TESTIMONY BEFORE THE GOP POLICY COMMITTEE OF THE HOUSE REPUBLICAN CAUCUS

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Good afternoon, I am Frank Rapoport, senior partner at the law firm of McKenna Long & Aldridge LLP and chairman of the firm's Public-Private Partnerships (PPP) practice. I work out of McKenna's Philadelphia office.

McKenna is a leader in the field of PPPs. Our private sector clients partner with the public sector in areas as diverse as transportation, infrastructure, project finance, college housing, education and even schools. For example, our client Balfour Beatty Communities in Newtown Square, PA is one of the nation's largest developers of privatized military housing, including the highly successful project at Carlisle Barracks. We recently served as strategic advisors to a team at the Port of Baltimore on a PPP valued at over $1.3 billion to the state. Our leadership in this field is further evidenced by our recent chairmanships at the California Infrastructure Summit and New York Infrastructure Summit. We continue to assess appropriate uses of PPPs at a number of event venues and hope

Pennsylvania will want to host a similar summit pending passage of legislation.

We understand that the Committee is seeking creative ideas and legislative strategies in working with the private sector to unlock the value inherent in present or future state transportation projects. We have counseled clients in this sector for many years and most recently testified before the New York State Assets Maximization Committee on asset maximization strategies for public school buildings.

My testimony to you today will cover three related subjects. First, I will talk about how PPP contributes to economic development and the corresponding shortcomings of both the economic stimulus act and traditional public sector delivery methods. Second, I will discuss the need for a PPP best practice center and the Council of Project Finance Advisors (CPFA) Working Group initiative I am co-leading with former state and national public officials. Third, and finally, I will address Senator Rafferty's bill and other legislative options that would maximize PPP opportunities in this state.

I. Public-Private Partnerships (PPPs) Deliver Lower Whole-Life Project Costs than Traditional Public Sector Delivery Methods

Like many others, I initially had great hopes for the economic recovery package as a catalyst for major infrastructure projects. As the legislative details merged, however, it became clear that the primary goal was to boost the economy and create jobs, rather than establish a plan for transportation infrastructure investment. Out of the $787 billion package, $80.9 billion involved new spending toward infrastructure. Of that $80.9

billion, $1.5 billion, or barely two percent, was designated as a discretionary fund for the Secretary of US DOT for “capital investments in… projects that will have a significant impact on the Nation, a metropolitan area or a region.” These TIGER grants attracted over $50 billion in application proposals last fall. High speed rail, another quotient of the stimulus infrastructure spending, carved out $8 billion. Yet, the US High Speed Rail Association estimates that over $600 billion is needed to achieve what is truly known as high speed rail. Even if one looks at the $80.9 billion for infrastructure in absolute terms, the American Society of Civil Engineers (ASCE) estimates that *$2.2 trillion* is needed over the next five years just to bring America to adequate condition.

Where is the money going to come from? The U.S. economy, and the quality of life of its citizens, is threatened by a massive need for merit-based infrastructure investments. Highway maintenance budgets do not nearly keep up with rates of deterioration; bridges across the country are badly in need of structural repairs; congestion requires new bridges, roads, and interchanges and better public transportation options; and our waterways suffer from deteriorating ports and locks. Unfortunately, at the same time, public pension plan investors and other sources of private capital that are designated for infrastructure investment are fleeing abroad where better business models and practices make other countries more inviting for US and international capital. In the current economic environment, with over $180 billion currently available through infrastructure funds, the US cannot afford to ignore this flight of capital and innovation for infrastructure investment, which is already negatively impacting our competitive global advantage and way of life.

It is a common misconception that the cost of delivery for an infrastructure project is always higher through a PPP than traditional public-sector methods due to differences in the cost of financing. While it is true that the public sector's cost of financing is typically a measure lower than that of the private sector for a PPP, this comparison fails to capture all of the costs associated with the delivery of the infrastructure project. Costs not captured in such a comparison include: (1) those associated with the risks that are retained by the public sector in traditional public sector delivery methods, but not retained in PPPs; and, (2) the annual cash flow difference attributable to capital costs over the whole life of the project as opposed to over the customary (shorter) term of governmental bonds. There are at least five elements to be considered in measuring the cost of infrastructure projects: 1) construction costs, 2) operating expenses, 3) cost of capital, 4) time to completion of the project (and the onset of project revenues and other benefits, and 5) the time horizon from recovery of the capital investment. All of these elements should be given their due weight in evaluating the different ownership and operating structures for infrastructure projects.

PPPs Can Benefit from Low-Cost Tax-Exempt Debt

While it is true that the cost of public sector debt financing is low due to the tax-exempt status of most municipal securities, tax-advantaged and low cost debt financing is available to the private sector for infrastructure projects. By using Private Activity Bonds (PABs) and/or the TIFIA loan program, the private sector is able to borrow at rates comparable to those of the public sector. As a result, the private sector also is able to substantially reduce the difference in the cost of financing infrastructure projects through PPPs versus that of the public sector. Although the aggregate amount of PABs that may be issued for this kind of project is not unlimited (the limit is $15 billion), there appears to be ample remaining capacity for projects that receive federal assistance under Title 23 of the U.S. Code Moreover, issuance of PABs for transportation projects of this type would not impinge on State-wide PAB volume caps for other types of PABs (IRC §146(d)). Indeed, under the American Recovery and Reinvestment Tax Act of 2009, the overall benefits from PABs in comparison to governmental tax-exempt bonds will be virtually identical at least for 2010.

Shifting Risk to the Private Sector Adds Value

PPPs allow the public sector to transfer a number of risks to the private sector – e.g., construction delivery and cost risk, revenue risk, maintenance risk and refinancing risk. In a PPP, the private sector considers all the risks that it takes on from the public sector and essentially incorporates their cost into the cost of equity it requires for investing in a particular PPP.

By contrast, traditional public sector delivery methods fail to recognize upfront the costs associated with many of the risks that the public sector underwrites. Rather, they recognize the costs only after the risk has materialized. For example, if an infrastructure project suffers from cost overruns or delays, or it otherwise fails to meet revenue expectations, this risk is borne entirely by the public either through higher taxes or higher user fees. A PPP shifts these risks to the private sector.

Whole-Life Costs are Lower Using PPPs

Determining the total delivery cost of an infrastructure project requires not only analyzing the upfront construction and financing costs, but also the ongoing maintenance, operating and financing costs over the whole life of the project. A comparison of whole-life costs using so-called Value-for-Money analysis has become central in the UK and Canada to properly determining whether an infrastructure project should be delivered through a PPP or a traditional public sector method. A 2003 study in the UK of whole-life costs found that 73% of traditional procurements experienced construction cost overruns paid for by the public sector, whereas only 22% of PPP projects experienced cost overruns. Clearly, PPPs have been proven to deliver.

PPPs Allow the Local Government to Avoid the Cost of Additional Leverage

In addition, a PPP would allow local government to avoid significantly increasing its current debt load. If local government were to incur additional debt it could negatively impact local government's credit ratings, and in turn raise its costs of financing across all of its debt outstanding going forward.

Conclusion

Whole-life project delivery costs for infrastructure projects can be lower as PPPs than traditional public sector procurement methods even where the municipal funding costs of the traditional public procurement method are lower. This is because financing costs represent only a single cost component of a complex project. All whole-life project costs need to be properly considered within the framework of a robust value-for-money analysis in order to ascertain which delivery method is truly lowest cost.

II. There exists a need for a federal best practices center to help local government better understand PPP.

My second major observation is there exists within the government official community a PPP "experience gap". To invest in infrastructure projects in the US, potential capital sources must navigate federal statutes, 50 state legislatures and thousands of local government units, which present significant hurdles for mutually beneficial PPP models. Consequently, public officials have no training or experience about PPPs. This fragmentation leads to high transaction costs (for both the public and private entities), as well as underutilized investment and human resources. As a result, it is easier for other countries to attract valuable private capital, enhancing local infrastructure that supports their vital national interests and quality of life of their citizens.

In response, I launched the CPFA Working Group with my colleagues, Mayor Stephen Goldsmith, former mayor of Indianapolis, and Governor Howard Dean, former governor of Vermont, to establish the CPFA, a centralized PPP resource that collects, analyzes and provides information on sound market concepts for public infrastructure development. The CPFA will have an opportunity to assist both public and private sectors by providing greater transparency and credibility to PPPs, while also opening up the bottleneck of PPP projects that have been identified in every state. Once established, the CPFA will be at the forefront of the effort to improve public trust in PPPs while addressing public sector challenges with innovative private sector concepts. The organization will serve to develop, manage and drive an effective legal and public policy strategy that will support the business strategy of this complex sector that spans various industries. The CPFA staff will offer an informed, experienced, organized and effective voice to policy makers, the press, and other influencers on the complex and challenging questions facing the PPP sector.

How can the CPFA help Pennsylvanians? The CPFA isn't a silver bullet solution, but will impact infrastructure investment in three ways:

1) Clarity in project assessments resulting in improved project performance. Not every project works within a PPP framework; the CPFA would be a resource to assist governments in identifying those project that deliver maximum value for money via alternative financing and delivery models. The CPFA would help government officials understand project risk and the cost-benefits of risk transfer allowing officials to identify, compare and choose from a spectrum of PPP models. In addition, the CPFA would engage a broad array of stakeholders from the start, adding better communications flow into the process, thus providing a higher level of transparency and accountability into the recommended best practices and project finance opportunities.

2) Enhancing U.S. economic development and capacity building. It is widely accepted that innovation is incubated in the private sector; thus the CPFA would bridge the public-private sector relationship providing an avenue for the private sector to reach out to public authorities in open discussions, fostering new ideas for project flow, finance and delivery. By introducing, considering and offering all procurement options available, including PPPs, public officials would further leverage the value of

taxpayer's money to provide a better and more effective and efficient foundation for services and infrastructure upgrades.

3) Avoiding costly mistakes and miscommunications between the public and private sectors. CPFA would serve as a centralized collection point for PPP activities in the US, as well as a source of competitive intelligence on projects in other countries. The organization would inventory for public officials information that will help them understand lessons from existing practices that will assist them in providing the proper foundation, background and analysis for PPPs including a deeper understanding of the different elements and benefits of the PPP model. The CPFA would provide a forum for bilateral/multilateral coordination and improve communication between public and private sectors, resulting in greater transparency, more efficient project delivery and collaboration opportunities.

A better managed approach to the selective use of PPPs will result in increased capital availability for critical US infrastructure needs, and will improve voter trust in these public-private relationships. But without authorizing legislation in Pennsylvania, our state rejects an additional tool in the toolbox.

III. **Specific comments on Senate Bill 693**

With respect to Senate Bill 693, I raise the following points and concerns:

Pg. 5 (lines 18-24) – "Maximum rate of return". While this is likely a public/political necessity, this will drive away interest from a number of equity providers, unless there is some kind of reciprocal protection on downside risk as well. In other words, if you give the concessionaire 100% traffic risk (which the bill seems to lean toward), then they will face downturn risk if traffic doesn't materialize as projected, but not reap any upside because of this maximum rate of return. At best, it will force the equity to be more conservative, making the equity more expensive in their initial proposals.

Pg. 8 (lines 6 – 27) – "Transportation development agreement". The first paragraph seems to limit the payment mechanism type to only direct tolls to private entity. One possibility to consider is having the Authority control the tolls and, then make payments to the Concessionaire (aka an Availability Payment mechanism). It is unclear in subsequent paragraphs if this approach would be permitted. One, this makes the equity less expensive and project more feasible since they are not assuming massive traffic risk. Second, it has good public perception because the tolling structure (i.e. rates) are controlled by the agency, and the public usually likes this better.

Pg. 9 (lines 12-24) – Transportation Commission's right to approve of contract. The big question here is when? We would highly recommend that the Commission be required to formally approve the format and structure of the contract before the procurement begins, otherwise the private sector will be reluctant to pursue a project and spend substantial dollars, only to have the Commission reject the contract and stop the project at the 11th hour.

Pg. 10 (line 15 +) – Solicited Proposals. This section should specifically allow the Authority to be able to have certain flexibility in their solicited proposal documents. Most importantly, this would include the right to shortlist after a RFQ stage, and the ability to pay a stipend for losing short listed firms who submit compliant proposals. Without these 2 items, the majority of the private sector will tend to not be interested in these solicited proposals.

Pg. 18 (lines 2-15) – Interim agreements. It is recommended that the legislation lay out the ground rules for how the winning team will be determined. Without such ground rules, protests are much more likely. The section on solicited proposals spells out related ground rules very well, while this section does not.

Pg. 29 (lines 18-19) – User fees. Section (a)(1) should match the approach of (a)(2), and both should state “may” instead of “shall”. This gives more flexibility to the Authority in developing said contracts.

General issue – Surety bonds (aka construction performance bonds). The legislation should allow the Authority to waive the requirement of a performance bond if the Development Agreement can be structured so that the public sector would not be at risk for non-performance of the construction portion of the project. In other words, if the lenders/private sector are 100% responsible for financing the construction and the public sector will be either paying no construction payments or tolls during this period, the public sector is not at risk for this performance, and should thus not require a performance bond.

In closing, I am encouraged by the proposed bill and implore the General Assembly to enact legislation for PPP transportation projects in Pennsylvania. Federal money will actually have an adverse effect on transportation planning if it is viewed as a prime funding source. Federal funds are limited and no state today, including Pennsylvania, can assume that Uncle Sam will meet its transportation needs. Instead, federal funds should be viewed as seed money, ideally used to identify and initially develop complex projects that will ultimately be brought to life through partnerships with the private sector.

A final observation: We see states far and wide rapidly passing PPP legislation in the past two years: Alabama, Arizona, California, Massachusetts. Moreover, local government which have home rule authority, and innovative mayors in Chicago and in Anaheim, are actively embracing PPP for new schools, airports, public buildings, parking, public buildings, state universities and dormitories and recreational centers. Also Port Authorities already with inherent PPP authority, are issuing RFPs right and left, to rebuild, expand and prepare for the future. Likewise, I hope Pennsylvania embraces PPP and becomes a leader in innovative financing for economic development.

Thank you for this opportunity to discuss these important topics with you today.

Respectfully submitted,

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