levels that might be received under public stewardship can be generated. Deals that do not focus on the up-front benefit retain the ability to maximize public benefit and provide credit stability.

Higher Premium Placed by Equity Investors:

The government should be able to garner a higher price for its assets from equity investors than debt investors. Bondholders require the certainty to be repaid regularly on specific dates, thus constraining the size of the transaction. Equity generally represents patient capital and values the opportunity for upside return, which is reflected in the larger amount in proceeds that the same revenue stream can command. It is also a way for governments to be paid for the tax benefits that only a private entity can capture, such as depreciation. It is important to note that an allowance for depreciation on privatized toll roads is a net negative to public coffers. It could result in statutory federal limitations on such an allowance in time, since the negative impact is greater at the federal level than at the state and local level.

Distance Government from Toll Increases:

While this is a double-edged sword from a credit standpoint, the political risk related to toll rate increases could be minimized by transferring the authority within an overall rate-setting framework to the private sector. The absence of political agendas and the separation from electoral politics should allow for steady, streamlined rate increases over time. Thus, it would be beneficial for toll rates generally to rise in step with inflation to ensure that the real cost of the tolls does not rapidly outpace current costs to users. The toll rate regime would also need to consider the toll road's ability to pay for capital improvements and reasonable equity returns.

More Efficient Transport of People, Goods, and Services:

Congestion on local and long-distance trips is a major issue for state and local governments all over the nation. It increases the cost of commuting and doing business. To the extent that privatizations result in improved corridor management through the

elimination of pinch-points, be it locally or regionally, the benefits should accrue to the government and provide credit stability.

■ **Issues Associated with Privatization**

With many states and local governments now considering privatization and some investigating the potential to enter into long-term leases with a quick turnaround time to solve short-term budgetary problems, the topic raises important credit issues. To the extent that the basis for these decisions comes into question in the future, negative public reaction could severely undermine these deals. Some of the issues that warrant attention when entering into privatizations are outlined below.

Greenfield vs. Brownfield Projects: Privatizations can transfer risks of challenging projects, be they start-up projects or existing problem assets. Start-up toll roads built in the U.S. over the last decade or so have had financial problems. There are obvious governmental benefits from transferring or sharing risks with the private sector. With established and profitable enterprises, there is much less risk to transfer and, consequently, less benefit from private involvement.

Decisions Not Based on Transportation Factors: Two of the major privatization decisions made recently, Chicago Skyway and Indiana Toll Road, were in part driven by operating and capital budgetary factors that have much shorter term benefits. The primary goal of highway infrastructure is to facilitate the movement of people, goods, and services. A shorter term monetary focus, decisions that do not consider the broader interests of improved mobility, and decisions that create or exacerbate structural budget gaps may prove problematic in the future.

Given the potential for larger profits over time, there needs to be clear grounds for granting the private sector the ability to control a major transportation asset. If it is because the money is needed to fund a budget fund gap or deficit, that clearly would have a negative credit impact on the governmental entity. Ultimately, this is a one-time resource and, over the long term, other sources of capital will have to be created to provide sustainable funding. Even if proceeds were to be used to fund reserves, it can be problematic. Having too much money on hand increases the likelihood that it could be used for operations and drawn on during budgetary crises and difficult economic times, leading to structural deficits. Strategies that lock up the reserves in trust arrangements

may help offset this risk. However, large cash balances can prompt taxpayer reaction during periods of rising tax burdens, contributing to the passage of tax limits like Proposition 13 in California during the 1970s. Transferring an asset to raise money for needed capital investment or debt reduction can have longer term economic benefits. However, that must be weighed against the loss of future cash flow and control.

Nature of Approved Toll Rate Regime: The nature of the approved toll rate regime is critical. The profit motive provides an incentive for the private sector to maximize profit, not throughput. High toll rates on major corridors could result in higher than anticipated diversion levels to the publicly supported, toll-free network, which tends to be already congested. The end result may be unanticipated pressure on state and local governments to incur costs to create greater capacity on alternative routes, while excess capacity remains unused on the tolled route. There is even greater concern on major national east-west and north-south corridors if toll rates are allowed to rise to very high levels. High levels of diversions could adversely affect economies, not just in neighboring states, but states all along the corridor. Establishing tolling strategies under an agreed upon regional and/or national framework could help mitigate this risk.

Inadequate Experience with Comparable Asset Valuation: The ability to forecast traffic and revenue levels over the long term remains an inexact science. Local and state governments in the U.S. have little experience with aggressive toll rate regimes. Entering into long-term arrangements without having a good sense of the true value of the arrangement can be problematic. The risk is that these privatizations may prove more valuable than originally anticipated. Fitch believes privatizations that share in the profits as they are earned through appropriate levels of percentage rent or other such arrangements will likely result in better public sector value over time, as the governmental entity and the private sector's interest will be better aligned. Alternatively, shadow toll and availability payment schemes can also facilitate project delivery, appropriately transfer risks, and provide a reasonable rate of return while retaining public sector value.

Solutions Must Be Tailored to Meet Local Needs: In extracting value, each jurisdiction needs to tailor its solutions to the specific needs of the area. State turnpike systems, like Florida, Maryland, and Oklahoma, and urban expressway systems, like Orlando, Houston, and Dallas, have extracted value from older segments of their respective systems to

407 ETR, Toronto, Canada

407 Electronic Toll Road (407 ETR) is a 108-kilometer, east-west, all-electronic toll road north of Toronto that connects Highway 7 on its eastern end to Queen Elizabeth Way in the west. The highway was originally built by the government for about \$1.6 billion, with the first segment opening in 1997. It was acquired by 407 ETR (the concessionaire) under a 99-year concession in 1999 for \$3.1 billion. With growing traffic congestion around Toronto and increasing toll rates on 407 ETR, reaction from the public and elected officials was negative. The Province of Ontario served a notice of default to the concessionaire in 2004, challenging the ability of the concessionaire to raise rates unilaterally. The matter ended up in court, where a decision was issued in favor of the concessionaire. Subsequent appeals also were determined in the concessionaire's favor, and tolls were finally raised in early 2005. Prior to that, in 2003, a class action law suit was filed against the concessionaire related to the late payment fee; it was subsequently settled. Also in 2003, the Province of Ontario's Registrar of Motor Vehicles denied the concessionaire's request to deny vehicle permits (license plates) to individuals who refuse to pay their tolls. The Ontario Court of Appeals recently ended the latest cycle of lawsuits by denying the provincial government's ability to appeal a lower court decision, ordering the resumption of license renewal denial against toll violators.

support new segments as the highway needs of their service areas have grown. In New York City, the Metropolitan Transportation Authority uses surplus revenues generated from the Triborough Bridge and Tunnel Authority to help subsidize the transit system and commuter railroads. Similarly, The Port Authority of New York and New Jersey uses the net revenues generated from its bridges, tunnels, and airports to support its rapid transit system and two bus terminals, among other deficit operations. In Texas, the City of Laredo's and Cameron County's bridge systems across the Rio Grande were originally supported by the municipal entities' general funds but now are self-sufficient and transfer their surpluses back to their respective general funds, which in turn reduces the tax liability of local residents. These are examples of how local jurisdictions have extracted value from their toll road systems. Any privatization effort would need to consider the ability to continue to serve the subsidy needs of the area or find viable, long-term alternatives.

Harris County, TX, which owns the Houston metro-area toll road system, is assessing the merits of privatization. The needs and challenges of a rapidly growing metropolis are hard to predict with certainty. The nature, pace, and direction of development are uncertain over a prolonged period, as are highway needs. Incorporating the need to expand the system will be challenging and possibly affect its valuation. Not incorporating it may increase the value up front but may have higher costs to government in the future.

Retaining Private Sector Interest: The private sector interest in any privatization is driven solely by the ability to make a profit. As a result, there will be considerable incentive to maximize returns and accelerate returns to generate the best value for shareholders. To the extent the profit potential wanes, their interest may also wane.

The private sector ran urban transit and intercity passenger rail in the U.S. since its inception through much of the first half of the 20th century. With the increasing popularity of the automobile, the economics changed, many systems fell into disrepair, and ultimately the companies filed for bankruptcy. The systems were then taken over by governments. Prison privatizations in the 1990s also had their share of problems, as the companies that managed them were unable to operate them profitably, operational problems resulted, and government had to step in again. Toll roads will likely not suffer from the issues faced with prisons, though technological advances could affect their economics in the long run. The larger issue with toll roads may well be the ability for the private sector with very long-term deals to take on high levels of leverage and accelerate profits; this would reduce private sector interest over time while increasing bondholder exposure and ultimately governmental headline risk if the economics change and debt service payment problems ensue. Privatization deals that are structured to preserve private sector interest over the life of the deal will tend to be more successful as well as provide more credit stability to bondholders.

Long-Term Leases Can Limit Flexibility: Today's decisions regarding privatization need to consider maintaining flexibility and control for future generations. The long-term needs of any population are hard to predict. To the extent that the privatization does not prove to be the best option down the road for that purpose, public officials should be able to make changes in public policy without significant cost. Economic development and growth patterns can change. Noncompete clauses, as much as they seem necessary today, could prove unwise. The cases of 407 Electronic Toll Road (407 ETR), a toll road north of Toronto, Canada, and 91 Express Lanes in Southern

91 Express Lanes, Orange County, CA

91 Express Lanes is a 10-mile, east-west, all-electronic toll road in the median of State Route 91 that connects Orange County, CA with Riverside County, CA to the east. The corridor is one of a very limited number of viable highway alternatives between the two counties for many commuters and commercial vehicles. The road opened successfully in late 1995 under a 35-year franchise agreement with the State of California. Rapidly growing congestion levels and inordinately high travel times permitted the raising of toll rates in the highest peak hour of travel from \$2.50 in December 1995 to \$4.75 in August 2003. These increases were essentially required to retain the value of these lanes by permitting free flow conditions. The noncompete clause in the franchise agreement was a severe constraint to the public sector, as it limited the flexibility to improve mobility in the corridor. Increased public and political opposition to the high tolls were followed by multiple legal challenges to the validity of the noncompete clause. The increased cost of legal expenses and individual financial and business considerations of the partners caused the private operator to agree to sell the franchise back to the public sector for \$207.5 million, a price that seems to have been significantly below the true value. Orange County Transportation Authority (OCTA) has been operating the express lanes since it acquired them in 2003. While there were calls for toll reductions, OCTA's board soon recognized the need to maintain free flow conditions, and rates in the highest peak hour have since risen to \$8.50. Importantly, freeway improvements are now ongoing, and surplus revenues from the express lanes are available to partially fund them.

California provide stark examples of the political risk that can emanate from these issues (*for more information, see boxes above and on page 9*).

With up-front payments, upside potential from the unknown true asset value is forfeited. If equity returns are greater than expected, it can increase the political risk from high toll rates and force public officials to terminate the contractual arrangement earlier than anticipated. The government's obligation to compensate the private sector by paying the then-current fair value of the deal could put decisionmakers in a difficult position, particularly if valuations are much higher in the future. Either taxes would have to go up or toll rates will need to remain high to support a termination payment. Long-term leases could have lasting credit implications for governments. Therefore, they need to be entered into with caution given the uncertainty regarding their long-standing impact.

Governmental Liability May Not Be Completely Transferable: While a governmental entity may transfer operational responsibility to the private sector, it may still be subject to lawsuits in the event deteriorating conditions result in property damage, injury, or loss of life. Governments are likely to be enjoined in any legal action along with the operator and other related parties. Even if the argument that the city failed to ensure a safe road is not successful, the governmental entity will likely incur costs.

Perception of Double-Taxation Remains for Near Term: Current privatization proposals aim to solve isolated transportation problems without improving the overall paradigm. As a result, their potential to provide enduring solutions may be limited. Whether warranted

or not, the public views tolls synonymously with taxes and a form of double-taxation. The current lack of cohesive regional or national plans that strategically alter the current funding framework and ensure that voters clearly understand the value garnered from gas taxes and the added value from tolling could potentially limit the benefit from current privatization initiatives in the U.S. A backlash could be problematic for both governmental entities and concession holders.

■ **Road Ahead**

Privatization decisions should consider all the broader and long-term economic, credit, and public policy implications tied to government responsibilities. That should include consideration of the numerous options available. In certain instances, long-term asset transfers may be appropriate. To the extent that they are not, the private sector may be able to bring value through short- to medium-term lease and O&M agreements that satisfy the goal of increased efficiency.

Toll roads are clearly attractive to private equity, because they are potentially lucrative investments. Government officials also could benefit by pursuing the privatization of other transportation infrastructure and services that require subsidies, such as nontoll highways and even passenger rail and transit. Moreover, this may also apply to nontransportation-related infrastructure and services. The goal of such privatizations would be subsidy minimization. Efficiencies from the elimination of constraints like statutory and civil service work rules, bidding rules, restrictive labor contracts, and union scales could lower the service cost to the taxpayer and user and ultimately benefit credit quality.

Privatization efforts of segments of the taxpayer-supported highway network in the U.S. through asset management contracts have shown promise in the Commonwealth of Virginia, where 250 miles of interstate roads are under performance-based contracts. On the other hand, certain privatization initiatives have been difficult to implement and manage in parts of the world, such as the privatization of commuter and passenger rail in the U.K. and Australia, where usage

levels were lower than forecast and operating costs were much higher than expected. To the extent that workable long-term risk-reward relationships can be defined, lower and more predictable subsidies would provide more meaningful benefits to the public sector. In many ways, given the breadth of subsidized government services, this is where the greatest potential for savings exists. It also represents the greater challenge in finding the optimal balance of risk transfer.

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