

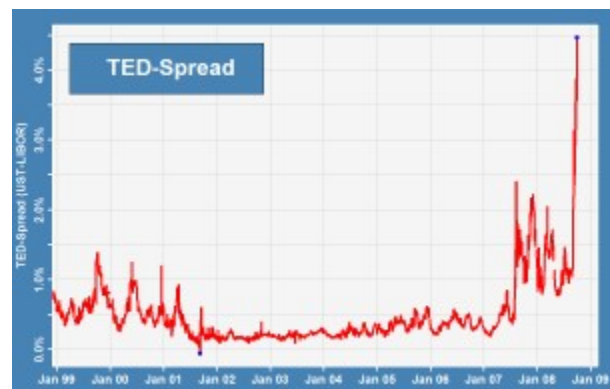
Uncertainty and Public Interest Problems in Private Infrastructure

In recent years some large institutional investors have shown interest in public infrastructure as a new asset class that they hope will be low risk and capable of producing of high returns. The private infrastructure market has grown fastest for toll roads and gained prominence three years ago when the city of Chicago signed a \$1.8 billion deal in return for 99-year concession on a toll road, followed the next year with Indiana's major toll road selling for \$3.6 billion deal for 75 years.

Like the mortgage industry, private infrastructure deals involve heavily leveraged debt and the trading of long-term risk. Some infrastructure investors such as Australia's Macquarie have followed the mortgage broker model by repackaging infrastructure deals into shares of listed infrastructure funds. Financial firms such as AIG and Goldman Sachs have followed suit.

But public watchdogs are increasingly wary of this trend. As the chairmen of the U.S. House Transportation and Infrastructure committee and the highway subcommittee [state](#), "The dependence of these firms on debt and asset inflation rather than income or cash flows to finance acquisitions and pay dividends to shareholders raises questions concerning the sustainability of this model." Other public interest advocates [note](#) that these deals are likely to be losers for taxpayers in the long term, will erode public control for transportation and environmental policies, and will force the state to compensate toll-road companies whenever policies reduce traffic levels.

The private infrastructure industry had benefited during the last five years from an unusually small gap between private debt costs and the still-lower borrowing costs of the public sector. Private companies must overcome this gap if they are to produce added value – instead of just a budget gimmick – for the public sector. - The line represents the gap for public versus private short-term borrowing costs over the last ten years. Private sector borrowing costs were recently less than 0.5 percent higher than in the public sector. That difference certainly adds up over 75 years; but not nearly so much as the much steeper interest rate difference over the past year. These comparisons understate the even larger gap for long-term debt used in long-term infrastructure deals.



In the face of higher borrowing costs, private infrastructure deals will be harder pressed to generate profits except by taking on higher risks, leveraging more long-term debt, and charging higher fees. Already much of industry's profits have been based on heavily leveraged debt, willingness of investors to pay very high fees, and dependence on the U.S. government to supply generous tax subsidies for accelerated depreciation on privately financed toll roads. In the future, investors should also be wary of the industry's risky debt financing and the effect that sagging

traffic levels and economic downturns will have on the industry's ability to meet aggressive revenue expectations.

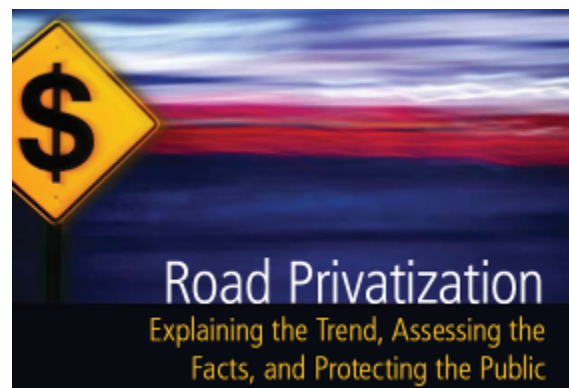
Risky debt financing

Many of the firms that have invested in toll roads acquired their investments with large amounts of borrowing. The peak of these acquisitions occurred several years ago when credit was cheap. Some firms even use credit to pay dividends to their stockholders. Some of the biggest deals are financed with interest rates that start low and balloon upwards over time, like those infamous mortgages with low teaser rates. An early critic of Enron, Jim Chanos in *Fortune* magazine [warns](#) about the largest such infrastructure firm, Macquarie, "'Borrowing future growth to pay investors today bears the hallmarks of a Ponzi scheme."

Whether or not such dire warnings are overstated, credit has certainly become more expensive which puts cost pressure on private toll operators' profits. Missouri officials recently scrapped a program for private replacement and repair of bridges because private financing, already more expensive than public borrowing, simply became too pricey. Most heavily [hit](#) on the private side are the Australian infrastructure financing groups Babcock & Brown, Transurban and Macquarie. These firms are leaders of Australia's well-developed infrastructure finance market. Stock prices for the three Australian firms fell dramatically in the past months before the market slide as investors began to worry that these firms had far less liquidity than they suggested. Many of these funds have been [downgraded](#) by rating agencies and analysts have posted warnings regarding these liquidity concerns.

Uncertain traffic levels

Toll road revenue projections are based on uncertain guesses about how much the American public will be driving decades into the future. New toll roads are particularly risky since projected traffic levels may not materialize, which will mean a devaluing of the company's underperforming asset and large write-off losses. In August, Macquarie slashed book values of its assets by \$1.7 billion. The biggest contributor to this amount came from a [devaluation](#) of Britain's M6 toll road from \$3 billion to \$2.2 billion. Several bond analysts have noted that toll road feasibility studies have been "overly optimistic." About half of the 10 private toll roads constructed in the US since the mid-1990s [have not met their traffic projections](#).



Revenue estimates based on front-loaded subsidies

Another source of uncertainty is that industry profits are based on large government subsidies. The biggest tax subsidy provided to private companies is a rule that allows them to amortize their debt in 15 years for roads that actually depreciate over 40 or more years. Investors must be wary about companies that have sacrificed long-term stability for short term profits. Towards the end

of concession deals toll operators will have exhausted these benefits and will meanwhile face contractual requirements to invest in expensive deteriorating assets. The profitability of many toll projects also depends on taxpayer subsidies through subsidized TIFIA loans through the Federal Department of Transportation. Cintra's proposed 50 year privatization deal for US Route 460 in Virginia, for instance, includes \$174.5 million in state subsidies for construction costs in addition to \$450 million in TIFIA loans because VDOT [financial analysis](#) determined that, "this project is not 'self-performing.'"

Vulnerable to Recessions, Higher Gas Prices, and Public Backlash

Toll road investors have counted on toll revenues being protected from economic downturns or other market volatility. Recent evidence, however, shows that driving habits are affected by recessions and rising gas prices once they reach a critical level. Driving levels have not fully rebounded to their growth before prices at the pump reached \$4 per gallon and transit ridership gains have remained steady. Wall Street [estimates](#) for global traffic have been revised in the last year as investors consider the economic factors facing many toll roads. In August, toll road operator Cintra [noted](#) that traffic fell for most of its concessions including drops between 6 to 7 percent on the Chicago Skyway and Indiana Toll Road. Traffic can be profoundly affected by unforeseen technological or demographic developments that might arise during the multiple generations spanned by concession contracts.

Finally, the wave of privatization may run into a public backlash that brings greater levels of oversight and public safeguards. The privatization agenda has been aggressively pushed by the outgoing Department of Transportation; but the new Administration will not be such zealous supporters and leaders in both House and Senate have expressed serious concerns. Faced with strong public opposition, New Jersey and Pennsylvania scrapped plans to privatize their toll roads. According to a national [poll](#) by the National Association of Realtors, 84 percent of Americans are opposed to private toll roads. Public support will likely grow even thinner as changing credit markets make it harder for companies to offer huge up-front payments.

¹ The TED spread is the difference between the rate on 3-month Treasury bills and 3-month yields on London Interbank dollar-denominated loans (LIBOR).