TESTIMONY

Regarding a Possible Lease of the Pennsylvania Turnpike

by

Roy Kienitz

Deputy Chief of Staff, Governor Edward G. Rendell

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Good morning Mr. Chairman and members of the Committee. My name is Roy Kienitz and I am Deputy Chief of Staff to Governor Rendell. I am here today in my role as the person coordinating the Governor's many efforts over the last several years to increase funding for roads, bridges and public transportation.

In my remarks here today I will primarily address the study that is the main focus of this hearing, but before going into specifics on that I would like to make a few points about the broader context; that is, the work that has gone on since 2004 to bring new funding to the Commonwealth's transportation program.

When the Governor announced last year that he was pursuing an effort to raise new transportation funds using the Pennsylvania Turnpike, he laid out a two-track strategy. Under this approach, we would work to develop two types of funding plans: one focused in the public sector, and one using a public-private partnership. His goal was to generate the most money possible to deal with the Commonwealth's major transportation needs. To achieve this goal, it was our intention to make these two strategies compete against one another to see which could produce the best deal for the Commonwealth.

The proponents of each strategy have a long list of reasons why their preferred method is superior. As I studied the matter over the past few years, I concluded that each side has strong points in its favor. But after we had heard all the arguments, we were uncomfortable in making a choice between a pubic sector option and a public-private option based solely on theory.

Although there are many policy issues at stake in a decision like this, surely one of the most important is how much money each option can produce. A solid grounding in the principles of public and private finance can help us guess what the numbers on either side might be, but for many reasons we became convinced that making policy decisions of this magnitude based on these estimates was not the right way to go.

And so the Governor proposed a process under which legislation would be adopted allowing for both scenarios to be developed, with the final decision made based on which proved superior in actuality.

As you know, this eventually led to Act 44 of 2007, a plan that is fully housed within the public sector.

Six weeks after Act 44 became law, the I-35 bridge in Minnesota collapsed, shining a bright and rather harsh light on the condition of the nation's infrastructure and the efforts underway around the country to improve these conditions.

Based on this, Governor Rendell felt that if there was anything we could do to increase transportation funding in Pennsylvania even more that was done under Act 44, we should consider it. And so since the fall of 2007 we have been working with the private sector to develop a process for taking bids on a turnpike lease.

These bids would be based on terms and conditions spelled out in a Concession Agreement that is currently under development. Once this document is final, official bids will be solicited and received, and then the winning amount and the terms of the Concession agreement will be released for all to see. Once this is done, all concerned will have the opportunity to decide for themselves whether the bid and the terms that pertain to it are superior to Act 44 or not.

This brings me to the study being presented here today. First, I would note that the questions asked by the authors are the right ones. That is:

> *"Financially, does it make sense for the Commonwealth to lease the Pennsylvania Turnpike ...?";* and
>
> *"Strategically, as a matter of public policy, does it make sense for the Commonwealth to lease the Pennsylvania Turnpike ...?"*

That said, we do not agree with the conclusions reached in response to these questions. I would like to explain why.

First, the two questions posed above, while correct, are not independent of one another. The key policy question that led to the debate over a turnpike lease is precisely a matter of money – how to pay for much needed improvements to Pennsylvania's roads and bridges. As you well know, despite the Governor's decision to triple funding for bridge repair in the last five years, Pennsylvania still ranks worst among all states for structurally deficient bridges. This is a major policy problem, and solving it takes money.

This leads to our most fundamental disagreement with the study, that is, its central conclusion:

> *"[w]e believe the Commonwealth is best served by staying the course with Act 44."*

We do not see the logic behind ruling out a lease – or any other funding option for that matter – without knowing how much it produces, and how many roads and bridges can thereby be repaired. At best, the report's central conclusion is premature. At worst, it dismisses out of hand a chance to make even greater progress on the most important transportation policy challenge facing the Commonwealth – the condition of its roads and bridges.

Second, we have concerns with the authors' estimate of lease value. We credit them for making an estimate, but this effort suffers from several drawbacks.

First and foremost, it is a guess. The authors are clearly well-versed in matters of finance, so perhaps it is better described as an educated guess. But an educated guess is still a guess.

Beyond this, while we have not reviewed the study's methodology in detail, we take issue with its implication that public agencies have an inherent advantage in monetizing assets due to their access to the tax-exempt market. This point of view has at least two weaknesses. It discounts the possibility for significant operating cost efficiencies when the roadway is operated by the private sector. Estimating the exact size of such savings is difficult, but this should not lead us to assume that such savings will be zero.

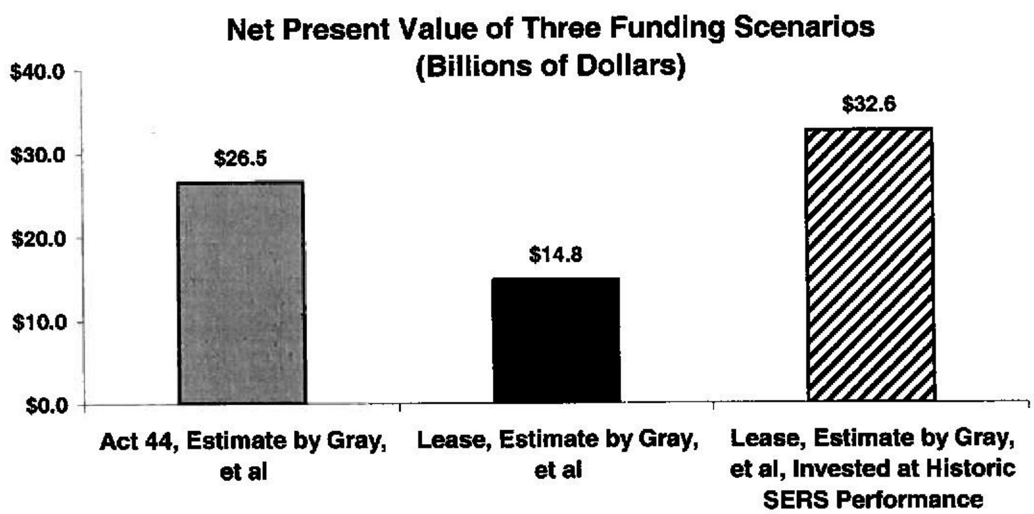
It also underrates the private sector's ability to lower its effective cost of capital using the federal tax code. Once again, it is difficult to model the exact value of this because each bidder has a different tax profile, but the effect can be significant. For a private concessionaire, interest on any debt will be tax-deductible, and so the authors' assumed cost of debt is overstated. And a concessionaire will be able to claim depreciation expenses on the roadway, offering a further advantage. Although the authors offer a lengthy discussion of tax issues, their most telling statement is the concluding one:

> *"The estimation of the amount of tax-loss carry forwards and the calculation of their present value are beyond the scope of this report."*

These matters of methodology in estimating the potential size of lease bids are meaningful, but in a larger sense they are beside the point. When the time comes for you and your colleagues to consider a lease, the number that matters will be the actual amount of the bid regardless of how it was arrived at. In a short time, we will all know how much the private market is willing to offer, and with a bid in hand we can weigh together all the appropriate financial and policy considerations.

Finally, once the amount of the bid is known, we believe the study's method of comparing net present values is a classic "apples-to-oranges" situation. It compares the net present value of Act 44's 50-year stream of payments against the cash value of an up-front lease payment. The study estimates the net present value of Act 44 to be $26.5 billion vs. $14.8 billion for a lease.

As the Governor has stated many times, it is his intention to use a lease to create a stream of payments to invest in transportation. A variety of ways to achieve this are possible but we will focus our comments on one. Under this scenario, an up-front cash payment would be placed in a restricted account under the management of an agency with a proven record of managing investments, for example, the State Employees' Retirement System (SERS.) Using the historical performance of SERS as a guide, such a strategy could yield a net present value of $32.6 billion. This figure is arrived at by simply using the last 20 years of actual SERS investment returns and applying them over a 50-year period to the estimate provided in the study for a lease payment. This "apples-to-apples" comparison is shown in my testimony on page 6.



Our intention is not to claim that a lease will produce these specific amounts, either in up-front proceeds or over time. Rather, it is to illustrate the potential benefit to the Commonwealth of a up-front payment not available under Act 44.

Obviously, any plan to invest proceeds is subject to variations in investment returns, but this must be considered against the risks inherent in Act 44. One thing is certain with an up-front payment: when the deal closes the Commonwealth has cash in hand. By contrast, Act 44 offers only the promise of payments in the future, with little in the way of meaningful penalties for non-payment. Furthermore, these payments are subordinated to many of the Turnpike Commission's other obligations. And to the extent that I-80 is not tolled, payments available under Act 44 drop dramatically.

Many claims and counter-claims are made about the merits of public vs. private toll road monetization. To cut through the confusion this creates, last spring the Governor proposed a simple idea. Both public and private solutions should be developed, and a decision should be made once we have seen the best each side has to offer. Act 44 accomplished this on the public side, but it was approved without the benefit of knowing how it compares to best the private sector can offer.

When the considerations described above are taken into account, one thing seems clear: any attempt to draw conclusions about the desirability of a lease vs. Act 44 is premature before we know the final bid price for the lease. Once that figure is known, all concerned can weigh the risks and benefits of each option.