COMMONWEALTH OF PENNSYLVANIA
HOUSE OF REPRESENTATIVES

TRANSPORTATION COMMITTEE HEARING

STATE CAPITOL
MAJORITY CAUCUS ROOM
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HARRISBURG, PENNSYLVANIA

THURSDAY, JUNE 26, 2008, 8:34 A.M.

PRESENTATION ON HOUSE BILL 2593
LEASING THE PENNSYLVANIA TURNPIKE

BEFORE:
HONORABLE JOSEPH F. MARKOSEK, MAJORITY CHAIRMAN
HONORABLE RICHARD A. GEIST, MINORITY CHAIRMAN
HONORABLE MIKE CARROLL
HONORABLE PAUL COSTA
HONORABLE GARY HALUSKA
HONORABLE KATE HARPER
HONORABLE DICK L. HESS
HONORABLE DAVID S. HICKERNELL
HONORABLE MARK K. KELLER
HONORABLE MARK LONGIETTI
HONORABLE JOHN MAHER
HONORABLE JENNIFER MANN
HONORABLE RON MARSICO
HONORABLE RON MILLER
HONORABLE TONY J. PAYTON, JR.
HONORABLE JOSEPH A. PETRARCA
HONORABLE TINA PICKETT
HONORABLE JEFFREY P. PYLE
HONORABLE JOHN P. SABATINA, JR.
HONORABLE DANTE SANTONI, JR.
HONORABLE MARIO M. SCAVELLO

BEFORE (cont.'d)
HONORABLE JOHN J. SIPTROTH
HONORABLE TIMOTHY J. SOLOBAY
HONORABLE CHELSA WAGNER
HONORABLE KATHARINE M. WATSON
HONORABLE EDWARD P. WOJNAROSKI, SR.

IN ATTENDANCE:
HONORABLE DWIGHT EVANS
HONORABLE STEVEN W. CAPPELLI

ALSO PRESENT:
STACIA A. RITTER
MAJORITY EXECUTIVE DIRECTOR
ERIC C. BUGAILE
MINORITY EXECUTIVE DIRECTOR

JEAN M. DAVIS, REPORTER
NOTARY PUBLIC

I N D E X

TESTIFIERS

CHAIRMAN MARKOSEK: Good morning, everybody, and welcome to the Pennsylvania House Transportation Committee hearing on House Bill 2593.

The first thing I want to do is ask everyone here to stand for the Pledge of Allegiance, and I'm going to ask Dwight Evans and Steve Cappelli to lead us, please, in the Pledge of Allegiance.

(The Pledge of Allegiance was recited.)

CHAIRMAN MARKOSEK: Again, I want to thank everybody for attending here today.

I'm Representative Joe Markosek, Majority Chairman of the House Transportation Committee, and with me, of course, is Representative Rick Geist, Minority Chair of the Transportation Committee.

I have just a couple of things to say. We have a short time frame today. We go on the floor at 10:30, and I would like to get through this this morning as expeditiously as we can. Because of that, the House rules indicate that we can't be here beyond that, so we want to certainly honor those House rules.

So I would ask the folks who are testifying and the folks who are answering questions to make their points as concisely as possible in the essence of time here this morning.

I have a brief remark, and then I'm going to recognize Representative Geist for brief remarks.

As most of you know, it's a very interesting issue in the Commonwealth of Pennsylvania. After the passage of Act 44 last summer, the Governor decided to test the market and see what was out there relative to a lease of perhaps, arguably, our most valuable asset in the Commonwealth, the Pennsylvania Turnpike.

As most of you know, I have not been the most enthusiastic person in the room relative to that issue, but the reason why we're here today is to vet the issue, to give it certainly a fair hearing, and let the folks not only here in the room and the committee members but also the folks within sight and sound of our voices and faces here today through the medium of PCN see it and understand and learn the various aspects of this issue.

I just want to very briefly say that, you know, one of the things that I have learned since I have been Chairman of this committee is that there's really no, certainly no "free" way in anything we do relative to transportation.

As I said many times, we ought to take that word out of the English language. There is no such thing. Everything has to be paid for. Everything has to be, in transportation, most of those things have to also be subsidized. And there is no free money in the public-private partnerships as well. Everything has to be paid back. This is essentially a financial deal which we will try to vet here this morning.

We have an obligation as members of the General Assembly to protect the public interests through these various agreements and activities and to protect and wisely spend and be good stewards of the public trust and the public treasury.

With that, I would like to introduce Representative Rick Geist for some brief remarks. Rick.

REPRESENTATIVE GEIST: Thank you, Joe, and good morning, Mr. Chairman, and members of the committee and guests.

I want to welcome you to today's public hearing, which I hope will mark the start of a thorough and substantive debate on how best to meet the needs of Pennsylvania's transportation infrastructure now and well into the future, long after all of us on this panel are gone.

The critical issue before us this morning is one that warrants the full attention of the General Assembly in the days and weeks ahead. It is incumbent upon this committee and upon the Legislature as a whole to objectively examine and evaluate this proposal to lease the Pennsylvania Turnpike.

Only then will we be able to mark and make an informal decision on a matter of public policy that could affect our citizens and our surface transportation system for generations to come.

Our focus this morning is on the question of whether or not to lease the turnpike, but we must analyze that question within the larger context of how we are going to fund, maintain, improve, and expand Pennsylvania's roads, bridges, and transit systems. That, ladies and gentlemen, is the overriding issue, and it transcends the turnpike.

Four years ago, I was appointed to serve on the Governor's Transportation Funding and Reform Commission. We spent 2 years studying and qualifying Pennsylvania's transportation infrastructure needs.

The commission concluded that in 2006, that an additional $1.7 billion was needed annually just to meet existing and immediate needs for maintenance of bridges and roads. That did not add $1 or one more car or truck capacity to the system within Pennsylvania. We also changed the formula for funding mass transit and recognized the total needs there.

Considerably more funding will be needed because of inflation -- that $1.7 billion number is way low -- and considering that, we have to find some way of meeting the infrastructure needs of the future.

The cold, hard truth is that Pennsylvania's infrastructure needs far surpass the public sector's ability to fund them. We have no choice but to explore other alternatives to bridging this funding gap, and I believe public-private partnerships represent a viable alternative.

That is why I, along with Chairman Markosek and seven other members of this committee, are sponsoring enabling legislation, House Bill 555, that would allow Pennsylvania to enter into public-private partnerships to help the Commonwealth fund its transportation needs.

In my view, enacting that broad-based legislation is essential to solving the problem that confronts us.

A public-private partnership is a

contractual arrangement between a public agency and a private-sector entity to develop a public service and deliver it.

These partnerships, which have been successful in other States and around the world, provide an infusion of private-sector capital that accelerates the maintenance, improvement, and expansion of roads, bridges, and other infrastructure.

A lease of the Pennsylvania Turnpike would be the largest public-private partnership in the history of the United States, but by no means is this the only scenario in which public-private partnerships could benefit the Commonwealth.

By investing private-sector capital and using the principal and interest exclusively to fund Pennsylvania's infrastructure needs, several ambitious projects around the State that would otherwise never materialize could be completed more expediently and more efficiently.

Thousands of Pennsylvanians could be put to work rebuilding our roads and bridges, and future generations would not be strapped by massive debt payments.

Pennsylvania cannot afford to wait. Our road and bridge needs are too immediate and too extensive.

The transportation funding plan that was enacted last July, Act 44, falls far short of solving this crisis, even as it mortgages our future with billions of dollars of borrowing.

I have devoted the last 30 years of my life as a Legislator and as a Chairman of this committee to achieving the goal of providing Pennsylvania with a surface transportation system that ensures mobility and prosperity for its citizens.

Now we are at a crossroads, facing a paradigm shift. We can either pursue that vision or stand by and watch a broken infrastructure continue to deteriorate.

With that, I look forward to today's testimony.

Thank you, Joe.

CHAIRMAN MARKOSEK: Thank you, Mr. Chairman.

A bit of housekeeping. There will be no roll taken today. This is not a voting meeting, and some of the members have to go to other meetings and they will be coming in and leaving as the meeting progresses.

The first folks we have to testify are the sponsors of House Bill 2593, Representative and Chairman of the Appropriations Committee, Dwight Evans, as well as Representative Steve Cappelli.

Gentlemen, welcome, and I also, after their testimony, have invited them up to join the committee to, again, ask questions of the other testifiers.

So gentlemen, welcome, and while you're fighting over who wants to go first--- Why don't I recognize Representative Dwight Evans.

Chairman Evans, welcome.

REPRESENTATIVE EVANS: Thank you, Chairman Markosek, and thank you, Chairman Geist.

This is an unusual seat for me to be sitting on this particular side. I will definitely have to be more sensitive during the budget time.

I would like to applaud the members, all of you, for keeping an open mind about the leasing of the turnpike or any other proposal to raise funds for bridges and transit.

And I would like to applaud Representative Steve Cappelli in this partnership of he and I working together, demonstrating that this is not a

Democrat or a Republican issue; this is a Pennsylvania issue, and it is important that we work together first.

I would also like to acknowledge on both sides of the debate for the passion regarding the open public debate, which I think is long overdue. But I would like to talk about, why did I move to this particular position to support this idea of leasing the turnpike?

As Chairman of the Appropriations Committee, now, I have an obligation to all of the citizens of the Commonwealth of Pennsylvania, and I do believe it is important to provide an opportunity for an open discussion.

This is a $12.8 billion proposal. We cannot just dismiss it out of hand. It is not prudent to do that.

I have been a long-time advocate for new transportation funding and understanding the historical and the institutional nature of the problem.

Now, I want to give you a little history, because I have been around here long enough to be able to give some history.

Every Governor, from Governor Thornburgh to

Governor Casey to Governor Ridge, has had to raise the gas tax.

Generally, the general feeling to raise the gas tax was the view that this was something that we needed to do to meet our transportation needs.

Unwilling to raise fees related to things such as tire disposal and other issues, in my view, we have now hit the wall. We are now asking ourselves some serious questions about, what do we do towards the future?

I can go back to my own history in terms of 1991 when we voted for the Public Transportation Assistance Fund. I can say to you, I have a chart here, and on this chart it basically shows -- at least I thought I had the chart with me. I don't have the chart, but I will get it for you. I understand the needs in the community.

I would like to tell you a little story on Fayette County. I was in Fayette County about a week or 2 weeks ago where there is a bridge that is not functioning that we cannot carry fire trucks or school buses across that particular bridge.

As for transit -- the national story these days -- as we all know, people are flocking to public transit to save money.

The Governor's Transportation Funding and Reform Commission, as you heard from Chairman Geist, identified $1.7 billion annually needed in transportation funding.

Act 44, which I supported, will provide an average of $946 million in each of the first 10 years. That's a great start, but it is not enough.

If the Federal government rejects the tolling proposal for Interstate 80, we need to find an alternative solution to this problem, even though I think both of these issues should be on the table. I think the tolling issue should be on the table, and I think the leasing of the turnpike should be on the table, because we cannot afford to say no to either.

Even if tolling Interstate 80 wins approval, that does not eliminate the legislative responsibility, meaning we still have a responsibility to come up with ways to make sure we deal with our infrastructure.

To investigate other transportation funding opportunities, history has shown us that this Legislature has been wrestling with the issues of transportation since the early 1960s. With gas prices at a historical high, we need more debate, more discussion, more options for State transportation needs.

Transformation is a necessity; it is not an option. Transformation is a necessity and not an option. I do believe we have to change our thinking and have an openness to consider every single option.

If we want to continue growing Pennsylvania's economy, there's a direct connection between the transportation infrastructure and the growth of this economy.

This is not a Democrat or a Republican issue. This is not a liberal or conservative issue. This is an issue about growing the economy.

Let me just say in closing, I have here, which I will share a copy, a chart that shows from the days of Scranton, Shafer, Shapp, Thornburgh, Casey, and Ridge. It shows you how far this goes back. Here we are, in 2008, the 21st century, still wrestling with this particular problem.

This is not an issue that we can afford to put our heads underground. This is an issue that we all have to be open-minded and a willingness, and a willingness to think outside the box.

I thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Thank you.

Representative Cappelli.

REPRESENTATIVE CAPPELLI: Thank you, Chairman Markosek, Chairman Geist, and members of the committee.

I, too, want to thank both Chairmen and the committee for this opportunity to begin the dialogue, if you will, on House Bill 2593 and the P3 partnership as advocated by the administration involving Abertis and Citi.

I will preface my brief comments today with the fact that I voted for Act 44. I didn't think the final version that came back to us from the Senate was the best approach, but at that time, it was the only option that we had.

And over these many, many months, since almost a year now, we have seen a rising tide of opposition, especially along the I-80 corridor, to tolls.

The information, sentiment, the suggestions that we've heard, many of us pointblank and quite bluntly, is that it will drive jobs out of central Pennsylvania, it will discourage new investment along that corridor, and it is not a wise or prudent thing for us to do from a policy perspective or from an economic development perspective.

What options do we have left? I think that is really the genesis of this committee hearing and the debate that will commence henceforth for the weeks and months ahead.

What do we have left? What can we do to deal with the more than 6,000 structurally-deficient bridges?

I think we are now probably the number one State in the country in terms of the number and/or percentage of structurally-deficient bridges, almost 9,000 miles of State highway. They are of an unsafe condition that needs to be reconstructed or repaired significantly. These are serious, real, inescapable realities that this Legislature must contend with.

With the still undetermined fate of Act 44 and the Federal Highway Administration, with the fact that our own Turnpike Commission has still yet to resubmit its tolling application, leads me to believe anyway that we may not be able to fit a square peg in a round hole, that we may be left only with a P3 alternative or raising our gas tax 24 to 26 cents per gallon to get us to that $1.1 or $1.2 billion a year in new money that we desperately need to begin addressing the infrastructure crisis and the transit crisis all across Pennsylvania.

I believe the proposal that has been put forth by Abertis and Citi and advocated by the administration is reasonable, it is fair, and it takes a great step towards getting us where we need to be financially relative to the investments that we heretofore have been unable to achieve in our infrastructure in Pennsylvania.

I won't detail the proposal; you know that. Others will speak to it today. But from the capital investment that we made initially to the future rates, toll increases, capped at the rate of inflation are 2 1/2 percent, the security provided, the labor force that works for the turnpike, I believe it is the best possible alternative to what we now know as Act 44.

I want to thank Chairman Evans for his leadership and his willingness to come forward and partner with me on this legislation.

It is truly a bipartisan effort that is driven solely -- solely -- by the interests of finding a solution to Pennsylvania's infrastructure crisis.

And I appreciate Chairman Markosek and

Chairman Geist for hosting this committee meeting, and thank you.

CHAIRMAN MARKOSEK: Okay. Thank you both.

I would like to invite both of you to come up here to the table. We'll spare you the draconian questioning that this committee is so often good at. But we appreciate that, and thank you. And please join us up here and feel free to ask questions during the hearing.

I would like to introduce the next folks to testify. This is an overview of the concession process and development of the legislation: Mr. Roy Kienitz, Deputy Chief of Staff of the Office of Governor Rendell; and Mr. Rob Collins, Executive Director and Head of Infrastructure M&A for Morgan Stanley.

So Roy and Rob, welcome. Thank you.

MR. KIENITZ: Sure.

CHAIRMAN MARKOSEK: Back by poplar demand.

For those who don't remember, these two were before our committee in a previous meeting and handled themselves very well and provided a lot of good information.

So Roy, would you go first, please?

MR. KIENITZ: Yes. Thank you, sir.

Good morning, Mr. Chairman, and Mr. Chairman, members of the committee. I'm glad to be back here again.

As I'm sure you know from the last time we were here, Mr. Collins and I have spent many hundreds and hundreds of hours over the last year working on this. It's hard to summarize all of that process in a few minutes, but I will attempt to try.

So I think where the story starts for us is really, as Chairman Geist said, last year or 2 years ago the recommendation had been made that we need an additional $1.7 billion a year in infrastructure funds. And so the Governor really, you know, starting over a year ago, looked around for ways to do that.

We looked at tolling of existing interstates. We looked at raising current gas taxes. We looked at adding fees. And basically every way that we were able to think of was money being taken out of the pockets of Pennsylvania citizens to pay for more transportation. And the end, of course, as the gentleman said, everything has to be paid for.

The real attraction to the Governor of a lease of the turnpike is that potentially given just an inflationary series of toll increases by really using the power of the market to monetize that value, we could brings billions and billions of dollars to transportation investment without an additional burden on the taxpayers or the toll payers or whoever it is going to be.

But that said, he was not initially of the view that the only way to do that was through the private sector. And as the folks here know, the legislation that we proposed last year would have established a process whereby the Turnpike Commission could develop a publicly financed option for monetizing the roadway.

We would work with Mr. Collins and his people at Morgan Stanley to develop specifications under which private operators of the turnpike could also bid.

And at the hearing where we were here before the committee the last time, we had, you know, a great debate with some of the gentlemen who are going to testify later today about whether the private sector is inherently better able to do this than the public sector is.

And our view, if you will remember, was always that the proof is in the pudding and that the only way that you will really know who can offer the best deal is to force them to compete against each other, and at the end of the day, you open the envelopes and you see who is willing to offer more money to fix roads and bridges and fund transit around the State. That was the Governor's original proposal.

The public financing portion of that was actively considered here, and that eventually became Act 44 with the addition of the tolling of Interstate 80.

But I think the Governor felt that the process that led to that was never forced to compete against the value that the private sector could offer. And so even after Act 44 was passed, we revived the process to ask for bids and a concession lease.

And so Mr. Collins and his team and I, starting in, I guess, about October, September or October of last year, started the process.

We sent out in September a request for expressions of interest in a private lease. As folks know, we got 14 different teams that responded to that. Some of those were the people that you see here today, from Abertis and Citigroup; they responded.

Teams that were the other two final bidders in the process responded, the team led by Goldman Sachs partnering with Transurban as an operating company, and the team led by Macquarie Infrastructure and Cintra, who have experience in this area. But we had many other respondents as well.

And the process we developed was one where it was really a two-track process, where we had a group of lawyers who, starting off of the templates for the concession agreements that were bid for the Chicago Skyway and the Indiana Toll Road, really just as a guide, developing a concession, a draft concession agreement for the Pennsylvania Turnpike that was specific to our needs and handled all of the technical issues, like which exact pieces of real estate were subject to the lease, and how the employees would be handled, and what about the pension fund for the retirees, and the much bigger issues about what would toll rates be, what would the maintenance requirements be.

That is an extremely long and laborious process to develop that document in a way which we believe is fully -- covers all the bases it needs to cover and grapples with all of the policy issues you need.

So that was months and months and months of work, and, you know, hundreds of hours of us in meetings and on conference calls doing that. And I think that that document went through 40-some drafts before we got to the end and we finally had a document.

At the same time, Rob, principally as the point person for the effort, was working with the bidder groups to try to get them to understand what exactly is this roadway, to get work with the Turnpike Commission, to get inspection teams, so that they can go drive up and down the roadway and see what they would be bidding on, and look at the bridges and look inside the tunnels and all of those things. So many of the teams sent groups out.

We did not discriminate between any of the teams of the original 14 that responded, but what happens in these processes is that it requires a great deal of commitment on behalf of a private bidder to go through the months of due diligence that is required to put them in a position where they can satisfy themselves and their lenders that the bid that they are submitting is a good bid for them and a good bid for us.

And so that requires the expenditure, honestly, of millions and millions of dollars, and the less serious of the people who had expressed interest gradually dropped out is what happened.

It got to the point where in the early part of this year, we had four groups that were still active. And at a certain point, we got word back that for a variety of reasons, one of those groups might drop out, but they were wondering if they could be given the authority to go and potentially pursue a new partnership.

And what happened is that Citigroup and Abertis began speaking to each other, and they had started out as separate bidding groups and they eventually came to an arrangement with one another and merged into a single bidding group, which had the real sort of operating, toll road operations and financial power of Abertis, which is one, as we know, one of the biggest private toll road companies in the world, as well as just the pure financial power, obviously, of Citigroup, which is, I think, the oldest bank in America, I believe.

So when we got down to the wire, we had three bidding groups, and the magic of this process really is doing everything we can to get them to bid against one another to offer absolutely the highest price.

I mean, it's no secret that, you know, they are profitmaking companies and their goal here is to get this project into their company and hopefully make a profit doing it. Our goal is to maximize the number of dollars that are available for the Commonwealth to fix roads and bridges in a way that protects the public interest on the roadway, that assures that it is operated professionally, that the tolls are reasonable, and that all of the maintenance and reconstruction work gets done.

And the question always was the question that we started with, which is, is the public-sector option or the private-sector option going to provide more money for the priority of the Commonwealth, which is road and bridge repair or transit?

We went to New York, we got the bids delivered, we opened the envelopes, and we found that the high bid at that point was $11.26 billion in the first round, and that was not the bid by the team that won. It was a bid by the Goldman Sachs group.

But the bid procedures that we had published said that if the highest bids were within 10 percent of one another, we could go back for a second round.

So we called the bidders back, Rob did, and informed them, the two high bidders, that they were within 10 percent of one another, but we didn't tell them who was higher or how close they were or all of the things they would have loved to have known. We said, you have 1 week; go back and sharpen your pencils.

One of the things that happened within that period is that some of the lending institutions and other financial partners that were originally affiliated with the third team that did not make the final round were all of a sudden out of a deal.

They did not have a bid anymore and they got released, and all of a sudden you had additional lenders and additional equity providers who were available to potentially one of the other teams.

So this team and the other team spent the week furiously scurrying around trying to add more partners to their teams to increase the number.

And so I think our feeling is that the best and final offer round was really a feature that was added to the process in Pennsylvania that did not occur in Indiana or Chicago road-leasing deals, which really has added value for us and gotten us really a better multiplier on the bids.

Once again, a week later, when the envelopes were delivered, we opened them and we found that the Abertis team had been, by virtue of being able to add some additional capital, had increased its bid by over $2 billion, and at $12.8 billion was, by far, the high bid. The second bid came in at 12.1 -- is that right? -- $12.1 billion.

What that bid is, I mean, what they delivered to us is a letter of credit for $100 million, which guarantees their bid.

They deliver a bid form, which basically says, I agree to provide to you, Commonwealth of Pennsylvania, the following amount of money according to the terms and conditions you have specified, and I agree to sign, in a legally binding way, the concession agreement that you have provided to me and that we have provided to the committee.

So the next step is for us to propose legislation, because right now, the Commonwealth does not have legal authority under which the Commonwealth could actually accept the bid, accept the money, and lease out the roadway, because the roadway is currently authorized to be operated by the Turnpike Commission.

So our lawyers have drafted a piece of legislation -- and I would like to introduce Mr. Shea from the PENNDOT counsel's office. He is raising his hand over there. He was very deeply involved in the drafting of the concession agreement and the drafting of the legislation. And to the degree the committee has technical questions about that, honestly, he's going to be the best resource.

And so we drafted a piece of legislation which would essentially authorize the Commonwealth to enter into the contract that has been drafted in the form of a concession agreement, go through a process of reaching closing, turn over the operation of the roadway to the concessionaire, and receive the funds into the treasury and a method for receiving and then investing those funds, as we have discussed at some length with the members of the committee.

So that is sort of how we got to where we are today. I will just reiterate at the end that the Governor's goal here has always been to try to get the best deal for the taxpayers in terms of fixing the roads and bridges in this State and paying for public transportation, which as everyone here, you know, knows better than I, there has been a long, long period of insufficient investment in these facilities, be they roads or transit, that we have all struggled with, and most of you much longer than I, to try to figure out a way to how to really close the gap.

His goal has been to do that in a way that protects the toll payers, protects the maintenance of the turnpike, but maximizes the dollars. He believes and I believe that the lease is the best way to do that, and that is why he is pursuing it.

And we would like to especially express our appreciation to Mr. Evans and Mr. Cappelli for joining us in this effort, and to you, the gentleman as the Chairman, for holding this hearing so we can explore it.

CHAIRMAN MARKOSEK: Okay. Thank you very much, Roy.

MR. KIENITZ: Thank you.

CHAIRMAN MARKOSEK: Rob, did you have anything specifically, or can we go into questions now? Is that---

MR. COLLINS: Well, maybe it would be helpful, just from a financial perspective, to share why this is a terrific deal.

And I think there has been a lot of press about $12.8 billion, but I think there are really three reasons that we see this at the very high end of our range of $12 to $18 billion dollars, and that is, first, we did publish a report in May 2007 where we estimated that the Commonwealth could receive between $12 and $18 billion dollars.

On page 1, we looked at three alternatives. We have been working for the Commonwealth since March of 2007, and one of the things we identified was that if tolling was consistent with the Chicago Skyway and the Indiana Toll Road, it was possible to get to the high end of the range of $18 billion.

We have a much different tolling schedule here. So the actual range that we show for a 75-year lease is $5 to $16.8 billion, and that's on page 3 of our report.

So I think that I can talk in more detail to the extent there are questions, but from a financial perspective, we believe this is a very compelling deal. And the multiple, compared to the Indiana Toll Road, is the same with respect to -- that was a $3.8 billion deal for 157 miles; this is a $12.8 billion deal for 500 miles. They are both

$25 million a mile, which we think is a terrific value.

CHAIRMAN MARKOSEK: Okay. Thank you.

I just really have one question, and I have been maybe one of your more vociferous critics of the process that this has been conducted in.

MR. KIENITZ: Yes.

CHAIRMAN MARKOSEK: I will use the word "secrecy" here, or behind closed doors. However you want to say it, I think we all know that if PENNDOT or the Turnpike, you know, bid their construction projects this way, first of all, it would probably be -- it would be illegal and certainly would not be in keeping with the Sunshine Act. But nevertheless, this is a different animal, as I understand.

On May 9th, you had the bids come in, if I have the date right, and at that point in time is when you had asked other folks or the other bidders or the close bidders to rebid.

Can you tell us who the high bid was at that point in time, and, you know, how did the current so-called winning bid or selected bid---

MR. KIENITZ: All right. We had--- I'm sorry.

CHAIRMAN MARKOSEK: Go ahead, Rob.

MR. KIENITZ: We had three bids received on May 9th. There was, let's see -- I'm doing this from memory, but I'm sure you have the information in there -- an $11.26 billion bid from the Goldman Sachs-Transurban group; the bid from Abertis and Citigroup was $10.6 billion; and the bid from the Macquarie-Cintra group was $8.1 billion. And that was surprising to us, because that was really quite a bit lower than the other two. And as I think folks here may know, Cintra-Macquarie was, by far, the high bidder in both the Chicago Skyway leasing process and in the Indiana Toll Road process.

So we opened the envelopes. We were somewhat surprised at the results. I think we were gratified. I mean, I think as some folks here know, I had been talking to Stacey and telling her sort of, you can expect interest soon; I think we're going to get an answer very soon, and then we go and we open the envelopes and then the answer is, we don't have an answer. So we sort of had to kind of string people along a little bit to give the process another week.

I think the bidding teams, honestly, had asked for more time. They didn't want to go on May 9th, and when May 9th came, they didn't want to have just

1 week to get it done, and it was really our job to press and press and press to try to get this process compacted as much as possible.

We then basically told them that 1 week later, they should deliver their revised bids. And then Rob spent basically most of that week on the phone with members of the various teams trying to, you know, pump them up and get them to believe in the value of the roadway and add additional, you know, equity and loan providers to the teams to make sure that they had the financial capacity to give the highest bid possible.

So if the Chairman would like, what I can do is actually just make Xerox copies of all of the forms that were provided by all of the bidders on each of those dates and the attestations that we have that the lawyers provided as to, you know, "the following envelope was received in a brown manila envelope with the words 'Cintra-Macquarie. Please Deliver' on the outside, and we opened the envelope, and the following documents were inside, and they read as follows...." And we have attestations that were signed by people present just certifying all those things.

I have copies of that, and we can provide that to you.

CHAIRMAN MARKOSEK: And just a quick question about the shelf life of these bids.

We've hit one deadline. You know, June 20th has come and gone. I understand now there's a 30-day extension on the current bid. I mean, I'm assuming it is the same 13.8 for another 30 days.

How many of these 30-day extensions is a typical bidder or this bidder willing to -- are we going to go on ad infinitum on these 30-day extensions?

You know, at some point, I have to think the market changes and the bid is no longer appropriate.

MR. KIENITZ: I think it is fair to say, it might be best to have the team speak to that question.

I think our view is, as long as they are willing to extend it and we have a debate going on, we would hope that they would do so. Obviously, it's their money and not mine, so I'm not in the driver's seat.

They certainly expressed a willingness to do a 30-day extension. I think that we have all discussed extending it sometime into the fall when the Legislature will come back after the summer recess to give some period for consideration in there. But they can speak to that better than I can.

Obviously, if there are major unanticipated events in the capital markets that could affect the possibility of them extending -- but they would best speak to that.

I would say the precedent honestly is that in the past, the bids are submitted, they are due for a certain period of time, and consideration up or down happens within that window. So I think we are a little bit in unchartered territory as to how long this thing can go on.

I will say that, and they can speak to this better than I, but my impression is that they are serious about this, they are here to stay, and they are not going to walk away after 30 days because they didn't get an immediate consideration.

And, you know, I think the Governor's view here is this is a serious proposal by a serious group of people that deserves a serious airing in forums just like this.

Let's take the time, and at the appropriate time, there is going to be a vote one way or another, either in the House or in the Senate, and it will rise or fall on the merits.

And that is really what we want, like every other proposal the Governor makes, for it to rise or fall on the merits. We think the merits are on our side, other people disagree, and that's the debate we are going to have.

CHAIRMAN MARKOSEK: Okay. Thank you.

I think it's appropriate that if a cell phone is going to go off, that it had a transportation motif to it, a train whistle. So would you please turn off your cell phones, BlackBerries, et cetera, please.

I would like to recognize Representative Geist for a question.

REPRESENTATIVE GEIST: Thank you very much, Joe.

I just have one question, Roy.

MR. KIENITZ: Sure.

REPRESENTATIVE GEIST: And this would go to your financial brain trust.

What is the bottom line on the real moneys that will be received to the State after the payoff of all the turnpike obligations? There have been so many numbers put out there and so much disinformation.

And then would you also codify for us how much that income off that would represent in liquid fuels and other methods that we currently raise money?

MR. KIENITZ: Well---

REPRESENTATIVE GEIST: I wish the Secretary of Transportation were with you today to answer these questions, and I hope that if we have any further hearings, that we will have the Secretary available.

MR. KIENITZ: Okay.

REPRESENTATIVE GEIST: Since he is both the Secretary of Transportation and also a voting member of the Turnpike Commission, and I think that becomes incumbent upon the Administration to put the top official in charge here in front of us.

And I know that Joe and I discussed this earlier, and I would sure hope that he could turn up.

So if you could answer that question on, when you subtract out all the obligations, how much money and what does that really represent? Because we talk millions and billions. It is really hard to reason in those amounts.

MR. KIENITZ: Right.
REPRESENTATIVE GEIST: I just use a penny a gallon at $63 million to kind of be the baseline for analyzing everything.
MR. KIENITZ: Right; right.
REPRESENTATIVE GEIST: And I know that Morgan has done much, much more far extensive work than that.
MR. KIENITZ: Yes.
REPRESENTATIVE GEIST: So that's the question.
MR. KIENITZ: I will summarize it, and then Rob can maybe provide some of the details.
The total bid is $12.8 billion. The first thing that has to happen is that the Turnpike Commission has outstanding debt that is secured by the roadway. That is tax-exempt debt. If you have a private operator for the roadway, the IRS does not allow you to have outstanding tax-exempt debt.
So that debt needs to be paid off. I believe that that is in the range of $2.7 billion?
MR. COLLINS: All in that, $2.3 billion.
MR. KIENITZ: Right. Well, the total is $2.7 billion, or $2.6 billion. They have, however, cash assets, reserve funds, and other accounts that

the Turnpike Commission controls which are held in reserve against those obligations. Once you liquidate the bonds, those reserve funds and everything can go into part of liquidating the bonds.

So we believe, through the analysis of our bond experts, that the net defeasance cost is $2.3 billion. So you subtract $2.3 billion off the top of $12.8 billion and you get $10.5 billion.

You can then take $10.5 billion, and there are a number of things that need to happen with that, the first of which is, our proposal is that that funding be deposited into an investment fund of some kind.

The suggestion that the Governor has made is to make an arrangement with the State Employees' Retirement System, which has a very strong record of investing large sums of money and earning well, to grow earnings over time.

A number of things would have to be paid. And the goal here would be to generate annual payments out of that fund to go to PENNDOT to pay for roads and transit.

A number of pieces have to be paid out of that, the largest of which is general revenue for roads, bridges, and transit.

A couple of smaller pieces are State Police costs. Right now, State Police patrols of the turnpike are paid out of the Turnpike Commission's operating budget, and if that operating budget goes away and is replaced by the lessor, that has to be paid.

So we have proposed to subtract an annual payment out of the earnings from this fund and transfer that to the State Police budget. Our assumption is that that starts out at $33 1/2 million in the first year, and then we have an assumption that there is a 3-percent growth per year after that.

There are a couple other miscellaneous items that will need to be paid.

There are current Turnpike Commission retirees. There are, I think, 1,800, 2,000, something like that, Turnpike Commission current retirees, and I may be overestimating that number. I don't have that number off the top of my head.

There are some ongoing legacy costs, we assume that the Turnpike Commission normally would simply pay out of its operating funds. If the Turnpike Commission becomes a radically smaller agency, they may be able to make some payment towards that, but probably not the entire amount.

Our actuaries have estimated that the totals or actuarial value of that is not large, $50, $60 million, something like that. That could be paid as a one-time item to set up a fund to earn and pay that over time, or it could be just paid like the State Police. Every year we take out a small amount of money, a few million dollars, and that gets paid.

The final issue is that there is going to be some portion of projects, construction projects on the turnpike, that are currently underway or will be underway at the time that the signing occurs and that the changeover occurs, and we had a very long internal debate over this.

Theoretically, the reason that you go to private bidder is in part so that they will take over all the construction projects and try to bring private-sector operating principles to them and do them efficiently.

But I think we ultimately came to the conclusion that trying to take an existing contract where a contractor is rebuilding a bridge, interrupt it at a point in time, de-authorize the contract with the Turnpike Commission, get that same contractor to write a new contract with a new entity that is operating the roadway, that that would just create enormous confusion in the implementation of these projects.

So what we said is that the capital projects that the private operator will be responsible for are those that commence after the date of the signing, and if there are any hangover costs on projects that are underway at the time of the signing, that those will be the responsibility of PENNDOT to pay for.

We have estimated, based on a -- it is a little bit hard to estimate what the cost of that is going to be. We know what all the projects under way are now. We have a reasonable idea of how much work has been done and how much cash has been paid out. But the final number really depends on what date the signing actually occurs on.

For the purpose of this analysis, we have assumed, you know, December 31, 2008, at midnight. We think that the overhang value of that will be $390 million approximately, and we figure that if PENNDOT pays about $40 million a year, between $40 and $50 million a year for first number of years out of the fund's earnings, that that could pay down and cover those projects.

That number may be the subject of some debate, because it is impossible for any of us to say what the exact situation and how much will or won't have been paid as of some future date that we don't know what the date is. So I understand that there has been some discussion of that.

So our view is that that is the totality of costs that need to be paid. You know, and I'm sure we will have a lot of debate about this later, if you take that amount of money and deposit it in the fund, grow earnings over time at the historical rate of return that service has earned, it generates on average about $1.1 billion a year over time, over the first 10 years and obviously escalating after that.

Our estimate is that that is between 10 and 15 percent higher than the payments under Act 44. To put it into terms, as Mr. Geist said, I think that that is about 17 cents of gas tax that would, if we weren't to have those funds and we would need to replace them with gas and diesel taxes, it would be the equivalent of about an additional 17 cents a gallon. I think everyone here understands that in the current environment, that would be a nonstarter.

So that, I hope that answers your question.

REPRESENTATIVE GEIST: Let me follow that up.

What we need on this committee, and especially from Morgan and the Governor's Office, is bulletproof numbers. There are entirely too many people throwing numbers around out there that are inaccurate.

MR. KIENITZ: Okay.

REPRESENTATIVE GEIST: And rather than publicly spanking them with the process of press releases, I really believe that we really need hard facts.

And the other thing that I think we need to bring out of all of this discussion is that when you are done with this process, the State is totally relieved of debt.

There is no reigning issue then other than to upgrade Pennsylvania's ability to carry debt, thus with the rest of the stuff we float, guaranteeing us a lower rate. Is that correct?

MR. KIENITZ: The debt that would be relieved is Turnpike Commission debt, and the Turnpike Commission debt is, as I understand it, it is a pledge of the revenues of the Turnpike Commission and its ability to impose tolls on the roadway.

The reason that they are able to get a good rate in their borrowing is that the internal covenants that govern the Turnpike Commission say that the members of the commission have the power to vote to raise tolls to any level necessary in order to meet their financial obligations.

Now, there has been a public announcement that it is the intention of the Turnpike Commission under Act 44 to raise tolls 25 percent on January 1, 2009, and 3 percent per year thereafter, and that's the benchmark that we have used in putting the lease deal together.

But the nature of the Turnpike Commission's obligations to its creditors is that they have an obligation to raise tolls to whatever level is necessary in order to repay that debt.

So in the past, frankly, the Turnpike Commission's toll increases have been I think below the level of increases generally seen nationally. I think we all understand that that is going to change now whether or not we have a lease or a publicly operated system.

But the limitations on toll increases on a private operator are a contractual obligation that they absolutely may not raise tolls above a certain level, and the net result is a change in the risk.

If you have a private operator, if traffic goes down or gas prices increase and people stop using the turnpike, or for whatever reason they don't get the amount of revenue coming in that they expect, they are at risk. Their shareholders are the people who bear the risk.

In a publicly operated system, if that same thing occurs and people stop using the turnpike, gas prices are so high or for whatever reason, it is ultimately turnpike users who are at risk, because the commission will have to raise rates in order to be able to pay off its debt.

So that is one of the main features of a lease arrangement, is that it really shifts on whom the risk falls.

CHAIRMAN MARKOSEK: Okay. Thank you.

We have right now nine members that want to ask these two questions, so I would ask everyone to make your questions very direct---

MR. KIENITZ: And answers as well, sir. Sorry.

CHAIRMAN MARKOSEK: ---if you could, please.

Representative Tony Payton from

Philadelphia.

REPRESENTATIVE PAYTON: Thank you, Mr. Chairman.

I have a couple of good questions.

In terms of what was said, I know that you said they spent a lot of their own money composing the lease, and I heard this gentleman say that "we" were working for the Commonwealth.

Just could you clear that up for me in terms of what was said, just to make sure?

MR. KIENITZ: Okay.

REPRESENTATIVE PAYTON: Are they working for the Commonwealth while composing the deal, or is that something that they did on their own?

MR. KIENITZ: I'm sorry. I was imprecise of speaking of two different groups.

The bidder groups -- Abertis and Citigroup, Cintra-Macquarie, Goldman Sachs -- they are working for themselves. They are spending their own money based on their view of whether this is a good deal for them or not.

REPRESENTATIVE PAYTON: I understand that.

MR. KIENITZ: Morgan Stanley---

REPRESENTATIVE PAYTON: He said "we" were working for the Commonwealth. I just wanted to clear that up.

MR. KIENITZ: "We," in his words, is Morgan Stanley.

REPRESENTATIVE PAYTON: Okay.

MR. KIENITZ: Morgan Stanley is under contract with the Commonwealth. The nature of that contract prohibits them from having any financial relationship on this deal with any of those other players. So they are working for us solely, and they are only going to get paid, frankly, if there is a deal.

I mean, the nature of our contract is a success fee. If there is a successful transaction, they get paid; if there isn't, they don't. So currently, he's been paid zero, I believe.

REPRESENTATIVE PAYTON: Okay.

MR. COLLINS: If there is a bond deal, our contract is set up such that we would be agnostic. Whether this deal actually passes or there are leveraged bond deals with the Turnpike Commission over time, we would ask to be considered to represent the turnpike in those deals.

REPRESENTATIVE PAYTON: All right.

And the next question is, how does this lease benefit mass transit?

MR. KIENITZ: The Governor's view has always been that a significant portion of these funds should go to mass transit. The benchmark that was arrived at in Act 44, I believe, was 44 percent of the funds went to transit and 56 went to road and bridge construction.

I think the Governor's view is that that was a fair deal. If there is 15 percent more money to pass out, then our view would be then there's 15 percent more money for public transportation. I suspect that this committee would want to have a say in that question, because people are always very interested in how we are spending money.

And so I think that would be the Governor's position; I'm not sure it would be everyone else here's position, so that is something we will have to spend time talking through, to see if we can reach an agreement.

REPRESENTATIVE PAYTON: Okay.

And another thing that you said is that, in what we are taking out from that $12.8 billion figure, you said the normal cost for roads and bridges, and in your estimation, what would that be?

MR. KIENITZ: That is simply money that gets transferred out of the Investment Fund into the

Motor License Fund to pay for the PENNDOT's 12-year capital plan.

REPRESENTATIVE PAYTON: How much is that currently?

MR. KIENITZ: How much is PENNDOT---?

PENNDOT right now spends $4.5 billion a year, I believe is the number, and that's a combination of State funds and Federal funds, and this would add about a billion. This is about a billion, so it would be that portion.

REPRESENTATIVE PAYTON: All right.

Thank you very much, Mr. Chairman.

CHAIRMAN MARKOSEK: Thank you.

Representative Miller.

REPRESENTATIVE MILLER: Thank you, Mr. Chairman.

I think it is indeed fortunate for the people of Pennsylvania that we are having this debate during these economic times.

I understand that the 12-percent return was based on a 20-year period, basically of SERS returns?

MR. KIENITZ: Correct.

REPRESENTATIVE MILLER: If I look at that chart, at the start of the 20 years, they were pretty good returns.

Have you shifted that chart, those returns, so that the 3 or 4 years where we had some very poor returns were front-loaded, assuming that we borrowed this money right now, the economy truly is in a downturn, which I might question, but let's assume it is, and over the next 3 or 4 years we have very bad returns and it is not front-loaded like the chart that was used, what that does to the actual returns and what that rate of return would be.

MR. KIENITZ: We did do something similar to that, although I will let Mr. Collins speak to that, because he may know more about it than I.

When we went back 20 years and used the actual returns, as you know, of the Employees' Retirement System year by year, and they have years when it is 20-plus and years when it is 1, and I think they had a negative year in there, after that came out, one of the reporters called me up and said, I suspected you guys were up to a trick, so I actually went back and looked back every year that the Employees' Retirement System has had market rate investments, and that goes back 28 years, I believe, to 1980 was the first year in which they were allowed to invest in equities.

And those first years coincided with the other significant down period in the SERS returns. It was the sort of the recession that was at the beginning of the Reagan years, '80, '81, '82, and so those were a couple of fairly poor years, and that analysis started with those years. And that analysis found that over the 28-year average, the average annual return on investment was actually slightly higher than the 12 percent that was estimated for the 20-year period.

So I'm not sure if we have done the exact analysis that you have suggested, but that 28-year picture actually pretty closely mirrors that exact scenario.

MR. COLLINS: And I would just add to that, as we really cut the numbers and did a deep dive on this, there have been years where service has been down as much as almost negative 11 percent. And SERS, over time, has done a terrific job of under-promising and over-delivering. They project 8.5-percent increases per year.

Over the last 20 years, as has been said, we have actually used the actual returns they have had. We have done it just using a 12-percent average, which still equates to about $1.1 billion a year.

Really, the main bumper sticker for all the work we have done is for any investment return over 5 percent. So even if the $10.5 billion or so is invested in treasuries and just the ultra-safe securities, that would create more proceeds for the taxpayers of Pennsylvania than Act 44 without tolling I-80.

REPRESENTATIVE MILLER: Okay. And just a real quick follow-up.

In your testimony, you said that you did look at the current retirees and providing for the cost of those.

MR. KIENITZ: Yes.

REPRESENTATIVE MILLER: But if we privatize the turnpike, we will have many employees now that are participating in the State retirement system that will not be.

What would be the loss, the impact of the loss of those retirement funds coming into this system? Has the Administration looked at that?

MR. KIENITZ: Honestly, I mean, the assessment that was done by our actuaries was that we take all of the existing Turnpike Commission retirees who are retired as of now and are on the system, and we can track them, and you value the actuarial cost of that.

And then you make some estimate of the people who are employed today but could choose to, either at the choice of the company for management employees or at their own choice for collective bargaining employees, not to transfer over to the new company. That might be a few hundred. We made an estimate of what that is, but those are individual decisions, so we can't really know in advance.

I think that the effect of a few hundred less people in the State Employees' Retirement System over the long term, given the 90,000 current employees we have, is going to be de minimus. But we did attempt to model the cost of those few hundred people who might not be moving on with the new company and calculate that into our assumption of the costs.

REPRESENTATIVE MILLER: Okay. Thank you.

MR. KIENITZ: And anyone who transfers over, their pension and health benefits would now need to be provided by the operating company at their expense.

REPRESENTATIVE MILLER: Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Okay. Thank you.

Representative Tina Pickett.

REPRESENTATIVE PICKETT: Thank you, Mr. Chairman.

Could you just, in the essence of an overview, give us the picture of why the turnpike offer might be better for Pennsylvania in general than Act 44?

MR. KIENITZ: Well, to really summarize it succinctly, I think it is three points.

Our view is that if the money is invested well, which this Employees' Retirement System has a very long track record of doing, it provides 10 to 15 percent more resources to repair roads and bridges and fund public transit. So that is, from the Governor's point of view, the most important reason.

The second reason, though, is it places a contractual cap on the ability of tolls to rise that does not exist when you have the public agency operating the roadway, and that is a level of security that some people might find comforting.

The third of which is, Abertis, you know, has a 40-year track record of being one of the largest toll road operators in the country, and their record is really one of bringing technology and innovation into the operation of these roadways.

And we think that their ability over the long term is to use better technology, create more convenience, more reliability for the user of the roadway, that they have a much greater ability and likelihood of doing that and really improving the operations of the roadway and making it less costly, more efficient, and more useful to the driver, and so we think that that's a benefit.

Those are really the three benefits that we see.

REPRESENTATIVE PICKETT: A lot of your comments were for that road in general, but how about all of the transportation users of Pennsylvania. Do they really come up better with this deal?

MR. KIENITZ: I would break other transportation users in Pennsylvania into three categories.

Transit users. Absolutely we think they are benefitted under the lease plan, because there are more funds available to fund public transit.

Drivers on Interstate 80. If you don't do a lease, I think the assumption is that Interstate 80 tolling will be the way that the Commonwealth raises funds for transportation, and so those folks will be paying tolls that they don't pay today.

And for people who are neither of those, who just use the other roads and bridges in Pennsylvania, those roads and bridges will have more money dedicated to their repair and upkeep.

So we think for non-turnpike users, it is a better deal, and for turnpike users, the level of tolls will be the same, the maintenance schedule will be the same, and it is our hope that the operations will actually be more efficient and more streamlined, and that would be a benefit.

REPRESENTATIVE PICKETT: Thank you.

CHAIRMAN MARKOSEK: Thank you.

Representative John Maher.

REPRESENTATIVE MAHER: Thank you, Mr. Chairman.

There certainly are important philosophical questions involved, but I'm going to skip past the philosophy for a moment and observe that if one makes a decision that privatizing the turnpike is the route to go, it is essentially trading, under this proposal, 75 years' worth of revenue for a bucket of money today. Is that---

MR. KIENITZ: Well---

REPRESENTATIVE MAHER: It is a financing transaction.

MR. KIENITZ: It is 75 years of revenue

being paid to the Turnpike Commission for $12.8 billion being paid to the Treasury.

REPRESENTATIVE MAHER: So the bucket that we have in front of us is $12.8 billion.

MR. KIENITZ: Right, but my only point is that money going to the Turnpike Commission and money going to the Treasury in Pennsylvania, that's a distinction with a difference.

REPRESENTATIVE MAHER: That's a very important distinction. That is fair.

So the swap is 75 years' worth of revenue for a bucket of money today. Obviously, it would seem to me that the goal should be to have the biggest bucket of money today.

And you describe the process in terms that the private sector perhaps is inclined in that direction, but help me with a bit of arithmetic.

Government can borrow money at a lower cost than the private sector, so the cost of money to government is less than the cost of money in the private sector.

MR. KIENITZ: Well---

REPRESENTATIVE MAHER: And if we are swapping a 75-year stream of dollars for a bucket of money today -- we are essentially doing a financing transaction -- if the cost of money for government is lower because of tax-exempt attributes---

MR. KIENITZ: Yes.

REPRESENTATIVE MAHER: ---how can we possibly get a bigger bucket of money by ignoring tax-exempt financing instead of taxable financing?

MR. KIENITZ: I will give two answers to that question, the first of which is, government is able to borrow at a lower rate than private business because of tax-exempt financing. However, private business can write off expenses against their taxes, and in this case, the depreciation expense is a big expense of the roadway.

If you look at the Turnpike Commission's financial statements for last year, there was more than $200 million of depreciation value.

When you have a tax-exempt entity, they report their depreciation, but they do not do anything with it. It does not advantage them. When you have a private company that has that amount of depreciation, that radically changes their tax profile with the Federal government. So that tends to equal out, to a certain degree, the theoretical value of the money.

The second of which is, ultimately the

theory is interesting, but what we are really interested in is, who is actually proposing what?

We know what Act 44 is. We know how much it provides, regardless of how it was arrived at. We know what this bid is. We know how much it provides, regardless of how it was arrived at. And the question really is, what is the relative value of the two streams of income we would get regardless of how they are arrived at? That is the comparison we use.

REPRESENTATIVE MAHER: So if I understand correctly, your theory is that because businesses have deductions on their tax returns, but you still pay taxes, somehow that makes them better off than an entity that not only doesn't pay taxes but is able to borrow money at a rate where those who are receiving the interest do not pay taxes on that.

But you think that because governments get to write it off, that they are better off? Is that right?

MR. KIENITZ: Well, I mean, this is a well understood principle of business finance, and I can allow my Wharton School M.B.A colleague here to go into greater depth, if you would like. But it is not my theory; it is a theory---

REPRESENTATIVE MAHER: No, it's a very interesting theory. Well, let me move on.

It is a very interesting theory, and I will observe that from my C.P.A. days, anytime somebody goes, oh, that's a deduction, well, if you want to give me a buck and I will give you 28 cents back, and if you feel you are better off for the experience because you got a deduction, I will do that with you all day long. But I guarantee, at the end of the day, you are not going to feel richer for the experience.

Now, Morgan Stanley's arrangement, as I understand it, he mentions a success-based deal.

MR. KIENITZ: Yes.

REPRESENTATIVE MAHER: Now, if the government were actually to simply go out and borrow money, does Morgan Stanley get paid?

MR. KIENITZ: If the government were to go--- Not for any--- I guess I do not understand your question.

REPRESENTATIVE MAHER: Well, Morgan Stanley gets paid if this transaction goes forward. How much would Morgan Stanley get paid?

MR. KIENITZ: They would get paid 12.5/100ths of a percent of the aggregate value of the---

REPRESENTATIVE MAHER: So $12.8 billion. I am guessing, Rob, you have probably done this math. How much do you get paid?

MR. COLLINS: Well, it is 12 1/2 basis points on the total value up front and certainly noncontingent payments.

REPRESENTATIVE MAHER: You have not done your arithmetic?

MR. COLLINS: We have looked at our range of numbers. It is moving because of the interest rate, which we addressed a little bit.

But I think that your question is a very good one, Representative, because our engagement letter is such that we would get paid if there is a taxpayer bond over time, if there is a good-faith endeavor on behalf of the Commonwealth to recognize the work that Morgan Stanley has done for the taxpayers.

And so we would, if there is a bond deal in connection with the Act 44 or otherwise, we would be involved in those transactions.

The way that our engagement letter is set up is as a dual track, so that when we did the study a year ago, we could evaluate comprehensively the

Commonwealth's strategic alternatives.

REPRESENTATIVE MAHER: All right. So you haven't figured out what $12.8 billion times whatever your percentage is? Hasn't Morgan Stanley been interested enough to do that arithmetic?

MR. COLLINS: I think we have done the math, but I think it's---

REPRESENTATIVE MAHER: Well, how much? Just tell me, in round numbers.

MR. COLLINS: In round numbers, it is in the $20 million area.

REPRESENTATIVE MAHER: $20 million.

MR. COLLINS: And that is consistent, just to show some perspective, the Indiana Toll Road deal was a $3.8 billion deal, and there were $20 million in engagement fees that were paid to the firm that did that. The Chicago Skyway was $1.8, and that was $10 million.

So in other words, the taxpayers of Pennsylvania are getting a terrific deal on the investment fees of this transaction for 10 times that.

REPRESENTATIVE MAHER: But you do not get that $20 million unless we do this deal.

MR. COLLINS: We would get something similar to that over time.

REPRESENTATIVE MAHER: You would?

MR. COLLINS: Yes.

MR. KIENITZ: Our original proposal---

REPRESENTATIVE MAHER: That is quite an arrangement.

MR. KIENITZ: Our original proposal was that we did not want the incentive system operating for them to be -- if there is a lease they get paid, but if the public finance alternative that we originally envisioned competing with the lease is a better deal, we didn't want them biased in favor of one or the other.

So we wrote a contract with them that says, if we engage in a public finance deal that the Governor sort of controls, that they would get a fee out of that. If we did a private finance deal, they would get a fee out of that.

Now, Act 44 ends up sort of being neither of those two things, but that is really a reflection of our goal, to make sure that they were neutral as to the method and were only incentivized as to the total number.

REPRESENTATIVE MAHER: So if the Turnpike were to go out and borrow this bucket of money and that Morgan Stanley had nothing to do hands-on with that transaction, you would still get paid? No, you do not get paid?

MR. KIENITZ: No. If we were---

REPRESENTATIVE MAHER: I am confused now, because I thought you just said that they would be neutral, so I'm just checking.

MR. KIENITZ: If we were to have enacted the piece of legislation that the Governor proposed last year, and that had resulted in a publicly financed deal---

REPRESENTATIVE MAHER: But we didn't do that. So as of today, if we do this deal, Morgan Stanley gets $20 million. If we do not do this deal, you don't get paid.

MR. KIENITZ: They would be eligible to participate in the bond deals that the Turnpike Commission will do over time and like any other bond underwriter.

REPRESENTATIVE MAHER: Rob, did you expect that you would get paid if we do not do this deal unless you enter into some other contract? Under your existing contract, do you get paid if we do not do this deal?

MR. COLLINS: Under existing contracts, we will be given a good-faith review for the future of bond transactions that are always discussed.

So we believe that we are in this for the long term with the State and with the Commonwealth of Pennsylvania, and from that perspective, we do not look at any one transaction just purely on the fees.

REPRESENTATIVE MAHER: And then just one last question, and this is really a Wall Street question.

There is some difference of opinion about the substance of the vote last week in the House which rejected this specific proposal, and there are some questions about -- and I am not certain I completely understand the answer -- questions about whether or not, since this specific proposal has been rejected by the House of Representatives, whether it can possibly be enacted.

I might expect and I suppose people on Wall Street would expect that if Pennsylvania were to continue down the path on this specific proposal, that there are any number of folks who might have merged and litigate the question as to whether or not Pennsylvania can in fact embrace this specific proposal.

Has anybody started forming an opinion on whether this litigation would begin, and do you expect it is in the Common Pleas Court, the Commonwealth Court, Supreme Court, where this would -- or is there a Federal nexus? And I suspect, because you have got to handicap this risk, do you have any thoughts on that?

MR. KIENITZ: I will give you my opinion on that, which is, I do not think that there is any question that the action on the House floor last week has affected the ability of the Commonwealth to enact the bill introduced by Representative Cappelli and Representative Evans.

There is no legal theory under which the ability of the Commonwealth to enact that bill has been called into question by the amendment that was offered. I do not think there is any confusion on that point.

REPRESENTATIVE MAHER: So you take the specific rejection of this specific proposal as being nonbinding?

MR. KIENITZ: No. There was an amendment offered on an unrelated bill that had nothing to do with the terms and conditions of House Bill -- whatever is it -- 2593.

REPRESENTATIVE MAHER: So House Bill 2593 -- and I have to confess, I have not actually read it front to back -- but House Bill 2593 then has nothing to do with this deal?

MR. KIENITZ: No. House Bill 2593 is a piece of legislation that is considered like any other.

If a member chooses to stand up on the floor, speak to the general topic, and offer an amendment to an unrelated bill, that is, of course, his or her right, but it has no legal bearing on the procedural question of where House Bill 2593 stands and---

REPRESENTATIVE MAHER: So your suggestion is that Wall Street should ignore the risk of litigation here.

MR. KIENITZ: I would never want you to be ignored, sir, but I do not think it poses any risk.

REPRESENTATIVE MAHER: And, Rob, you are comfortable that Wall Street--- I can see by your look you do not really want to address this. That is okay. I will let you go.

Thank you.

CHAIRMAN MARKOSEK: Thank you. Thank you, John.

We have three more questioners: Representative Harper, Representative Carroll, and Representative Hess.

Representative Harper.

REPRESENTATIVE HARPER: Thank you very much, Mr. Chairman.

This question is for Roy.

MR. KIENITZ: Yes, ma'am.

REPRESENTATIVE HARPER: I voted for Act 44 because I felt that it would provide mass transit and particularly SEPTA with a stable source of funding in the future.

In fact, this budget season has been notable, because I am no longer bumping into the SEPTA folks in the hallways begging, whining, threatening, because they need the money.

Now, if I understood your earlier answer, though, you are saying that the Governor is committed to mass transit, which does not surprise me, but I have a real-world question: What does that mean? Does that mean that the money that is invested, whatever it throws off, goes into the General Fund?

I read the summary of the bill, 600 pages long. It suggests that the investment board, which is basically the Governor and two Secretaries, determines not only the investments but also how much money gets paid over and when.

MR. KIENITZ: Yes.

REPRESENTATIVE HARPER: So my question to you is, does that mean it just goes back into the budget mix and SEPTA is going to be up here every year, as they have previously been, you know, trying to get a stable source of money?

And it is important to me, because I know that the Turnpike is already paying them, and I know that they are already using that money.

MR. KIENITZ: Yes.

REPRESENTATIVE HARPER: And so I need to know whether this -- how does this deal work in real life for mass transit?

MR. KIENITZ: I will answer that in two ways, the first of which is, I think specifying a greater level of detail about whatever discretion is granted to the folks managing that money use that I think is something that is going to require further discussion generally, and certainly within this committee, to try to nail that down as much as possible.

I think the Governor's view would certainly be that that money should not be just transferred into the general treasury and be the subject of the annual food fight that we have here about paying for things.

But I think the Public Transportation Trust Fund that was established by Act 44 is an excellent structure that this Commonwealth has been needing for a long time and was finally created last year with the help of many people here.

And so our view would be, that would be a minimum standard of dedicated funding for transit, just as we dedicate money for highways. The specific mechanisms of that, I think, need to be worked out as part of the legislative process.

REPRESENTATIVE HARPER: Okay. So the quick and dirty answer is the current legislation that we are reviewing this morning does not have any set-aside or mechanism to provide mass transit with a dedicated stable funding source, but you would be amenable to some sort of an amendment that might allow that. Is that what you are trying to say?

MR. KIENITZ: Yes. Our view was that our time would most productively be spent in doing the thing that our experts were best at understanding, which is the lease transaction and the generation of the funds.

The type of thing that this group has the greatest expertise at is Commonwealth finances, how to arrange them, how to dedicate funds to the right things, and that those arrangements were best worked out in the legislative process, and that is what we would like to do.

REPRESENTATIVE HARPER: Thank you.

One tiny little follow-up, Mr. Chairman. It will be very quick.

Where does the gentleman sitting to your left get the $20 million?

MR. KIENITZ: If the transaction goes through, he would be paid out of the proceeds, or his company would be paid out of the proceeds of the transaction.

REPRESENTATIVE HARPER: Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Okay. Thank you. Good question.

Representative Mike Carroll.

REPRESENTATIVE CARROLL: Thank you, Mr. Chairman.

Roy, in your testimony, you mention that this process started back in September and October of

'07, and it seems to me at that time, Act 44 was just in its infancy.

MR. KIENITZ: Correct.

REPRESENTATIVE CARROLL: The bill and the act were done in July.

The question I have is, it seems that Act 44, being in its infancy, we haven't even, really at that time in September and October, had not even begun down the path.

Why was the decision made and what was the thought process that resulted in "let us move forward with this alternative" when the push was on and when the agreement was made and the bill was passed to bring forward Act 44?

I am confused by why we changed course so quickly after enacting Act 44.

MR. KIENITZ: That was a decision of the Governor, and from speaking to him about it, I think I can explain what I understand of his thinking, but it was his thinking, and so I will do the best I can.

I think it is really two things, the first of which is, he was always convinced that the possibility of a lease could bring a larger amount of money. And I think he was somewhat frustrated last year when the Act 44 process didn't give really any serious consideration to the possibility of a lease.

But given the nature of the crisis that was existing for SEPTA and the Port Authority and the other transit agencies at that time, he was in no position to say no to an agreement that the Legislature had come up with to provide funding for those needs, if it was not his preferred option.

So the first of which is, he has always been a believer that a lease could potentially be an even more lucrative funding source.

The second of which, I think the precipitating event was the bridge collapse in Minnesota, and he saw that as a real wake-up call for us and for the country that any possibility that we have to do more than we are now doing is something that we have an obligation to pursue. And I think that really crystallized in his mind the idea that, like Act 44, it was a lot more money than we had before. That's a good thing. But if we can generate an even greater amount through some other system, we have a responsibility to pursue that to try to see if that is true.

So we spent many, many months, as you know, getting to this point. We believe now the answer is, yes, it is more, and so that is why we are here.

REPRESENTATIVE CARROLL: Thank you.

CHAIRMAN MARKOSEK: Okay. Thank you.

Our last questioner: Representative Dick Hess.

REPRESENTATIVE HESS: Thank you, Mr. Chairman.

Roy, just two quick questions.

MR. KIENITZ: Yes, sir.

REPRESENTATIVE HESS: Going back to the bonds, the 2.7 in outstanding bonds to be repaid. On those outstanding bonds to be repaid, are those bonds all callable?

MR. KIENITZ: Are they all callable?

REPRESENTATIVE HESS: Callable.

MR. KIENITZ: Well, I believe, and others understand this better than I, there is a mixture of contracts, and some of those are just standard bond contracts that I think can be called. Some of them are contracts on which swap agreements have been entered into, interest-rate swaps.

As you know, the Commonwealth itself is not authorized to enter into interest-rate swaps, but the Turnpike Commission may do so. So in order to pay off some of those bonds, you need to go in and liquidate the swap contracts, and there are some payments that are due to some of the counterparties in those contracts.

At the end of the day, all those bonds can be paid off. The process that you would go through with some of them is relatively simple, and with some of them it is relatively complicated.

REPRESENTATIVE HESS: Okay. One quick question.

In your answer to Representative Pickett when she asked several questions, your statement was that the maintenance problem, maintenance will continue the same as before.

MR. KIENITZ: Yes.

REPRESENTATIVE HESS: How can you say that it will when it will be a different company operating it?

MR. KIENITZ: Well---

REPRESENTATIVE HESS: I mean, they can operate it at their speed.

MR. KIENITZ: Right. The reason for that is really two things, the first of which is, the Turnpike Commission right now has a 10-year capital plan which lists by item hundreds and hundreds of capital projects that they intend to do over the next 10 years. We have simply taken that list and incorporated it into the text of the concession agreement. So that is the first thing. And they are operating off essentially the same list.

The second thing is that the way that these concession agreements have worked in other places is we are establishing numerical performance standards -- you know, international roughness index measurements for the roadway, and that is an internationally recognized way to determine how smooth a road is, and bridge sufficiency ratings, which is the national rating established that is used all over the country -- and the private operator will have to actually meet standards and be audited against those standards. And if they are not meeting the standards, then they will have to cure them, and if they do not cure them, then we can take the roadway back.

Those are a set of requirements which will necessarily cause them to spend very large amounts of money making sure that they are meeting those standards so they are not in jeopardy of default.

The Turnpike Commission over its history has had a varied history. I think right now, I think that everyone understands that they are entering into a somewhat more aggressive reconstruction program that has been past practice. But in many years, the reluctance to raise tolls has really led to many years going by without a whole lot of those standards being met.

So once again, as with tolls, the private operator is subject to a contract which requires them to meet certain standards, and the public agency is not subject to any such hard requirement.

REPRESENTATIVE HESS: Thank you.

MR. KIENITZ: Yes, sir.

CHAIRMAN MARKOSEK: Okay. Thank you very much, gentlemen. You did well. Thank you.

MR. KIENITZ: Thank you, sir.

I apologize; I have to go up -- we are having a leadership meeting on an energy bill, so I have to run up to that.

CHAIRMAN MARKOSEK: I understand. You are busy folks.

MR. KIENITZ: And Mr. Shea is here from PENNDOT, if there are any further questions.

CHAIRMAN MARKOSEK: Thank you. That was a lot of good information. We appreciate that.

MR. KIENITZ: Thank you.

CHAIRMAN MARKOSEK: Just so the folks know here, we can go until about 11 o'clock. The rules state that we can be here until they take master roll, and I think they are going to hold that off until right around 11.

And then we are going to be back in this room, if we do not finish, by about 2 o'clock this afternoon. Session should be over. There is a funeral that a lot of members have to attend, so we do have the room here.

So whatever we do not get through here this morning on the agenda, we will do again at about 2 o'clock here in this room. Great.

We welcome our next set of testifiers here. The winning bidders, for lack of a better term, selected bidders, the Pennsylvania lottery here today: Mr. Jordi Graells, who is the Managing Director of North America and International Motorways for Abertis Infraestructures, SA, and President of Abertis USA; and Michael B. G. Froman, Managing Director and Head of Infrastructure and Sustainable Development Investments for Citi Infrastructure Investors. Boy---

MR. FROMAN: Isn't that a mouthful?

CHAIRMAN MARKOSEK: Yeah; it is not even

that early and I'm having a hard time with that one.

And I see another old favorite here, back by popular demand, Rob Collins from Morgan Stanley, who we welcome again.

So gentlemen--- Jordi, would you like to go first? Mr. Froman?

MR. FROMAN: Thanks very much, Mr. Chairman and Chairman Geist, and you have our written testimony, so I will not go through all of it, but we will try and touch on points and allow you to get to questions as soon as possible.

I am Mike Froman. I am from the Citigroup, City Alternative Investments, Citi Infrastructure Investors. That is the part of Citigroup that invests in infrastructure assets in the United States and around the world.

I do not think that Citi needs much of an introduction here. It is one of the leading U.S. financial services firms with operations in over a hundred countries and has had a longstanding presence in Pennsylvania, having over 8,000 Pennsylvanians who work for various Citigroup businesses and being active in the community here.

We are pleased to be here as part of the winning consortium with our partner, Abertis, who together we make up the Pennsylvania Transportation Partners, and we are pleased to present our $12.8 billion bid, which, as Rob had gone over before, was $700 million more than the next highest bidder.

The two members of Citi Infrastructure Investors have had extensive experience in overseeing and managing toll roads successfully around the world, including the United States, Europe, Australia, and Latin America.

We have broad and deep backgrounds in a number of infrastructure sectors, including airports, ports, and utilities, and our recent investments include a water company in the United Kingdom and a partnership with Vancouver Airport Services to manage 18 airports around the world.

We are excited and honored to bring that experience to Pennsylvania with regard to the turnpike.

Today I wanted to touch on three issues.

First, our view that the public ownership and private management model of the Pennsylvania Turnpike is in the best interests of Pennsylvanians, the users of the turnpike, and the Commonwealth itself as it will provide a better roadway for the Commonwealth, import best practices and new technologies to improve the soundness of the road and the safety of its users, and improve the overall experience, and my colleague, Jordi Graells, will go into detail about that.

Secondly, as has been discussed, it is the only option that puts $12.8 billion of investments into the Commonwealth, plus a contractual commitment to invest another $11 billion to expand and improve the road, which would allow the Commonwealth to address its urgent infrastructure needs.

And thirdly and very importantly, the lease allows the Commonwealth to transfer a number of very important risks to Pennsylvania Transportation Partners, to this consortium, and by way of risks, and I will go into this a bit later, I mean about the risks of decreased traffic, increased fuel prices, increased cost, and market instability.

As has been mentioned, Pennsylvania Transportation Partners is committed to providing the highest standards for the roadway. Just to address, I think it was Representative Hess's comment earlier, we have an extensive maintenance and operation commitment, and it is a commitment that -- I am not sure whether it was Representative Hess or Representative Carroll; I'm sorry -- that not only maintains the highest standards internationally of maintaining a roadway, but it is a commitment that the Commonwealth can change over time.

If standards change over time, the Commonwealth has the ability to increase the maintenance and operation standards that we have to uphold or we will be in breach of the agreement, and that is an important theme throughout this lease discussion.

This is not the privatization of the turnpike. The Commonwealth retains ownership of the turnpike and, in many ways, retains important elements of control over the turnpike, including over the maintenance and operation standards over the life of the turnpike.

As Chairman Geist mentioned earlier, there has been the Pennsylvania Transportation Funding and Reform Commission that has cited more than $1.7 billion of needs for infrastructure in Pennsylvania: the 9,000 miles of roads that are in poor condition; the 6,000 structurally-deficient bridges; the fact that Pennsylvania ranks number one in the country in terms of State-owned bridges that are over 75 years in age.

And as was mentioned, as the first anniversary of the collapse of the bridge in Minnesota approaches, we are reminded that doing everything we can to get those repairs done quickly should be of utmost priority.

This lease brings in a $12.8 billion investment up front, plus an $11 billion commitment to capital expenditures, to fund investment in roads, bridges, and mass transit, resulting in the acceleration of critical repair and maintenance projects of the Commonwealth without banking on the tolling of I-80.

Issues of driver safety are too important for politics as usual, and between the fixing of the bridges and roads and the technology that we intend to put into the turnpike to manage safety and incidents better, we think this is in the best interests of the Commonwealth's drivers.

And finally, as an important issue for Pennsylvania's economy, the Federal Highway Administration estimates that for every billion dollars invested in surface transportation, more than 47,000 well-paying jobs are created. This will allow more money to go more quickly into infrastructure and create more jobs here in the Commonwealth.

Very importantly, the lease shifts important risks to Pennsylvania Transportation Partners from the Commonwealth, the users of the turnpike, and Pennsylvania's taxpayers.

While the Commonwealth retains ownership of the turnpike and retains important elements of control, we, the private managers, assume the risks of lower traffic, higher costs, and market instabilities.

Under the terms of the lease, toll increases after the first year are capped at the higher of inflation and 2.5 percent. If traffic decreases, we cannot increase tolls beyond that to make up for the volume. If the costs of maintenance or construction increase, we cannot increase tolls to compensate. And if the markets go through the sort of instability we have seen recently, we cannot raise tolls or reduce payments to the Commonwealth.

None of those protections apply if the lease is rejected. Instead, the risks of lower traffic, higher costs, and unstable debt markets would remain those of the Turnpike Commission and, ultimately, of the Commonwealth's taxpayers and road users.

From our perspective, from a purely

financial perspective, the choice is stark: a $12.8 billion investment up front, at least $11 billion of further investments, capped tolls, and reduced risk versus no up-front investment with the Commonwealth assuming the full risk of increased debt, lower traffic, and higher costs.

We look forward to working with you and your colleagues as this bill is considered, and thank you for taking the time to have this discussion.

CHAIRMAN MARKOSEK: Thank you.

Mr. Jordi Graells for brief remarks, please.

MR. GRAELLS: Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: You are welcome.

MR. GRAELLS: Thank you.

It is a pleasure for me to be here to have the opportunity to explain to you some of the features of what we are going to do here and how are we going to manage, how are we going to incorporate new elements of high value to this turnpike.

A few words on us beforehand.

We are a group that has been here around in this business for 40 years already. We started in banking in 1967 as a consortium company in Spain.

We have evolved into being a very large group, operating 60 businesses, different businesses, in 17 countries on four continents. We are about 12,000 people globally, worldwide, working in this industry.

We directly manage some 2,000 miles of toll roads, and we also participate in the management of an additional 3,000 miles of toll roads as well.

So we are present in Europe and France and Spain, in Portugal and Italy and England. We are in Africa; we are in South Africa. We are in Latin America. We also are in Puerto Rico.

We also operate a number of assets, a number of facilities here in the United States, especially in the airport business. We are operating Concordia of Atlanta International Airport as well as other airports in the United States, such as Orlando Sanford, Burbank, and other airports in Georgia.

We also operate on the U.S. territory of Puerto Rico, the toll bridge of Teodoro Moscoso in San Juan.

So we are here already. We are well known for being, you know, very close to whoever is around us there.

We are going to explain a little bit what a leasing concession is, in our opinion, after our experience. We have been around for 40 years, as I said.

We think that the leasing concession, again, of an infrastructure like this will provide several benefits. There are sites that will benefit, including the transfer, again, of long-term risk of traffic and revenue, together with the reconstruction costs to the private sector, as the whole turnpike will likely have to be reconstructed over the length of the concession.

The second big element is that -- and I will, you know, focus on that in a few minutes -- is the increased efficiency in the operations and management of the turnpike.

We think that we would bring abilities, practices, methods, procedures, that will significantly enhance the operation and the management of the turnpike, and the maintenance. We are going to focus our activity on the user and on the facility.

And then there is another thing that we have, that you will have us as a benefit of this leasing concession agreement, which is an increased accountability for our activity.

We are subject to a huge number of controls in Pennsylvania, from the DOT, from the PENNDOT, and then we will likely, you know, to be explaining everything that we do in terms of standards, performance, and the like.

You already know, because as has been extensively explained to you, that we are subject to a very strict operation and maintenance manual set up for this schedule, which was not there before, so we are going to have to work better than before.

And we also, we will incorporate something like which is the best practices in tolling and the electronic, you know, solutions for keeping track of the traffic and being able to provide a fast response to any incident in the roadway. This is something we will talk about a little bit later to you.

And, of course, the last but not least element is the up-front payment. Remember that this is $12.8 billion. It is not only the largest infrastructure dealing in the United States; it is also worldwide. So it is something to be considered.

We will work closely with the Commonwealth, with the DOT, to ensure that the turnpike will be maintained to highest performance standards all the time and that it provides a safe and swift journey to the users. We have a very good track record on this worldwide.

We have a lot of experience on these types of deals. I will cite one of them.

Some 3 years ago we were in a very similar process in France. We were the bidder that was the winning bidder in the signed leasing concession agreement, and then there was a $10 billion deal.

We, well, some of the management transition challenges that we will have here happened there, so we have a very recent experience on how to deal with something that was similar in size. Actually, it was 1,000 miles of toll road in France. So we are going to have similar requirements in terms of standards and maintenance and operations.

So we have a very recent experience. You can see that. And you will see that, you know, France's government is very happy with that management there, and we are working closely with them all the time.

In terms of capital and expenditures, we have a long experience and expertise on the maintenance of payments, structures, tunnels, traffic, electronic equipment, tolling systems, landscaping, traffic signals, and all the other possible projects that are going to be here.

We will bring the newest and most efficient tolling systems, and we will improve safety and efficiency throughout the Commonwealth. We are going to be very, very outstanding on this, believe me.

There is something in the lease concession agreement which is very good for the future of the roadway, which is that this is a long-term contract.

It has got a toll, a schedule, which is foreseeable for the future. This allows us and will allow us to plan in the long run, to have long-term plans for maintenance, for roadway reconstruction, for adding new lanes -- something we have to do as needed, as the traffic needs it -- and to, well, not to have to neglect maintenance and neglect or to overspend in some periods.

We have another experience. We are focused on the maintenance, on the facility.

We are also going to be focused on service to the user. The user deserves the best attention.

We are going to have, you know, a fiber optics installed along the roadway so that it lets us have an instant communication with all those persons in the roadway, having cameras all the time, 24 hours a day, having fiber messaging so that any incident that is taking place in the roadway will be detected in, well, of course, you know, a very few minutes, and then the response will be organized from the operations center.

We will have also a fleet of people going around all the time to intervene to have a very short time response to the user.

We have something like 2,000 different types of incidents detected, characterized, so that we have a protocol for each incident: what to do; what to do first, second, third, and so forth, every day, every year, and when there appear new types of incidents, very, very rare. But, you know, most of them, it is in the range of 2,000 that can be taking place in the highway.

This center, this control on the roadway, will provide fast response to the users 24 hours a day, 365 days a year. Well, this is going to be much better than what it is now. They do not have, just images and moving images to any place, so their response is, frankly, much slower.

Well, and then the toll systems. We are going to move along with the technology, of course. You know that there is something called E-ZPass, which is a part of here. There is something called I-PASS in the area of Illinois and then in some parts of Florida.

These three groups are trying to find out a common standard for evolving into that. There is a lot of discussion. We will eventually go there. We will be updating all the technology all the time to provide the users with the best possible technology.

As well as, we will deal with the user, you know, so that the user knows that he is being taken care of, such as providing with some kind of discounts for frequency or rebates for consumption.

So this is something we do already in France and Spain, and it works very well. It creates a really, you know, reliable base of customers that, you know, appreciate this kind of thing.

So in short, we are going to be working hard to provide a first-class type of facility with a first-class type of service to the users, and we are going to get engaged, you know, with knowing everybody along the route and all the communities to know their needs and to be, you know, frankly, useful for them and a development engine for that.

CHAIRMAN MARKOSEK: Okay. Thank you very much, gentlemen.

I have a brief question.

I know Abertis and Citi have formed a partnership, a consortium, Penn Trans Partners, I believe it is, as it is called. Who exactly will be signing the lease agreement? Will each of you sign as individual companies, or will Penn Trans sign as the consortium?

And the follow-up to that is, can somebody drop out down the road if you sign now, but if Citi down the road runs into problems, can they drop out? Can they sell the mortgage, so to speak, to some other bank?

I see that Mr. Collins is shaking his head. Would you like to take this?

MR. COLLINS: Sure, Mr. Chairman.

Just to immediately address your last question first.

With respect to, can Citigroup or Abertis withdraw or change the ownership of Pennsylvania Transportation Partners? They cannot without the Commonwealth's prior consent. And so it is very clear in the concession agreement that this is a long-term public-private partnership.

Ultimately, the way we structured it where it is all paid up front, that is really the ultimate club to ensure compliance, and so the Commonwealth does have approval rights on changes in ownership.

CHAIRMAN MARKOSEK: Who actually signs then?

MR. COLLINS: Pennsylvania Transportation Partners will sign and select them.

CHAIRMAN MARKOSEK: Okay. And what does happen if one of the partners runs into financial problems 5 years down the road, for example?

MR. COLLINS: I think this is structured as a separate LLC, and so effectively it is a limited corporation partnership that will be nonrecoursed to their parents.

But if something happens to the partnership -- it is a very good question, Mr. Chairman -- in that case, there will be a period, an opportunity for them to cure. So their lenders can appoint another operator to stand in and continue to operate the road for a period of time.

If that is not satisfactory, the Commonwealth will take back the road ultimately, and that is the ultimate cure for a default or bankruptcy or anything else that happens in an Armageddon situation.

CHAIRMAN MARKOSEK: Okay. I believe that Indiana is having a similar problem to that right now, if I am not mistaken, with their concessionaire or one of their partners there. Can you shed some light on that?

MR. GRAELLS: Well, actually, when we created this company, this PTP company we are talking about, the partners put their equity there, and then this company is incurring to debt from third parties, which is no recourse to the partners.

So if one of the partners has problems, it is going to be their problem, not the problem of the company, because the company will have already the paid in capital, equity capital that they have provided at the outset.

We have to pay that equity capital for paying the investment needed, I mean, honoring the commitment that we submitted in the bid, and this is made of equity and debt. So the equity in that will be the equity of that company.

So if any of the shareholders of that company -- that is, Citi or Abertis -- have problems later on, well, it is going to be their problem. It is going to be not affected. I mean, the company is not going to be affected by that.

CHAIRMAN MARKOSEK: Just a comment.

I have been a little skeptical about some of the talk, not necessarily from you but from others that have indicated that, gee, if this doesn't work out, we just simply take back the road.

You know, my naive knowledge of legal goings-on would tell me differently, that we would have a huge legal battle and perhaps even have to pay some sort of premium to get the road back at some point.

And that is one of the things that, you know, when we say, well, gee, if you have a problem, and I do not want to say that you are incorrect -- because you certainly know more about the financial and probably the legal world than I do -- but I just and I think a reasonable person would look at any kind of a take-back of that road to be a huge, huge monumental legal battle for Pennsylvania and a very costly one as well.

Representative Geist.

REPRESENTATIVE GEIST: Thank you very much, Joe.

You actually took my question, my first one.

And I just wanted to tell you that this morning on CNBC, the Goldman battle with you is not over. They gave you guys quite a shot today on your stocks. So maybe tomorrow you can get even.

In the plans that you have for operating the turnpike, and in the talks that I had with Babcock & Brown and Macquarie and others, they were very succinct in their corporate plans for inducing ridership onto the turnpike rather than stating that ridership was status quo and that we would just add to the tolls.

And they had specific plans, and some of those plans were time-of-day pricing, especially midnight to 6 a.m., with incentives also greater than the pricing for the trucking companies that use the turnpike frequently, the immediate building of slip ramps, the immediate construction of high-speed exits onto the interstates so that they would have congestion mitigation, and there were many others that were mentioned in my office engineering-wise that made very, very practical sense.

Do you have any plans to do those, and are they built into that price that you have on that 10-year plan? And I think that we have to ameliorate a lot of fears about information, once again, misinformation that is out there on professional management of infrastructure.

So if you are going to take that, that would be fine.

MR. GRAELLS: Yes; thank you, Mr. Chairman.

Yes, we are going to make our living out of a good service. So providing the best possible service to the users, either in terms of infrastructure, maintenance, or pure personal service which is essential for, you know, meeting our target, our goals, you know, our company objectives. So we are going to be, out of the pure contractual terms, we are going to be very, you know, creative in that sense.

We will probably, you know, implement some frequent-user discounts. Let us say if a commuter is using the turnpike from A to B, let us say 40 times a month, he will probably get a lower price for each ride after ride No. 20 or after ride No. 15 and a decreasing price.

He will also get probably a rebate of the whole year after, you know, the consumption of a number of dollars on that, and this is going to be applicable, too, to the commercial vehicles. We will study that in detail. We still have to get some more data about the exact amount of traffic which is running from A to B in this turnpike. And then we will figure out if it is needed.

This is really creating a good, you know, feeling with the customers, and this will be effectively increasing our use of the turnpike.

Of course, we are going to also be very creative on these other kinds of things. We will study whether in congested sections of the roadway it is worthwhile to establish some difference of pricing between peak or nonpeak hours, but always within the caps that we have for each trip between A to B, which is what we have right now.

And we are going to be very creative. Probably in the outskirts of Philadelphia, northeast of Philadelphia, it is the section where we can find that possibility of congestion. We will try to derive, you know, the users from peak hours to nonpeak hours, some of them, those that can derive their trips, and that that is going to lead to varied use, the most efficient use of the facility.

So it is, of course, you know, maintaining of the smoothness of the roadway as well as, you know, the extensive use of testing techniques for the capacity of the highway in order to determine the best possible intervention within these mandatory projects, and all the other projects that, you know, are mandatory for us is something that we are going to do extensively, and we will get the best use of each dollar, something which is essential for us.

We want to spend dollars, many dollars, and make the best use of them.

REPRESENTATIVE GEIST: One of the House members insisted that when they write this legislation, there has to be a clause in the legislation that you install 70-mile-an-hour ramps at Valley Forge, and they do not like that interchange. So I said I would say that today.

So, well, the question on inducements. One firm gave me a number that said that with their management and their experience worldwide, that their percentage of inducements of new traffic onto the turnpike would be 20 percent. Is that a realistic number for you?

MR. GRAELLS: I would say for us that a 15-percent figure will be acceptable, and it can be obtained.

REPRESENTATIVE GEIST: Well, I hope you are able to get that message out, because I know that in my town meeting last night and others, that people fear that you will be pushing traffic off of the turnpike onto 30 and 22 and other highways in and near the turnpike, so I think you have got a big mission there.

MR. GRAELLS: Okay.

REPRESENTATIVE GEIST: Representative Miller is not back from Appropriations. Is it okay if I ask this question?

Representative Miller had a question for you: What improvements to the turnpike are anticipated, and who will perform the work?

And the reason he asked that is, there are many rumors about that the legislation and/or the lease agreement has stipulations that only closed shops would be able to bid on work for your firm and the new partnership.

We need to get clear and concise information from you that you will be able to have the current contractors and other people who do work for the turnpike as well as others bid work. And we need to get -- I think that question is actually a very good question that needs to be addressed, and especially by Morgan.

MR. COLLINS: Thank you, Mr. Chairman.

It is an excellent question, and the concession agreement is very clear on these points: The concessionaire must comply with all applicable State and Federal laws regarding nondiscrimination; must comply with the Pennsylvania Prevailing Wage

Act; must comply with the Reciprocal Limitations Act; must comply with the Steel Products Procurement Act and the Trade Practices Act.

And so effectively, the operator will be functionally in compliance with exactly the way the PTC operates today in its contracting activities.

REPRESENTATIVE GEIST: Thank you very much.

I am now the new Joe Markosek. He just took the hall pass and left.

We will proceed down the line, and next on the list is a man who is an expert in light bars and other things like that, Tim Solobay.

REPRESENTATIVE SOLOBAY: Thank you, Mr. Chairman.

If the proposed lease agreement goes through, we obviously, the Commonwealth, realizes that with the up-front payment, we will lose our ability of getting the revenues from the tolling and the other means of revenues along the turnpike.

What other losses will the State realize in revenue loss with the lease agreement as far as maybe taxes paid? There is rumor that there are certain types of property taxes and other revenues that are received via the turnpike that may go away, and what would those figures be and how would that equate out at the overall?

MR. GRAELLS: Just a quick comment before Rob Collins comments.

The only difference would be, current statute is going to be that we are going to pay income tax to the State. That is the only thing different. Everything else will remain the same.

REPRESENTATIVE SOLOBAY: So there will be no other revenue losses to the Commonwealth, other than the toll loss?

MR. GRAELLS: There is not going to be any loss; it is going to be a gain.

MR. COLLINS: It will be a gain, actually.

As was well said, I mean, this is another area where we tried to model exactly the impact to the Commonwealth of the PTC and wanted to make sure that the operator has all the obligations of the PTC.

And as Jordi has said very well, this will actually create a new taxpayer to the Commonwealth of Pennsylvania. There will be no tax revenues that change other than that.

REPRESENTATIVE SOLOBAY: The income tax you are saying you would pay, is that from the employee side of things or from the revenues you that generate off of the operations?

MR. GRAELLS: The profits of the company.

MR. COLLINS: As a business.

MR. GRAELLS: Yes.

MR. COLLINS: It will be a new business. The Transportation Partners will be a taxpayer of the Commonwealth of Pennsylvania.

MR. GRAELLS: And I bet that in a very few years, this company will become one of the biggest taxpayers for the State.

REPRESENTATIVE SOLOBAY: Thank you.

REPRESENTATIVE GEIST: Thank you very much, Tim.

Next is Representative Jeff Pyle.

REPRESENTATIVE PYLE: Thanks, Mr. Chairman.

I want to thank our panel for showing up today.

I gripe about my commute, but Mr. Graells has me beat by a couple thousand miles.

My favorite President, Ronald Reagan, once said "Trust but verify," and you have just cited your experience with these public-private partnerships.

Can you give me examples of other endeavors you might have here in the United States? Like if I wanted to go see how you run your show, where could I go see this?

MR. GRAELLS: A toll road, you mean.

Yes, a toll road is the best place. The most recent experience we have had, which is very comparable to this one, is in France, in northern France. You can go. We operate four out of the seven access roads to Paris, major access roads to Paris, some of them going north to the English Channel, others going to Normandy. You know, they end up in Cannes. Omaha Beach, a very well-known spot by you all, and then the other one going east to Strasbourg to the German border.

This is 1,000 miles of toll roads, and you can see how it works. And it is a very healthy company. It is, you know, very well run, very efficiently and with a lot of expenditures taking care of the road, of the user, and so forth.

And furthermore I would say that we have an experience, a very good experience as well in Spain and other places. But this is a very peculiar place where we have had the experience of running, well, business with the unions there.

You know that France is probably the most unionized country in the world; everybody belongs to a union. And well, it is political unions also, I mean, in that sense.

We have been having in these last 3 years very good experience. There are something like seven yearly labor agreements to be discussed every year. And there are something like 10 biannual or another 10 with 5 annual agreements. So there is a whole library of agreements there, and we are, you know, faring very well.

So we have a lot of experience on that, and that is why we feel very comfortable here, when we will, you know, we will go to the real ground.

MR. COLLINS: And if I could just add one other comment.

REPRESENTATIVE PYLE: Sure.

MR. COLLINS: Morgan Stanley is representing the Commonwealth of Puerto Rico and exploring a concession lease of their toll road system, and the reason they are doing that is because Abertis has operated the Teodoro Moscoso Bridge under a similar concession so well and for a number of years, I believe it is about 15 or 20 years, and I wonder if Jordi might want to comment on that.

MR. GRAELLS: You can also see U.S. airports, as I said before. You know, you can go to Concourse E of the Atlanta International Airport.

You can see that. We operate that.

We also operate a number of other -- another airport in Florida, which is Orlando Sanford, as well as smaller airports in Burbank, California, and others in Georgia.

So these are activities in the U.S. right now. Of course, if you want to go South to Latin America, you can see things in Argentina and Chile and other countries.

REPRESENTATIVE PYLE: Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Thank you.

Representative Tina Pickett.

REPRESENTATIVE PICKETT: Thank you, Mr. Chairman.

I have been in business for many years myself, so I know that it is important to attract your customers to the product that you are trying to sell. And I did find of interest your incentives that you talked about to get people to drive or ride your roadway.

However, people do spend a fair amount of fuss and concern on rising tolls: What will that lead to; will I really have to search for another way to get to wherever I need to go; and this is an important roadway for me to use, whoever that person may be.

Could you just talk again a little bit about, what are the limitations on the tolls, and how does that get measured throughout the entire length of this lease as a long time?

MR. FROMAN: The current PTC plan, as you know, is to raise tolls 25 percent in January and then 3 percent a year thereafter.

This agreement caps our toll increase after the first year at 2 1/2 percent for a CPI. So our cap is actually lower -- well, we have a cap, whereas the PTC does not have a cap under Act 44, and what they have indicated is that their toll increases would be 3 percent going forward.

I think you are on to really the key issue here, because what is really at stake here is a $12.8 billion investment into Pennsylvania or higher tolls on the turnpike and new tolls on I-80, higher gas taxes or higher debt. Those are the various ways you get to the same, try to get to the same funding, if you can, for investing in these roads and bridges and mass transport infrastructure that Pennsylvania needs.

None of those other options are mutually exclusive. You can do this and do other options, but this allows you to bring in more money for critical infrastructure investments sooner, create greater safety in the bridges and the roads, without raising tolls higher than they would be raised, imposing new tolls on I-80, raising gas taxes, or increasing the debt of the PTC of the Commonwealth.

REPRESENTATIVE PICKETT: And those tolls are capped for the entire length of the lease?

MR. FROMAN: The entire 75 years.

MR. GRAELLS: Right.

REPRESENTATIVE PICKETT: Thank you.

How many people are in your consortium? How many groups?

MR. GRAELLS: How many companies, do you mean?

MR. FROMAN: It is ourselves and there is an investor related to Abertis, a shareholder of Abertis.

MR. GRAELLS: Three companies.

MR. FROMAN: Three companies.

REPRESENTATIVE PICKETT: And certainly Abertis gave us a lot of insight today into his transportation experience, but do the other partners also have some transportation experience?

MR. FROMAN: We have, in Citi Infrastructure Investors, people who have come out of infrastructure investing and managing infrastructure assets for more than 15 years, including toll roads, airports, ports, water companies, electricity generation, gas distribution, in North America, Europe, and Australia. So we have people who are a part of our team who have also had direct experience in investing in and managing toll roads.

And I should just, by way just to add to that, this is a joint partnership between Abertis and Citi. It is joint management.

Citi appoints the Chairman, Citi and Abertis jointly appoint the CEO, and Abertis is the day-to-day operator. So it is a true partnership between the two institutions.

REPRESENTATIVE PICKETT: Thank you.

CHAIRMAN MARKOSEK: Representative Harper.

REPRESENTATIVE HARPER: Thank you, Mr. Chairman.

I have been on your road to Normandy and Omaha Beach, and it is a magnificent road.

MR. GRAELLS: Thank you.

REPRESENTATIVE HARPER: I do not have any worries about your ability to run the road in an efficient way, although you could use a few more women's restrooms, which seems to be a problem worldwide.

MR. GRAELLS: We will fix it.

REPRESENTATIVE HARPER: But my concern relates not only to the people that I represent who use the road mostly as a commuter road, but also to the people who live alongside of the road.

Does the lease give you -- and I do not know who wants to answer this -- the ability to use eminent domain to expand the road, put in slip ramps, or otherwise do things near the road?

MR. GRAELLS: Yes; I will take that.

This road has a public domain area, a right-of-way of 200 feet wide along the road, which is something that spans from the Delaware River through. So, well, there is quite ample room there to add lanes from the sections that are two-by-two or three-by-three to either three or four.

So we do not see any prospect of having to buy additional land at the sides for expansions, because at least a 200-foot wide strip is enough for building most of the things. So---

REPRESENTATIVE HARPER: But my understanding is that some of that 200-wide right-of-way has already been used, and I am speaking of the stretch which is the busiest on the turnpike, from Willow Grove to King of Prussia and from Plymouth Meeting to Lansdale.

MR. GRAELLS: We have calculated, we have seen and we have inspected the road all through, and we see that a four-by-four section is going to be able to fit there. So there is not going to be any need to make any additional purchases of land.

REPRESENTATIVE HARPER: But on the Northeast Extension specifically?

MR. GRAELLS: Right; on any section of the road.

So the right-of-way is already there. It is already bought, was bought when the road was built. So there is ample room for fitting new lanes there.

So we do not see any need for that, except maybe at the end of the 75-year period in some very, very specific places, but that probably is not going to happen.

REPRESENTATIVE HARPER: And my next question is, are you going to be paying all of the taxes than any other Pennsylvania business would be paying?

MR. GRAELLS: We are going to be paying the taxes that are set by the---

REPRESENTATIVE HARPER: I think you said you limited them.

My question is, are you going to be paying everything that a Pennsylvania business is paying?

MR. COLLINS: There are certain taxes that, given the unique nature of this transaction and the fact that it really is a partnership with the Commonwealth, so that if the Commonwealth is actually selling the road, then the Pennsylvania Transportation Partners would be asked to pay gross receipts taxes and property taxes and everything else.

The fact that the Commonwealth owns the road and is merely leasing it created a situation where the taxes, we wanted the Commonwealth to be tax neutral between the Turnpike Commission and the PTP.

So the net result of all that -- and this is a long way of answering your question -- is that, as Jordi said, this will create, in a number of years, probably the single largest taxpayer as a business in the Commonwealth of Pennsylvania. But today it would be neutral from the overall tax receipts perspective.

REPRESENTATIVE HARPER: Well, neutral because it is already in public hands. But if we are going to put the road in the operation thereof and the collection of tolls into private hands, what taxes are they paying and what taxes are they not paying? Just give me the answer.

MR. COLLINS: They are not paying gross receipts tax or property taxes on the road.

REPRESENTATIVE HARPER: Thank you very much, Mr. Chairman.

CHAIRMAN MARKOSEK: Thank you.

Representative John Maher, with Representative Payton on the on-deck circle.

REPRESENTATIVE MAHER: Thank you.

Good to see you again.

I am going to follow up on Representative Harper's question.

You know, seventy-five years is a fairly long period. Heck, I might even be retired by the end of that. And the turnpike, the nation's first superhighway, the world's first superhighway, is not even 75 years old now.

Now, when it was established, it ran from Carlisle to Irwin, and I presume the best thinking of that time in the 1940s was that a road from Carlisle to Irwin was fantastic, which it was, and that was the best thinking of the day.

Now, if the turnpike, 60-some years later, still ran from Carlisle to Irwin and nowhere else, we would, I think, all agree that probably would not be the best answer for today's conditions.

So across 75 years, what arrangements exist in this agreement that would allow the operators to add exits, remove exits, add extensions to the road? Are there provisions that would allow you to extend where the road travels to or where the exits are or to close exits?

MR. COLLINS: Maybe I can just answer it at a high level and then we can do a deeper dive, if you would like, Representative.

With respect to modifications, and it is an important question, the Commonwealth will always have the right to force the PTP to make changes to the road that the Commonwealth believes are in its best interests, and that will be an engineering discussion on assigning relative benefits, because there is a situation where there is a win-win scenario that the Commonwealth wants a new road or a new interchange somewhere, and that will increase revenue to the PTP. And so from that perspective, it will be a negotiation.

And the spirit of this agreement -- and I have it right here -- it is 500 pages of operating standards and it is 200 pages of actual requirements on this front in terms of setting the framework for the partnership over the 75 years, and it is really set up to create a framework of negotiation such that the Commonwealth can always improve and enhance transportation in the Commonwealth.

MR. GRAELLS: You know, this is a PPP. This is a type of PPP which is a public-private partnership. That is, both parties are talking to each other all the time.

They are, you know, assessing the changing needs of this elusive sector, which is transportation, which changes all the time, you know, the needs change. And then every new need will be assessed and, well, a solution will be worked out from both parties, of course within the limits of the facility that this company will be operating.

Of course, there has got to be some new interchanges. There is the initiative of the authority, the DOT. Well, there will be a negotiation. The company will invest the moneys. And, you know, if the revenues, the additional revenues, cover that additional investment, that is going to be okay for everybody.

And if we find that there could be a sizable, you know, a good, interesting need to change somewhere or to change an existing interchange, well, we will propose that to the authority.

Remember that we have to have every single project, every single design, every single construction that we do, approved by the DOT all the time, every time. We are under close scrutiny of the DOT, and they will actually be upon us and they will, you know, be of service. They will represent the public interests, and we will be working gladly for them.

REPRESENTATIVE MAHER: Thank you.

In the interests of public transparency, I probably should mention that Mr. Graells and I had the opportunity to meet maybe 10 days or so ago, and I will observe that, frankly, I think you are brilliant.

With your MIT pedigree, you are a very, very smart guy, and even though I was candid that I am not enthusiastic about this particular proposal, I did commit to you that I would do my best to bring it to a vote, and I am happy to have obliged.

MR. GRAELLS: Thank you.

REPRESENTATIVE MAHER: I want to ask you

about the entity.

MR. GRAELLS: Well, of course. There has got to be, you know, a large debate; we are starting the debate. This is only the first step of the debate.

There is, you know, a whole contract here. This is a system which is very useful, and we, again, are talking about the same thing -- $12.8 billion and improving management and the relief of the burden, the possible burden on all the taxpayers of more taxes or higher tolls than we will have or tolls where there are not tolls yet.

REPRESENTATIVE MAHER: Well, this really is a borrowing. It is just not enumerated in currency.

Pennsylvania is essentially borrowing $12.8 billion, and to repay that debt would be providing you the use of this road and all the revenues therefrom for 75 years.

That is a long piece of debt, in my mind. And we can call it a lease or we can call it a borrowing, but we are borrowing $12.8 billion and paying you back with the road.

And then this gets back to the question -- and I think you were in the room when we were talking about the relative size of buckets of money, and we heard Mr. Kienitz observe that business has the advantage of paying income taxes, and therefore, being able to deduct depreciation on calculating your income taxes.

I am curious, Mr. Froman, do you find your obligation to pay income taxes to be a competitive advantage?

MR. FROMAN: Well---

REPRESENTATIVE MAHER: And if you do, would higher taxes further advantage you?

MR. FROMAN: That sounds like a subject of a longer discussion.

I think, as I recall, Roy was answering your question about why not just stick with public borrowing, and I will defer to Rob who is more of an expert in this than I am.

But I would say the difference between the lease and the $12.8 billion and the $5.5 billion of capital expenditure is, this is new money coming in to Pennsylvania. This is equity, which, of course, the PTC doesn't have, and debt that we bear the risk for versus borrowing $31 billion or so that the PTC would do instead.

So there is a choice there of whether we prefer to put $31 billion of debt on the books of a Commonwealth entity or bring in $12.8 billion plus $5.5 billion in present value terms of the new capital to Pennsylvania, including equity and debt. And that is really the difference of the capital structures, as you know.

REPRESENTATIVE MAHER: And if I could go with one further question then.

Speaking of the equity versus debt, this Penn Trans Partnership, PTP, as I understand it, it is a new entity created for the special purpose of taking on this lease.

You know, we have seen in recent years businesses that folks would have thought of as being as solid as the Rock of Gibraltar just disappear overnight, boom -- Arthur Andersen, Enron, TheWorld.com, Bear Stearns, and the list goes on and on and on.

What is the current equity, what is the balance sheet of Penn Trans Partners? What do you own?

MR. COLLINS: Well, maybe to address the question from the standpoint of risk to the taxpayers of the Commonwealth---

REPRESENTATIVE MAHER: Well, no. This is

just a simple, not a philosophy question; it is a simple -- it is a balance-sheet question. What does your balance sheet look like? What are your assets? How much assets, how much equity, how much debt? What do you have?

MR. FROMAN: I think the way to answer it is that the Pennsylvania Transportation Partners is the vehicle through which Citi Infrastructure Abertis and Abertis will deliver $12.8 billion to the Commonwealth.

REPRESENTATIVE MAHER: So I am thinking you are telling me there is nothing there at this point -- zero.

MR. FROMAN: It is a vehicle through which we invest.

REPRESENTATIVE MAHER: Okay. But right now, the balance sheet, is there equity? Is there cash? Is there anything?

MR. COLLINS: I mean, I think the real answer is there is $6 billion of equity right now that they want to transfer to the Commonwealth along with $6.8 billion of debt, and so that's---

REPRESENTATIVE MAHER: So Penn Trans Partners today has $6 billion in the bank.

MR. COLLINS: They have $6 billion of

committed capital---

MR. GRAELLS: Less the debt.

REPRESENTATIVE MAHER: Oh, okay; not real money but a commitment for more.

MR. GRAELLS: $1.8 billion.

REPRESENTATIVE MAHER: Now, let me ask you this follow-up question: In terms of performance, because 75 years is a very long time, the full faith and credit of Abertis, the full faith and credit of Citi, are they pledged to this special purpose entity, or is the only backing for performance going to be this entity that currently has nothing?

MR. COLLINS: Well, we thought about actually doing that as part of this agreement, and if this was an agreement that was going to pay $450 million a year like Act 44 will without I-80 tolling, which is really the apples-to-apples comparison, we would need to do that.

The facts are that because PTP will pay the $12.8 billion up front as an investment, that is really the guarantee to the Commonwealth that this entity will survive.

They have $12.8 billion of their capital they are transferring to an investment for the Commonwealth, and they have to perform under this contract or they lose that investment for the life. And the Commonwealth can ultimately release the asset or reconstitute the Turnpike Commission if that was decided by the Legislature.

REPRESENTATIVE MAHER: So if one of the parents over the course of these 75 years were to encounter difficulties -- and I am not forecasting and I certainly hope it doesn't happen, but let us say Citi or Abertis were to go into bankruptcy -- what, of course in the case of Abertis, have we sorted out which nation's bankruptcy courts would decide who will receive the asset of the ownership interest in this road? What nation's courts?

MR. COLLINS: The U.S. courts, so this would be---

MR. GRAELLS: Just for the U.S.

REPRESENTATIVE MAHER: So for Abertis, if a parent goes bankrupt in Spain---

MR. GRAELLS: No effect.

REPRESENTATIVE MAHER: Well, I would assume that somebody would say, well, this is one of your assets, and in a bankruptcy, those assets are going to go to somebody. I am asking, who makes that decision?

And I do not understand your answer that it would be a U.S. court deciding on a bankruptcy in a Spanish filing.

MR. COLLINS: Well, this is a stand-alone corporation that would be---

REPRESENTATIVE MAHER: But somebody owns it.

MR. GRAELLS: This is---

REPRESENTATIVE MAHER: I am saying the folks that own it, if they go bankrupt---

MR. GRAELLS: Let me just say something.

This asset is not our asset. We don't own the road; we own the contract. We have a contract. So the contract is ruled by U.S. law.

If we are bankrupt here, our rights are, you know, according to our country, will be ruled here, not in Spain.

We do not own the asset. There is no way to guess---

REPRESENTATIVE MAHER: No, I'm not asking--- I may have confused you.

I am not talking about -- I am not assuming you actually own the road. I am talking about this agreement gives you rights for 75 years.

MR. GRAELLS: Yes.

REPRESENTATIVE MAHER: That has a value to it, obviously, or you wouldn't be here. And across those 75 years, if some unfortunate circumstance were to befall the parent, who decides who takes ownership of your rights under this contract?

MR. GRAELLS: Any change of ownership there will have to be approved by the venture here.

REPRESENTATIVE MAHER: Okay. That is helpful. Thank you.

MR. COLLINS: And just to clarify, the lenders could step in, and say J.P. Morgan would be a lender in this transaction? They could step in and assist---

REPRESENTATIVE MAHER: If the parent goes bankrupt---

MR. COLLINS: Yes.

REPRESENTATIVE MAHER: ---that you have a contractual right---

MR. COLLINS: If there is a lender, yes, and it is subject to their lender agreements. But that is true.

REPRESENTATIVE MAHER: Thank you, Mr. Chairman, and I will conclude. But I will be interested and perhaps you could provide me some analysis as to how these contract agreements can negotiate away the rights of creditors that exist in a foreign country. I do not understand how that is accomplished, but I would appreciate if you could provide that analysis.

Thank you.

CHAIRMAN MARKOSEK: Okay. Thank you.

The next person is Representative Tony Payton, and we will bang the gavel at exactly 11 o'clock. They will take master roll at 11.

So Tony and John Siptroth. Quick questions, please.

REPRESENTATIVE PAYTON: Thank you, Mr. Chair.

Going back to the tolling, looking here it reads, specifically it says that the turnpike, for each vehicle toll class and bid date, shall increase January 1, 2010, and each January 1 thereafter until the end date to the greater of the maximum toll level applicable to the immediate preceding 1-year period being, A, adjusted for inflation "and" increased by 2 1/2 percent.

So that "and," that "and" indicates to me that it is both. So is it both or is it one or the other?

MR. GRAELLS: That is one or the other.

MR. COLLINS: That is true; it is the maximum of either. So either inflation or the

2 1/2 percent.

MR. GRAELLS: The greater of A and B.

REPRESENTATIVE PAYTON: All right. That makes sense, but it is a bit confusing in the way it is drafted.

And if you could quickly answer this for me.

Just please explain to us, just for clarity sake, what perceived deficits would you have or would there be for the consumers of this toll road?

MR. FROMAN: Just to clarify, what would be the perceived adverse effects for the consumers of the toll road?

REPRESENTATIVE PAYTON: Adverse effects; yes.

MR. FROMAN: Are there any downsides for the consumers of the toll road?

MR. GRAELLS: No, not at all. The tolling schedule is going to be the same as it is today.

There is going to be a 25-percent increase in generally the first of 2009, like the PTC is forecasting in Act 44. And then after that, there is going to be a smooth and constant increase of the CPI every year. So the real value of the toll is going to be maintained constant, all the time.

So, I mean, we do not foresee any negative effect of this toll schedule on the user of the facility. Actually---

REPRESENTATIVE PAYTON: And then---

MR. GRAELLS: Actually, as you well know---

REPRESENTATIVE PAYTON: I could add some context.

The reason I asked that question is that there are articles that are coming out about the Indiana Toll Road and the difference in pricing and price gouging, and that is the reasoning behind that question.

MR. FROMAN: That is a very different circumstance.

REPRESENTATIVE PAYTON: So that will not happen under your management?

MR. GRAELLS: No, it will not.

MR. FROMAN: Correct.

MR. GRAELLS: Because we have a different tolling schedule.

REPRESENTATIVE PAYTON: Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Thank you very much.

Representative Siptroth.

REPRESENTATIVE SIPTROTH: Thank you, Mr. Chairman. I will make this very quick.

I have two concerns. Number one, that the oversight is only a three-member board, being the Governor, the Budget Secretary, and the Secretary of Transportation. There is no legislative oversight incorporated in this bill. That is an extreme concern of mine.

Another concern is, what is the disposition of the employees that currently are employed by the Turnpike Commission, the union that represents them, and their retirement status?

MR. GRAELLS: Yes; I will answer this last question.

We have to take all jobs existing -- I mean, everybody which is unionized, we have to honor the existing agreements, which is something which will last for the next 4 years.

And then after that, we will have to renegotiate, as the PTC will have to. And we will have to honor all the retirement benefits and everything else for these people out there.

So this is built in the contract. We have to honor that.

REPRESENTATIVE SIPTROTH: Okay.

Well, just before we move on to the next one, after that 4 years, it will be the good faith of the organization to renegotiate a contract and not to eliminate the union?

MR. GRAELLS: No. This workforce amounts to three-fourths of the workforce of the turnpike today. We will indeed be very unwise if we just got rid of, you know, a sizable amount of them. We are going to need these people, of course, because they are those who work out there, and they have lots of abilities and experience and everything else.

So I foresee a very, you know, a normal type of negotiation. It will lead to a new agreement. So this is something that, as I said before, in France and Spain and other places, we have been through that for many years and it works.

I mean, normally if you give people, you know, a new objective, a new target, and everything else, people are getting bored and it is easier for people to, you know---

MR. FROMAN: I would just add that Abertis currently operates in a number of highly organized, unionized environments, and it has had no industrial action against them. So they have a good reputation for working well with the workforce to come to solutions.

REPRESENTATIVE SIPTROTH: Okay.

And the other question---

MR. COLLINS: Representative, with respect to legislative oversight, the Legislature will decide how the $10.5 billion net defeasance cost is spent. And in terms of the way that this actual contract is implemented, it is up to the Legislature to decide how to ultimately approve the bill.

REPRESENTATIVE SIPTROTH: Well, historically we change Governor's about every 8 years here, and so go along the Budget Secretary and the Secretary of Transportation. So as the Administration changes, I am very fearful, whether it be Democrat or Republican, that in fact moneys will be expended from this account that should not be, and there needs to be some protectionism built in.

Thank you.

CHAIRMAN MARKOSEK: Representative Hess, and then we are going to recess until after session, which should be somewhere around 1:30 or 2.

Representative Hess for the last question.

REPRESENTATIVE HESS: Thank you, Mr. Chairman.

Just one quick question of Rob.

Rob, in projecting the 12-percent return over the 75 years, what factors or formula or crystal ball or whatever did you use to come up with that number?

MR. COLLINS: Well, I wish I had a crystal ball. The 12 percent is the SERS return. So that is what has been recognized over the last 20 years.

It is also, when we look at other benchmarks with respect to endowment returns, the University of Pennsylvania has posted close to a 20-percent return in many years.

So we wanted to look at the full spectrum, but I think it really comes back to, we don't know. I think that we feel that there could be, you know, as high as upwards of 20 percent in some years and as low as 5 percent in some years, if it was invested in treasuries.

And so that is why the math that we have done would suggest that even if it were invested in treasuries, the whole $12.8 billion net of defeasance costs, $10.5 billion in up-front proceeds, even if that were invested just in treasuries, at a 5-percent return, it would be better than Act 44 without I-80 tolling.

REPRESENTATIVE HESS: Well, I wouldn't want to put my reputation on the line with Morgan Stanley saying that we were going to get 12 percent. I am afraid it will come back to bite you.

Thank you.

CHAIRMAN MARKOSEK: Okay. Thank you very much.

I want to thank the gentlemen here from Abertis and Citi and Rob Collins, our premier testifier of this committee, and say that, again, we are going to recess until 1:30.

At that point in time, we are going to have Dr. Gary Gray and Dr. Pat Cusatis with their testimony. And if Abertis will be here at that time, we can call you back if some of the members have additional questions of you.

We have to honor the rules, so we will be back here after the adjournment of session.

MR. COLLINS: Thank you.

CHAIRMAN MARKOSEK: The meeting is recessed.

(A recess was taken.)

CHAIRMAN MARKOSEK: Okay. Good afternoon.

We are reconvening the Transportation hearing, and I want to thank everybody for their patience. We have honored the House rules and took a little recess and we are back.

And I especially want to thank our next testifiers who, instead of being able to get out of here perhaps a little earlier, were gracious enough to stick around.

REPRESENTATIVE GEIST: They get paid by the hour, so they're making big bucks.

CHAIRMAN MARKOSEK: I would like to introduce *An Analysis of the Proposed Lease and Reinvestment Program* by Dr. Gary J. Gray, Ph.D., Visiting Professor of Finance for the Pennsylvania State University; and also Dr. Pat Cusatis, Ph.D., C.F.A., Assistant Professor of Finance for the Pennsylvania State University, Harrisburg Campus.

So Gary, we will have you start, and Pat, both welcome.

DR. GRAY: This is our second tour of duty for the House Democratic Caucus. We were involved at the beginning of this here and produce for whom the road tolls.

And Pat and I are in academics, but we are not Ivory Tower types. I was 25 years in investment banking, Managing Director of Lehman Brothers and a Senior Vice President of E.F. Hutton. Pat ran a $3 billion municipal bond portfolio for First Union, so we come from the real-world side of it.

Before I present, though, I would like to mention a couple of conflicts that I have kept away from Stacey for this long -- sorry.

But first, my wife and I both are members of the SERS 111,000 annuitants, so we want to see SERS do as well as anybody.

Second is, I have a farm located about 1 mile from the Lamar exit of I-80, and I am on I-80 all the time in Representative Hanna's district. And I'm not a big fan of tolling Route 80, so let me get that out there.

That being said, here is the study: *An Analysis of the Proposed Lease and Reinvestment Program*, and we really attacked this in two pieces: one looking at the lease, and one looking at the reinvestment program. And let us review the bidding and figure out how we arrived at where we are now.

We understand that the ultimate goal of any transaction is to best fill the $1.725 billion annual funding gap that has been identified by the Pennsylvania Transportation Funding and Reform Commission Study to fund highway and transit.

Now, this 2006 study threw a spotlight on funding deficiencies in highway and transit. So the General Assembly and the Governor decided to attack this $1.7 billion annual funding gap.

Now the question is, what is the most cost effective way to fund that gap? Is it leasing the turnpike for an up-front payment that will be invested at some unknown rate? We will explore that alternative when we address these two interrelated questions.

Financially, is the up-front lease payment fair and adequate? Is the tolling schedule appropriate for a 75-year lease of the turnpike? For the first half of the presentation, we will focus on that question.

The second half. From a risk/reward perspective, how realistic is the proposed reinvestment program?

Well, to begin the attack on this $1.725 billion annual funding gap, the General Assembly passed Act 44. Act 44 did everything that is listed there. Act 44 was a pretty good start.

Then Morgan Stanley had been researching funding alternatives and believed they came up with a better solution to Act 44. So they put out feelers and found interest from among 34 firms, 14 groups, to lease the turnpike.

And Governor Rendell noted in his budget address, on slide 104, that Morgan Stanley advised the Commonwealth a long-term lease could fund the entire estimated $1.7 billion in annual highway and transit needs, significantly more funding than Act 44.

So Morgan Stanley created a study dated May 24, 2007, in which it showed a matrix where it showed estimates of net investable proceeds of the lease going from $12 to $18 billion, and interest rates at which they can be invested going from 7 percent to 9 percent.

So here is a screen capture from that. So coupled with this rate of return, the investment would generate up to $1.6 billion per year in perpetuity.

Now, I am not an English major, but I think "perpetuity" means forever, and that is not what we are going to see here.

So what happens? Subprime mortgage market occurs, leads to a full-blown credit crisis, leads to drops in hedge funds, leads to turmoil at investment banks, the demise of Bear Stearns. No one on Wall Street right now wants to take risk, and the markets are showing that.

So Morgan Stanley decides it is time to take the turnpike out to bid. Why? I don't know. Act 44 is working. It just generated $750 million this year. It is still in the high payout period; don't worry about dropping down if I-80 is not tolled. it is going to generate $800 million next year, $900 million the year after. I do not quite understand the decision to go out for bid in the face of the type of market that we are in.

Well, the market was abysmal for bidders. I think I spelled "abysmal" right; I'm not quite sure. But Morgan Stanley receives three initial bids, two final bids, all of which were significantly lower than their $12 to $18 billion net investable proceeds, and let me show you what I mean.

The winning gross bid of $12.8 billion needs to be adjusted to get a net investable amount. How much can be invested by a yet to be created P3 investment board that Morgan Stanley assumes will turn out vast amounts of investment income?

So we take the winning gross bid, which is $12.801 billion. Then we subtract the defeasance costs. Now, that is the money that has to be placed in escrow to make sure that those bonds are paid, when the Pennsylvania Turnpike bonds can be paid when they can either be called or escrow them to maturity, and there is a cost associated with that.

I think Morgan Stanley estimated that cost was $2.3 or $2.5 billion. The cost is actually $2.817 billion. It seems it was underestimated because the turnpike had four deals in the market between April and May of this year, and at least some of them, it seems, maybe not to have been taken into consideration in the structure of the deal.

So there is a deduction for defeasance costs of $2.8 billion; derivatives termination for the turnpike of about $95 million, $96 million. There were indenture funds that were freed up that could add to the deposit of investable funds of $300 million.

So the net investable proceeds, which I think was the number you were looking at, Representative Geist, we come up to be $10.188 billion. Now, that is the amount of money they should be able to pop in to the investment program after the deal occurs.

But there is one problem or one thing that is occurring in the background now. There is an interest rate option that was part of the documentation -- I think it is on page 29 of the concession agreement that we will talk about a little bit later.

But right now that option has a cost for the

Commonwealth of $358 million. So that would reduce the investable proceeds down below $10 billion. So that is the first set of adjustments.

Now let us get to what the bid is truly worth.

Present value of the bid. We take the net investable proceeds. The turnpike pays for Pennsylvania State Police Troop T. Present value of those payments over the 75-year period is about $800 million, so that is a negative.

Present value of the difference in capital expenditures between what the turnpike was proposing as part of their capital plan and what is being proposed under this concession lease is about a billion 4. That brings the present value of the lease down to slightly less than $8 billion. So that's the second number we look at.

Now, we don't use that number accept for comparisons. The net investable proceeds is the money that is going to go on the deposit and earn interest at whatever rate that is.

Let's take a look at the differences in present value. So if we take -- and how does it compare to expectations? How does it compare to alternatives?

Well, this $7.998 billion is the present value of a 75-year turnpike lease. Morgan Stanley estimated $18 billion; it's 55 percent below that. It's 33 below Morgan Stanley's -- 33 percent below Morgan Stanley's low estimate of $12 billion.

It's 70 percent below the Act 44 present value estimate of $26.5 billion over only 50 years with tolling of I-80, and it's 20 percent below Act 44 present value estimate of $9.94 billion, 50 years, without tolling I-80.

So why did Morgan Stanley go out for bids in this abysmal market? Why not wait until the markets realigned? There was no pressure. Act 44 was turning out the PENNDOT subsidies. The results must have been far worse than they had hoped. So we have a disappointing bid; a great deal for Abertis; a relative steal, some would say.

Now, let's talk a little bit about future tolls.

The Act 44 tolling schedule: plus 25 percent, 3 percent thereafter. Turnpike lease tolling schedule: plus 25 percent, then the higher of 2 1/2 percent or CPI.

Now, both bump 25 percent in the first year. So what's the effect after that? What about

CPI?

Well, we looked at a 75-year history of CPI, coincident with the term of the lease. CPI has been very volatile. It was up 14.4 percent in 1947, down 2.1 percent in 1937.

There's a graph in today's Wall Street Journal of CPI and the volatility of that versus interest rates, showing we're in a negative real-interest-rate scenario. So CPI is a concern. It's a major concern. People think it has gone up.

So 6 times it has been in double digits, 4 times negative; 27 times below it, a 2 1/2-percent floor; 48 times above it. What does that mean? Well, let's take a look at this chart.

The solid line going steadily upwards from the left side to the right side of the page is the turnpike lease, 2.5 percent or CPI. The dashed line is the Act 44 3-percent growth.

Over the last 75 years, from 1933 to 2007, if it cost you a dollar to go across the State in 1933, if you use the Turnpike's tolls, the 3-percent tolls that are being considered, that would have been increased about ninefold, to $8.91 in 2007.

If you use the Abertis formula for the

turnpike lease of 2 1/2 percent or CPI over 75 years, tolls would have increased 23 times from a dollar to $23.09 in 2007. So the tolls would be more than 1 1/2 times that under the turnpike Act 44.

Okay. Now a little bit about the Abertis interest-rate option.

First of all, it's an option that if the 30-year LIBOR swap rate increases by a certain amount, the price or the bid, the up-front bid paid by Abertis, decreases by a certain amount. It's a one-way option. If interest rates on 30-year swaps go down, the option doesn't go below zero. It's an unusual thing and it's likened to a swap, and in swaps, they're usually two-way transactions. This is a one-way transaction.

In any event, the 30-year swap rate increased from 4.838 percent on May 9th to 5.12 percent the day before yesterday, so it's up by 28 basis points. That means that the up-front payment of $12.8 billion decreases by 2.8 percent, or $358 million. So maybe you're getting $12.8 billion, maybe you're getting $11.7 billion. I don't know. It depends on what the payoffs are on this LIBOR option.

All right. That's the proposed turnpike

lease.

Focusing only on the lease now, not yet even looking at the reinvestment program, our recommendation is -- reject the bids.

The bid is too low. Why sell your prize asset in a buyer's market? Gross lease bid of $12.8 billion and present value of $7.9 billion -- far too low for a 75-year lease of the turnpike. You can't achieve your $1.7 billion a year goal by doing this.

The toll structure under the lease is much more aggressive than under Act 44, and the interest-rate option is one-sided, unfair, and costly.

Now, if you are happy with the bid and you believe that it's adequate, let's now look at the reinvestment program.

Now, you remember slide 6 where Morgan Stanley showed their matrix of investable proceeds of $12 to $18 billion, investment returns of $7 to $9 billion. Morgan Stanley now decides to increase rates of return to 12 percent to offset this low bid.

They create an investment board with no history or investment experience that will, quote, "consult with SERS," which has an 8.5-percent investment return assumption.

Now, how unrealistic is the 12-percent rate assumption of Morgan Stanley? Let me read you a paragraph from a blog by Richard Dreyfuss, pension expert and senior fellow with the Commonwealth Fund:

"The proceeds from the proposed 75-year Pennsylvania Turnpike lease are presumed to be invested with..." SERS "and projected to earn an annual rate of return of 12 percent. But SERS maintains a long-term investment horizon of 8.5 percent annually for pension assets. And the national average for public pension funds is about 8 percent. Many pension plans in both the public and private sectors are lowering long-term investment expectations for a variety of macro- and micro-economic reasons.

"A more realistic range, given the nature of the proposed lease" -- that's a key term, "the nature of the proposed lease"; this is an unusual lease -- "would be 6 percent to 7.5 percent. And let's not forget that SERS this year will first have to get out of the red before it can achieve even its own projected 8.5 percent return, let alone the

12 percent return projected for the money provided by a turnpike lease. Double-digit growth in SERS investments is not likely to be achieved again anytime soon."

Now, that's the first thing I've seen from the Commonwealth Foundation that I've agreed with. So it was just an interesting wow when I saw that.

Okay. The next slide is a screen capture from a Morgan Stanley projection of the money generated by investing the proceeds of the lease at 12 percent for 75 years versus Act 44 payments with tolling for 50 years and without tolling. And it shows the steady upward stream of money coming in from the investment account. It shows it outperforming Act 44 payments out through 50 years and then nothing coming from Act 44 thereafter. A pretty smug, confident exhibit.

In the next screen capture, Morgan Stanley shows Act 44 payments of $83.3 billion over 50 years, $23.6 billion over 50 years without tolls. They compare it to $96 billion over 50 years, $213 billion over 75 years, to create this 75-year transportation funding solution.

This is important. Please note footnote

No. 3: Applies maximum allowable yearly withdrawals for 75 years, with such draws increasing by 2 1/2 percent, assuming annual interest rate is a cycle that reflects the return received by PA SERS from 1988 to 2007, beginning with 1988.

So Morgan Stanley determines not only the expected rate of return but also the timing and the volatility of the returns. No respect here for the gods of the market.

So the Turnpike Lease Fund is not a pension fund or an endowment fund. Pension plans have inflows and outflows that are relatively predictable. You can't predict your investment earnings but you play the law of averages, the law of large numbers. You know your outflows. If you have a bad year of investment earnings, the Commonwealth kicks in some more money.

The Endowment Fund is somewhat similar. Development officers constantly scour alumni for donations for chaired professor salaries or deserving student scholarships.

Well, the Turnpike Fund is a bear. It's an immediate pay single-premium annuity with a 10-percent immediate draw and a 2 1/2-percent accretion. You don't have the time to accumulate profits. You don't have any inflows if you have losses. It's not a pension fund. No one is there to pump money into the fund.

Now, if you asked a life insurance company or a pension company to take a look at these cash flows and give you a bid on what they would pay for that, what type of yield you would receive, it would probably be somewhere in the 6- to 7-percent range. That's my belief.

All right, Patrick, risk versus return.

DR. CUSATIS: In portfolio management, we always think of things in terms of risk and return. So we've put together three charts that show the relationship between risk and return.

There has been a lot of discussion today and over the last few months about this 12-percent rate of return, and it's very important that we discuss this in terms of the rate of return that is received relative to the amount of risk that is taken.

So what we have done is put together three charts, and the first one shows a normal distribution based on the historic returns of SERS with an average return of 12 percent and a standard deviation of 10.35 percent.

Now, SERS has done very well. Those are

great returns historically, and the standard deviation is relatively low given that level of returns. But there is volatility.

This first graph shows what a normal density would look like based on that particular average rate of return in that standard deviation. You can see the range of returns from about minus 15 percent to as high as 40 percent.

The point being here that there's a lot of uncertainty. We don't know where rates are going, and to get a high rate of return or a high expected rate of return you need to take a lot of risk.

The next chart shows historically by asset class, the types of returns that could be expected or historically were received over about 100 years and the return volatility that goes along with that.

Starting with the U.S. Treasury bills, the annual return average, 3.7 percent, with a standard deviation of 3.1 percent.

If we go down to the most risky asset class here, we see an annual return of about 12 1/2 percent with a standard deviation of 32.6 percent.

The only way to have a high expected return is to take on a fair amount of risk, and that's our point in these slides.

On the next slide what we did was take the S&P 500, the return on the S&P 500 over the time period of the 21st century, starting in 2000 to the present.

Now, we looked at the return, and our point here and the reason for showing this is that large cap stocks, in fact in any market, is not predictable. We can't predict where returns will be or the rate of return in any market, not even in the large cap stock markets, okay? Of the assets we showed, this is not the riskiest asset class. It is a risky asset class.

But in this time period, say you had invested in 1999 when the index was at 1469 and continued to invest in the S&P 500 over this entire time period until the end of 2007. You see the index was at 1468.36. You would have made nothing -- okay? -- over that entire time period.

This is not assuming that there are any draws over the time period. That, of course, would make things worse. The point being that there is tremendous volatility in the market.

So it's very important when we are talking about historic performance that we don't treat it as if it's predictive. Historic performance is in no way predictive.

In fact, if you take a look on the SEC's Web page, they have a paragraph where they specifically warn investors never to use historic information to make investment decisions, all right?

The SEC gives that advice, and I think it's very good advice. We know that we can't in any way project -- I'm not saying that the returns of SERS have not been very good; they were, but we can't predict what next year's return is or the following year or any year's returns or any time period's returns, especially not based on historic performance.

DR. GRAY: And it's important to note that from this 1468, the S&P is down further 10 percent this year. Year to date, it's down 10 percent from there. The same with the Dow Jones Industrial Average. The international markets are down much worse.

Okay. So now let's get into modeling these SERS payouts with the needs of PENNDOT and Pennsylvania Troop T.

Now, we believe the Morgan Stanley assumption of 12 percent is ridiculous, highly unlikely, but we will play their game for a little bit.

Based on their assumption of rates following this 19--- Yes, sir? Okay; certainly. I apologize. Okay; I apologize.

Based on the assumption of rates following the 1988 to 2007 20-year cycle, we plugged those rates into a spreadsheet, took out the PENNDOT scheduled contributions and the State Police costs, and see what happens.

We show the year 2009. Now, this shows a return of 12.8 percent. That corresponds to the return of SERS for the year 1988. And then 2010 corresponds to the return for SERS in 1989 and so on down the first 20 areas.

Now, you'll notice in 2022, there's a negative 7.9. There's a negative 10.9 in 2023. There's a very small return of 2.2 percent in 2021. I'll use that to address something that was asked earlier.

Now, what happens when you plug the correct investable amount, net investable amount number of 10.188 million, you take out the PENNDOT draw, you take out the Pennsylvania State Police draw: the growth of the PENNDOT draw is 2 1/2 percent, growth of the Pennsylvania State Police draw is 5 percent. We have that the Turnpike Lease Fund goes bankrupt in 28 years. It runs out; it's no longer there.

Now, that's the base-case scenario for Morgan Stanley. They created it, all right?

Now, the next chart we look at shows the effects of timing and volatility on the Turnpike Lease Fund. We use the same 20-year period, but we start at a different time.

We are going to start in 2000 when rates were pretty bad. We'll do that to 2007. We'll take those 8 years into effect, then we'll go back to 1988 to go to 1999, take those 12 years into effect and see how that affects performance.

So we use those actual rates of return in the slightly altered time frame that we have, and the Turnpike Lease Fund in this case goes bankrupt in 13 years. So this shows the effect of timing and volatility, that if you get bad performance up front, your fund is going to go away real quick. I mean, there's tremendous risk in this type of payout.

Now, if 12 percent isn't the right return, what's the right, what's a good investment assumption? How do we get there?

Well, academicians and sophisticated

practitioners use pricing models based on risk and risk premiums. Most are variance of something called the Capital Asset Pricing Model, which we describe in a paper that we produced for the House Democratic Caucus.

The rate that we would think that would be a rate that is achievable maybe 50 percent of the time, roughly 8.89, and based on 8.89, a flat 89, the fund goes bankrupt in 16 years.

So then we looked at the Project Eagle graph revised. In the dotted lines, the brief dotted lines, we looked at the turnpike lease versus Act 44, no I-80 tolls and Act 44 with I-80 tolls.

We also looked -- the next set was bar charts, which shows how the reinvestment program is expected to do based on that 8.89. You'll see the reinvestment program does very well in year 5 and year 10, but it isn't there in year 25, 45, 50, or 75.

We looked at the estimated maximum in table A-7. All of these are in our detailed report, that I think will be placed on the Web site of the House Democratic Caucus.

Table A-7 estimated the maximum Turnpike Fund term assuming a fixed rate of return over the life of the lease, also assuming no volatility. So if we say annual return of 7.5 percent, we mean annual return every year 7.5 percent, not an average 7.5 percent. Volatility kills this kind of a fund.

So this table shows the year in which the Turnpike Fund is expected to go bankrupt based on a specified average rate of return with no volatility. And once you get out to 12.67 percent over 75 years, the deal carries at 12.67 percent with no volatility.

We also looked at the initial draw plus 2 1/2 percent, supported by a given rate of 7.5 to 12.67. You have to take out the Pennsylvania Troop T from this initial draw, so it's usually minus about $35 million there. But this is what the cash flows will support.

And then our proposed reinvestment program, our recommendation regarding it: Reject the bids. We think it's seriously flawed, speculative, doesn't work. The 12-percent rate assumed is too high and unrealistic. The P3 Investment Board has no operating history or investment experience. Investment income would be risky, volatile, and unpredictable.

We looked at the present value of the three alternatives, the turnpike lease being $7.98 billion; the Act 44 without tolling, $9.94 billion; Act 44 with tolling, $26.4 billion.

CHAIRMAN MARKOSEK: Okay. Thank you.

And just a note on behalf of full disclosure, these gentlemen's services were hired by the House Democratic Caucus, so I wanted to get that out on the table.

Representative Tina Pickett.

REPRESENTATIVE PICKETT: Thank you, Mr. Chairman.

Is it correct that your survey is based on Act 44 with I-80 tolled?

DR. GRAY: It is based on both. We look at numbers, looking at with the tolling and without the tolling.

REPRESENTATIVE PICKETT: Could you enlarge a little more on what happens if I-80 is denied tolling?

DR. GRAY: From what I understand, if I-80 is denied tolling after 2010, the Pennsylvania Turnpike Commission will make contributions to PENNDOT totaling a flat $450 million per year.

REPRESENTATIVE PICKETT: But how does it

compare to the turnpike deal if that happens?

DR. GRAY: The present value of the two alternatives are better under keeping Act 44 without tolling.

The present value of Act 44 without tolling is $9.94 billion. The present value of the turnpike lease is $7.98 billion. So it's 20-percent better to have Act 44 without tolling.

REPRESENTATIVE PICKETT: The Governor's $10.5 billion this morning.

I see what Chairman Geist means about numbers rolling everywhere. Whoa; it's hard to keep up with them. But can you comment on the number that---

DR. GRAY: Surely.

Just reviewing the bidding on the numbers -- and let's go back there so maybe we all understand that. This is on slide 9.

We take the winning gross bid of $12.801 billion. We subtract out the defeasance costs.

Now, our defeasance costs are different than Morgan Stanley's defeasance costs because of certain -- we took into account four deals that were done by the turnpike in April and May. I don't know whether Morgan Stanley did that or not. But our defeasance costs were $2.817; derivatives termination fees, $96 million; freed-up indenture funds -- so this is a positive -- $300 million going into, increase that winning net investable proceeds.

So we get net investable proceeds of $10.188 billion. That's our calculation of what could be invested today if the turnpike lease goes through -- $10.188 billion.

Now, there's a problem or there's an option that exists that Abertis was basically given in the concession agreement, and that option, if interest rates increase on a certain rate of interest -- it is a 30-year LIBOR swap rate -- if it increases on the rate, the amount of their bid will decrease.

Now, so far the increase has been -- let me go to that slide -- the increase in the 30-year swap rate has been 28 basis points. That brings the bid down by 2.8 percent, or down by $358 million.

So you would take that $10.188 billion, subtract out $358 million, so you would have roughly $9.8 billion to invest if it were to be done today. So you would invest that at whatever rate you receive.

Now, that's not the net present value. Net present value is another calculation from here.

That's the money that can be invested in the Turnpike Lease Fund.

With the net present value, you have to take out two adjustments. Right now, the Pennsylvania State Police Troop T, as I understand it, is paid by the Pennsylvania Turnpike. If this lease goes through, the Commonwealth of Pennsylvania will have to pay for their expenses and take over the costs of Troop T. The present value of those payments over the lease of the turnpike is roughly $800 million.

There's also a differential in costs associated with capital expenditures. The present value and the difference of capital expenditures that would be paid if the turnpike continued with their 10-year plan versus a turnpike lease is about $1.4 billion, giving a net present value of the turnpike lease -- $7.98 billion.

REPRESENTATIVE PICKETT: Well, the State Police value would not -- that's over the entire period. We don't pay that up front; we pay at a future---

DR. GRAY: No; understood. The present value of that, I mean, you are picking that up and you are going to effectively subsidize that. But the present value of that stream of payments is

$808 million.

REPRESENTATIVE PICKETT: I have to tell you, I'm not an accountant, but that doesn't sound quite square to me.

DR. GRAY: It's $35 million today, increasing at 5 percent per year over 75 years. If you brought that back down, and we'll---

REPRESENTATIVE PICKETT: True, but to apply it against the 10.1 just is what doesn't seem quite square to me. But I'm going to leave that to somebody who follows me who is probably a lot better with the numbers.

But another thing, another factor that's, you know, riding around with all of this is that now we don't have anybody paying tolls on I-80 either.

So I'm going to leave somebody else to argue that last number with you a little bit.

CHAIRMAN MARKOSEK: Okay. Thank you.

We do have Mr. Collins and Abertis, who have been nice enough to stick around, and after these gentlemen are finished, if they are willing, we will bring them back up here for additional questions by the committee.

REPRESENTATIVE GEIST: They may be too bloody.

CHAIRMAN MARKOSEK: Representative Jeff Pyle.

REPRESENTATIVE PYLE: Thank you, Mr. Chairman. I appreciate it.

And Dr. Gray and Dr. -- and help make sure I get this right -- Cusatis?

DR. CUSATIS: That's correct.

REPRESENTATIVE PYLE: That comes from a Slovak town.

A couple of questions here, and like Representative Pickett, I'm not a financial analyst, but I have done a lot of research and studies, did some Federal grant writing, stuff like that.

I have a question: What criteria were you charged with measuring when the House Democratic Caucus contacted you to do this study?

DR. GRAY: I was actually asked to answer, we were asked to answer six or seven direct questions---

REPRESENTATIVE PYLE: Could you reveal those questions for us?

DR. GRAY: We got a full study that's available on the Web site.

REPRESENTATIVE PYLE: I'm not in the Democratic Caucus. I don't have that Web site.

DR. GRAY: All right.

REPRESENTATIVE PYLE: Perhaps I could talk to the Chairman later about sharing. Thank you.

DR. GRAY: The specific questions that we were asked -- I forget where I put it in this study.

Okay. Here would go. The specific questions that we examined and upon which we present our findings are:

1. How realistic is Morgan Stanley's assumed 12-percent average return on investment over the life of the lease, 75 years?

2. If the Commonwealth invested the net value of the lease with an investment board similar to SERS, what would be a reasonable long-term return on investment if we want to maximize annual payouts with 2.5-percent annual growth until the end of the term?

3. Given the likely discount rate, what would be the present value of the State Police services for the turnpike, assuming historic growth for inflation?

4. Provide a year-by-year, apples-to-apples comparison among the following: Act 44 payments; Act 44 payments without tolling I-80; Morgan

Stanley's assumptions, 12-percent rate of return for their reinvestment program; and a realistic scenario for a return on the net amount over the 75 years. Net amount includes deductions for bond defeasance, State Police services, other required payouts less available, non-obligated cash on hand of the turnpike, and any adjustments for differences in capital programs.

Finally, are there other risks or considerations of the turnpike lease and reinvestment program that the General Assembly ought to be mindful of with respect to accepting the winning bid?

Those were the specific questions.

REPRESENTATIVE PYLE: Super.

Here's a question for you; I have got a couple here.

I've got to state, I have neither of these running through my district, but I am in fact bracketed to the north by I-80 and to the south by the turnpike. But a lot of the things you brought up are of great interest to me.

Why should the State care about Morgan Stanley's investment figures? Once they pay us $12.8 billion and we take care of the Turnpike's debts and whatnot, what happens to their money is their business. I really don't see that as being our business.

DR. GRAY: Well---

REPRESENTATIVE PYLE: The second question: Return on SERS investment? That's also kind of the Commonwealth's business and not really the guys who are making this offer for the turnpike, which, by the way, I'm still on the fence about.

I do have a question: When you did your study, the apples-to-apples, oranges-to-oranges -- Act 44 with tolls, Act 44 without tolls versus turnpike leasing -- did you make any kind of projection on economic impact on the I-80 corridor?

That's a pretty rural stretch of Pennsylvania. They kind of rely on that.

DR. GRAY: We are available for hire, too.

REPRESENTATIVE PYLE: I don't work for the Democratic Caucus. That's twice now.

DR. GRAY: No; we did not, sir.

REPRESENTATIVE PYLE: Okay, and one last question here for you.

DR. GRAY: Sure.

REPRESENTATIVE PYLE: You are much more learned in finance than I am. What's your opinion on the concession agreements for along the turnpike?

DR. GRAY: The concession agreement that people worked to get, I think, was fairer than any concession agreement I've seen yet -- from that standpoint.

REPRESENTATIVE PYLE: Okay.

DR. GRAY: It's just from what I understood the goals of a transaction to be, this doesn't seem to mesh.

If the goal is to fill this $1.7 million per year funding gap for a very, very long time, this doesn't do it. This might be good for 7 years, 8 years maybe, maybe until everybody is out of office that votes on it, But it's not a long-term funding solution. I truly believe that.

REPRESENTATIVE PYLE: Well, tolls on 80 that have no foreseeable end are a long-term, and I would debate the meaning of the word "solution" with you. I didn't vote for it the first time.

I think that's about it for me, Mr. Chairman. Thank you.

CHAIRMAN MARKOSEK: Okay. Thank you.

Representative John Maher.

REPRESENTATIVE MAHER: I have to admit that I was surprised to hear you say that, since you are from Penn State, that you believe "perpetuity" is forever. I think we established in this room a few years ago that Graham Spanier thinks perpetuity is about 6 years.

Let me just make sure I understood a couple of things. And this I found startling, and I'd be interested in looking at your spreadsheet, which maybe is in your report.

DR. GRAY: It is, and we could send you a copy.

REPRESENTATIVE MAHER: That would be good.

You are saying that your calculation of the actual present value, factoring in defeasance, factoring in future costs that would be borne, that had been borne by the Turnpike, it comes up with a figure which is actually 20 percent less than the status quo. And when I say status quo, that's without any tolls on I-80.

DR. GRAY: Yes.

REPRESENTATIVE MAHER: So if we continue the status quo and did not toll I-80, the State would actually have -- I think if it's 20 percent less, that means it would be 25 percent more -- would have 25 percent more availability of funds for road and bridge projects with the status quo.

DR. GRAY: Yes.

REPRESENTATIVE MAHER: I am very interested in that spreadsheet, because if that's the case, it gets to be a pretty easy decision, I think, for those who are pondering it. Because if we don't toll I-80, we would still wind up with more funds available---

DR. GRAY: Present value.

REPRESENTATIVE MAHER: Present value, present value of the funds available, and it would be 25 percent more present value available under the status quo than under---

DR. GRAY: About 25 percent.

REPRESENTATIVE MAHER: ---than under the proposal that's before us.

DR. GRAY: Yes.

REPRESENTATIVE MAHER: That's huge.

All right. Let me also ask this.

I was surprised here about this---

DR. GRAY: Interest-rate option.

REPRESENTATIVE MAHER: The option.

Now, I often have seen agreements where, recognizing that there will be some lag time between when a proposal is made and when a settlement occurs, that there will be provisions in there that both parties will agree with, if the rates move, that will make that appropriate adjustment at the time of the close. Do you often see that being a one-way street?

I can't remember seeing one like that, but that's not to say that maybe that's the new trend. I just hasn't seen one.

DR. GRAY: It's unusual, and I understand that maybe as a bargaining tool trying to get the bid up, that that option which -- it should be a two-sided thing. If rates go down, you should benefit; if rates go up, you maybe pay, but that's the fair way to do it.

But I guess, too, in an effort to get a higher up-front bid from the syndicates, that might have been thrown into the mix. But that option is now $350 million against you.

REPRESENTATIVE MAHER: And it's been exercised?

DR. GRAY: No, it has not been exercised. No.

REPRESENTATIVE MAHER: Okay.

DR. GRAY: It wouldn't be exercised if you don't do the deal.

REPRESENTATIVE MAHER: Okay. But if we were to be heading towards transacting---

DR. GRAY: My understanding is at closing, you wouldn't receive 12.8; you'd receive that minus whatever.

REPRESENTATIVE MAHER: Minus, at this point, 358.

DR. GRAY: Maybe they give you the 12.8 and they ask you for whatever it is back immediately. I don't know that, But that's what I would suspect.

REPRESENTATIVE MAHER: Okay.

I'm just asking you now about this rate of return.

DR. GRAY: Okay.

REPRESENTATIVE MAHER: The 12-percent benchmark. And there's a chart here that shows a pro forma, as if the activity of the past, I think it was 28 years, would be predictive of the next 28 years.

DR. GRAY: Yes.

REPRESENTATIVE MAHER: And I understand your point that, you know, those who use the history as a predictor are soon separated from their wallets.

But what I have been interested in is, if I understand -- and Morgan Stanley, if they choose to rejoin the conversation later, can straighten me out if I'm mistaken -- but my understanding is that the 12 percent is the arithmetic average of the returns over that 28-year period.

And I'm curious, in your courses at Penn State, do you teach students that the arithmetic average of a, what normally would be a compounding or descending interest transaction is a useful measure?

And just for the sake of folks who aren't maybe following my question yet, if you lose 50 percent one year and gain 50 percent back the next year, you're not even.

DR. GRAY: No, you're not.

REPRESENTATIVE MAHER: If you lose 50 percent one year and gain 50 percent back the next year, you are at 75 percent.

DR. GRAY: Correct.

REPRESENTATIVE MAHER: So to just average those and say the average over 2 years is that you're even isn't a very useful statistic in my mind. But again, I'm away from school a long time. Maybe they have changed views on this.

DR. GRAY: In our study, in the appendix we address that exact concern.

The simple average of the SERS return over the period that they are looking at is 12 percent. The geometric return, taking into account losses equally--- And simple averages, if you have losses, are biased upwards. If you do a geometric return, their return isn't 12 percent; it's somewhere around 11 1/2 percent.

REPRESENTATIVE MAHER: That's still pretty good then.

DR. GRAY: It's still pretty good, but it doesn't fund the engine for what you need.

REPRESENTATIVE MAHER: So if you had a student that was -- if you asked them what was the return over this period, and they gave you a simple arithmetic average, you'd probably mark that answer wrong.

DR. GRAY: That's a question I ask in every exam that we give to make sure they understand it.

REPRESENTATIVE MAHER: Thank you.

CHAIRMAN MARKOSEK: Thank you.

Representative Mark Longietti.

REPRESENTATIVE LONGIETTI: Thank you, Mr. Chairman.

Thank you for your testimony this afternoon. A few questions.

I believe that the Citigroup-Abertis folks talk about that you can't just look at the

$12.8 billion, that they also have a commitment of $1.1 billion a year in capital expenditures for the first 5 years. I just want to educate myself on that.

What do you know about that, and is that accurate or is that something that you don't get involved?

DR. GRAY: I don't know, I haven't strongly looked at their capital expenditure payout schedule. I just know what is talked about being reduced and what the present value of those reductions are. So I'm sorry I can't answer.

REPRESENTATIVE LONGIETTI: Okay. So that's something that you didn't necessarily look at when you conducted your study and you are not completely familiar with that.

DR. GRAY: Right.

REPRESENTATIVE LONGIETTI: Okay.

And if I gather correctly in listening to your presentation and looking at the slides, what you generally conducted was a present value analysis, and that is a way to compare different proposals and determine what appears to be -- I don't want to necessarily say the best proposal, but the one that has the highest present value and perhaps gives the best opportunity to generate the most dollars over time. Is that correct?

DR. GRAY: That's correct.

REPRESENTATIVE LONGIETTI: Okay.

And I know Mr. Maher went over this, but based on your recommendations, looking at those three options, one being this turnpike lease that is proposed and one continuation of Act 44 but without tolling on Interstate 80, and then the third being Act 44 fully implemented with tolling 80, the lowest present value then was leasing the turnpike. Is that correct?

DR. GRAY: Correct.

REPRESENTATIVE LONGIETTI: Now, in that regard, just to follow up on some previous questions, in that regard, you did not consider, for example, finding that the highest present value is Act 44 with tolling I-80, that you didn't consider, you just did a straight present value and you didn't consider other things like what would be the economic effect of tolling Interstate 80 on the Commonwealth, in particular those communities that are in the I-80 corridor?

DR. GRAY: Correct; we did not consider that at all.

REPRESENTATIVE LONGIETTI: Okay.

Nor did you consider traffic-diversion issues. If Interstate 80 is tolled, and currently it's not, but if it were tolled, that there's the potential for traffic to be diverted onto local roads, meaning a higher maintenance cost for those local roads?

DR. GRAY: We did not study that, sir.

REPRESENTATIVE LONGIETTI: Okay.

So when you did your study, really, I mean, your study is strictly a present value study. It is not a philosophical question at all about, you know, whether tolling an interstate is an idea that the State ought to embrace, or it's not necessarily even saying, well, this is the option that ought to be picked. It's just saying, if you looked at the present value of three different options, this one produces the highest present value, but we haven't looked at other considerations that could be cost factors to the Commonwealth of a particular option?

DR. GRAY: That's correct.

REPRESENTATIVE LONGIETTI: Okay. Just a couple other questions.

When you arrived at your numbers, I think it's on slide No. 9 or page No. 9, I just want to make sure I understand, you explained what the defeasance costs are, which would be, in your mind, reduced from the $12.8 billion bid.

Could you explain what the derivatives termination, what that means, and also what the indenture funds, which adds some money, what those two items mean?

DR. CUSATIS: Okay.

DR. GRAY: Here's our derivatives expert.

DR. CUSATIS: The defeasance costs you are okay with?

REPRESENTATIVE LONGIETTI: Yes. I think you explained that and it made sense to me.

DR. CUSATIS: Its the money to take out the existing bonds.

The derivatives termination is, there are some swap contracts in place, and they would have to be terminated, and that's the termination fee to remove those swap contracts.

REPRESENTATIVE LONGIETTI: Okay.

So that would be a cost then to the Commonwealth?

DR. CUSATIS: That's correct.

REPRESENTATIVE LONGIETTI: So therefore you take and you reduce that $12.8 billion bid, because you are seeing a cost that is coming to the Commonwealth.

DR. CUSATIS: That's correct.

REPRESENTATIVE LONGIETTI: And just if you could explain the indenture funds, with a small addition.

DR. CUSATIS: Yes.

The indenture funds is money that is available, assets that are available that the Turnpike owns currently. They would be freed up when the bonds were defeased essentially, and that would come to the Commonwealth.

REPRESENTATIVE LONGIETTI: Okay.

DR. GRAY: Money in the current debt service reserve funds basically or other funds that would be available once the claims, the bondholder claims, evaporate on them.

REPRESENTATIVE LONGIETTI: Just a couple more questions.

I read some newspaper articles, and somewhere along the line, you know, one of the articles claimed that one of the reasons why these types of deals have such long-term leases -- I'm talking about leasing the turnpike, a 75-year lease, and obviously one reason would be to generate more money, a higher bid -- but the claim was made that there are tax advantages when you have a long lease like a 75-year lease that allows the lessor, or I guess the lessee, to depreciate the asset over a short period of time, maybe 15 years, and then thereby gain a tax advantage.

And the claim being made in that newspaper article was, well, then you have got to look at the bid and say, well, there is going to be lost tax revenues because of the tax advantage, and that ought to be factored in.

I wanted to hear your comments on that, because I'm not sure if that's correct or incorrect or what your view is.

DR. GRAY: The local tax effects or property tax effects, we are just looking at present values and cash flows associated with the lease versus the Turnpike currently. So we didn't really get into those very important issues. But those are things we just didn't have time to look at.

REPRESENTATIVE LONGIETTI: Okay. So that's something, obviously, that was not part of your study, and as we sit here today, you're just not familiar enough with those issues to even comment whether that's accurate, that the reason that the lease period is so long is to provide these tax advantages, which will be---

DR. GRAY: I'm certain that that's correct. To get the certain tax advantages, you do need a term of the lease.

Now, that's embedded in the lease bid that you've already received, the fact that they can depreciate certain property of the Turnpike as, quote, "tax owners." But that's already in the bid.

DR. CUSATIS: From a tax standpoint, the lease has to be long enough to be considered a sale, and that way, they can depreciate the value of the asset, even though they don't truly own it. But that affects the bid. It doesn't affect our analysis.

REPRESENTATIVE LONGIETTI: So at the very least, that tax advantage, at least in the government's eyes because the lease is so long, it's viewed as a sale that provides something to the lessee that they can increase their bid offer as a result of that.

DR. GRAY: Yes.

REPRESENTATIVE LONGIETTI: Okay. I think

those are all my questions. I appreciate it.
Thank you, Mr. Chairman.
Thank you, gentlemen.
CHAIRMAN MARKOSEK: Thank you, Representative. Very good questions.
Representative Tony Payton from Philadelphia County.
REPRESENTATIVE PAYTON: Thank you, Mr. Chairman.
Thank you for your presentation. This is a pretty scathing report, as I would put it. And I see at the end you say "Reject the Bids!" Is that your recommendation, is to reject the bid? For the record.
DR. GRAY: I think so. Yes.
REPRESENTATIVE PAYTON: I just wanted to be clear on that. Thanks.
DR. GRAY: Sure.
CHAIRMAN MARKOSEK: All right. Very, very quickly, because we are out of time. We can recognize you later, if you want to---
REPRESENTATIVE PYLE: Thanks, Mr. Chairman.
I appreciate Representative Payton's question. If you are saying that---
DR. GRAY: That's Representative Pyle.

REPRESENTATIVE PYLE: Thank you.

The bad play is to lease the turnpike, but what is the good play? Tolling 80? I mean, wasn't that stated earlier?

DR. GRAY: This is a different -- we're looking at a single decision here. I don't think you are necessarily saying a vote against this -- well, in theory -- a vote against this isn't a vote for tolling the turnpike. At least, that's not the way I see it.

I have got a farm 1 mile off the turnpike, or 1 mile off I-80. I'm on there all the time. I don't like tolling I-80, but I just don't think this, we don't think this turnpike bid -- the market that they came out in was the worse market possible. the timing was incredibly bad. It just didn't work.

I mean, if they had gotten $18 or $20 billion, it might be a different story, but it's just not good.

REPRESENTATIVE PYLE: The market right now being as bad as it is, you say conditions are not optimal to execute or enter into this kind of discussion as to leasing a State entity like this.

Now, I have a question, and John Maher

really is much more qualified than I am to ask it. But given that bond issues do affect bids that are put out on public entities like this, would the money the Turnpike Commission took out between April and May have lowered our bond rating to the point where it might have brought down the bid?

DR. GRAY: I don't know.

REPRESENTATIVE PYLE: That defeasance we keep referring to?

DR. GRAY: What brought up the defeasance requirement, yes.

REPRESENTATIVE PYLE: Okay. Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Representative Paul Costa, Allegheny County -- my neighbor.

REPRESENTATIVE COSTA: Thank you, Mr. Chairman.

Thank you for testifying. A couple quick questions.

Obviously you think that the leasing of the turnpike is a bad idea, but if we take the tolling of I-80 out of the equation and now we leave it, would it be better for us to just walk away and let the Turnpike exist the way they are today, or do you think it would be a better idea for the Turnpike to actually try and do what Morgan Stanley is proposing?

DR. GRAY: You are in discussions of politics way beyond my grade level here.

I don't know how to respond to that.

REPRESENTATIVE COSTA: Well, I'm trying to figure out, I mean, I've been saying all along, I always have been under the understanding that the Turnpike could do what Morgan Stanley is attempting to do or proposing that we do, that they can invest the money themselves and they can continue to run the turnpike the way they are doing it today.

But according to your numbers on your report, it doesn't matter who makes the investment; it's not a good idea to be investing at this time.

DR. GRAY: Now, according to the numbers on our report, the current structure of having the Turnpike generate whatever they are generating -- 750, 800, 900, and then 450, or 900 plus 2 1/2 percent, it has a present value today worth more than this 7.98 net present value did.

REPRESENTATIVE COSTA: So that would be doing absolutely nothing?

DR. GRAY: That would be existing as you

were with the Turnpike.

REPRESENTATIVE COSTA: Okay.

DR. GRAY: If you can't toll 80, then I would suggest discussions open up and that 450 ad infinitum is discussed.

REPRESENTATIVE COSTA: Okay. Thank you.

Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Thank you, Representative.

Representative Kate Harper.

REPRESENTATIVE HARPER: Thank you, Mr. Chairman.

We have been discussing something that I'm not sure you actually had in your sights when you were doing your work, Professor, so let me just run down something for you.

DR. GRAY: Okay.

REPRESENTATIVE HARPER: Eleven months ago, some of us in this room voted for Act 44, which included, among other things, the tolling of I-80.

I myself voted for it because Interstate 80 costs this Commonwealth about a hundred million dollars a year to maintain.

You know, it's a pretty long road. It's up in the part of the State where your farm is, where we have a pretty bad freeze-thaw cycle, and we spend a ton of money up there which is averaging a hundred million a year.

So when I voted for Act 44, it was within my contemplation that if I-80 paid for itself, that would leave a hundred million that is now coming out of PENNDOT's budget that we could use elsewhere -- roads, bridges, whatever. But a hundred million is a lot of money.

So I guess my question is, when you did your three numbers, the present values of the alternatives, and you came up with the fact that 44, without tolling I-80, had a number, I have got to believe that you weren't thinking about the hundred million that we would not have to spend if I-80 were tolled. Am I right on that?

DR. GRAY: What Act 44 without the I-80 tolling was, the number was, $450 million a year after 2010 discounted back to the day at the cost of borrowing.

That number all told, so we didn't -- when you are saying did we take into account an extra hundred million dollars that should free up? No, we did not.

REPRESENTATIVE HARPER: Okay.

And the converse would also be true, that a hundred million of whatever we could get with I-80's tolls per year is going to get spent on I-80, so it would not be available for these other projects. Does that work?

DR. GRAY: And the Turnpike annual contribution to PENNDOT goes up to that 900 plus 2 1/2---

REPRESENTATIVE HARPER: Right. And they have revenue and things like that to defray it.

Okay. I just wanted to make sure my colleagues were aware of that, because in the manner of politicians, if you can do something that avoids making anybody unhappy, that's usually the easiest path.

And so there are some in the room who would want to not sell or long-term lease the turnpike and also not toll I-80, and I think that we have to keep in mind that I-80 has a cost itself. That was probably not part of your calculation.

REPRESENTATIVE GEIST: And they don't have enough women's restrooms.

REPRESENTATIVE HARPER: And they don't have enough women's restrooms. But we covered that this morning.

Thank you very much.

CHAIRMAN MARKOSEK: Thank you.

Representative Kathy Watson.

REPRESENTATIVE WATSON: Thank you, Mr. Chairman.

Both of you, I'll be very brief.

Going to the last slide that you had, in light of questions that have been raised, I want to be very specific.

An English teacher in me wants that the definitions are correct and we agree on the terms.

You say, "Our Recommendation -- Reject the Bids!" with an exclamation point. You are saying to us, reject the bids that are proposed now. But some of my colleagues have said -- and I want to be very clear -- you are not making a judgment saying that. Conceptually it might be possible in a different market, with a different concession contract, that this could be a very good deal for Pennsylvania.

And indeed -- I don't want to put words in your mouth, but I'm not the lawyer so I can -- but you are saying, or I'm hearing or thinking that you are saying, it could work in a different deal. Public-private partnerships, you are not making a judgment anywhere here, and you spoke to us before, that conceptually that is bad for government to be involved in, but you are specific to what you were saying and what you have shown us in your numbers perhaps to be re---

DR. GRAY: Rehashed.

REPRESENTATIVE WATSON: Yes, or changed or said, because numbers can be made to do so many wonderful things. But according to your numbers, your calculations, this particular deal at this particular time is not overall beneficial to the Commonwealth of Pennsylvania to achieve the goal that we want, which is to fund payment for our roads and bridges. Is that correct?

DR. GRAY: That's correct.

REPRESENTATIVE WATSON: I love mass transit. I come from the southeast. We can deal with all that separately, but that's my point, that if the market were a little different, if even the participants -- though, this time it would be wonderful if somehow the General Assembly was included in some of this and we didn't get a 500-page document after the fact, but that's another story.

But very seriously, if it were a different time and a different agreement, you could very well have used your pencil and paper and you would come back to us possibly to say this is a really good deal.

DR. GRAY: Yes.

REPRESENTATIVE WATSON: Okay. I thought that was important for all of us to hear, to understand, and so what we're really working with is a small parameter.

And according to Representative Harper, too, it doesn't necessarily negate whether I think ultimately tolling I-80, or perhaps for my colleague up there, Mr. Pyle, 95 in my area, would be lucrative or whatever, but a user-pay type approach. We are not going there. We are just looking at the way this deal is set up and structured, and I was interested.

And thank you for information that was contained in a deal that really -- I had to run in and out this morning, but it was never brought out until you brought it out with some other numbers where we lose money here, there, by the time the deal is finally signed.

Thank you.

CHAIRMAN MARKOSEK: Okay. Thank you very much.

Representative Mike Carroll.

REPRESENTATIVE CARROLL: Thank you, Mr. Chairman.

Doctor, did you do a calculation, with a given 8.89 as a rate of return, what the bid would have to be to be equivalent to Act 44 with and without tolls on 80?

DR. GRAY: No, but we could work that up for your next meeting if you would like. We just didn't---

REPRESENTATIVE CARROLL: You can't give us a sense of how much more beyond the 12.801 it would have to be in order to put us in the ballpark?

DR. GRAY: When you talk about average returns over time, the volatility that Representative Maher talked about---

REPRESENTATIVE CARROLL: Let's interrupt you.

The question was, given a steady 8.89 as used in your one slide---

DR. GRAY: Let me think about that. We might be able to get that for you in a couple of minutes.

REPRESENTATIVE CARROLL: Or even if you could provide it to the committee after the meeting, that would be fine.

DR. GRAY: Pat, who is a human computer and is unbelievable on the keyboard, says around $20 billion.

REPRESENTATIVE CARROLL: That is with the tolls on 80 or without the tolls on 80?

DR. CUSATIS: Well, that's a number that would provide enough money. I'd say 8.89 percent to pay the $1.7 billion needed for funding.

DR. GRAY: To fulfill the gap of the Pennsylvania Transportation Reform Committee.

REPRESENTATIVE CARROLL: Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Okay. Thank you.

Seeing no other questions, gentlemen, thank you very much. Very interesting and compelling testimony.

We have a bonus round here today. I think you were tied for the number of times you have been before the committee, but Rob Collins is about to take you over. This is at least his fourth time, I think.

And the Abertis folks are welcome to come back. Some of the members weren't here this morning or weren't here very much this morning.

Gary and Pat, you are welcome to stay. I don't want to turn this into a debate, but if you're here for background, that would be great.

Okay. So for the benefit of the stenographer--- You have them? Okay; great.

Our gentlemen are back here again: Mr. Graells, Mr. Collins, and Mr. Froman.

So Morgan Stanley---

MR. COLLINS: Sure.

CHAIRMAN MARKOSEK: I guess you are the prize witness.

MR. COLLINS: Thank you, Mr. Chairman, for the opportunity to speak again.

You know, I think that there are a number of things in the report that we actually agree with. There are a few things that I think we would have an alternative point of view on.

And maybe just to start, with respect to the market, we actually think this is a terrific market to be looking at this transaction.

Infrastructure is countercyclical, and we've seen over the last 12 months over $700 billion of levered purchasing power coming into the market that have been focused on high-quality assets like the Pennsylvania Turnpike.

So for the Commonwealth of Pennsylvania to be looking at a transaction like this, it's good to be an early mover than a late mover to really maximize the bid price.

And we've seen that in the process where we ran a best and final offer, which has never been done before in U.S. infrastructure. And so Citigroup-Abertis were able to increase their bid $2 billion in one week just because of how competitive the process was, because we had multiple bids within 10 percent of each other.

So let me just start there. If the market was falling off, as previously characterized, we would not have had a best and final offer round and really would not be sitting here today, because it would be difficult to raise $12.8 billion of committed financing.

And we've had multiple bids that, in the aggregate, have been able to put together almost $30 billion of fully committed financing. It's really unprecedented in U.S. infrastructure.

So with respect to the actual bid amount, the $12.8 billion, I think there are three things to consider when you reflect on our previous reports that I mentioned earlier today back in

May 2007.

The first is that -- again, the tolls on this transaction are capped in a way that has never before been seen.

The Indiana Toll Road and the Chicago Skyway concession lease agreements have caps, but they are really estimated to be 5.5 percent. The caps on this, if you look at inflation over a reasonable amount of time where rating agencies look at inflation, they would say it's 2 1/2 percent, or 3 percent perhaps, over an extended period of time.

Every percentage point in tolling, we estimate it to be an incremental $2 billion in value to the Commonwealth. And so should the Governor had gone out with a concession lease agreement that had nominal GDP per capita or what was on parity with the Indiana Toll Road deal, the Chicago Skyway deal, there is a possibility that you would have gotten an incremental $6 billion, or $18.8 billion up front, and that would be at the extraordinarily high end of any of our ranges.

The other thing -- and I know time is short, so I want to be respectful of the committee's time and use your time, Mr. Chairman, efficiently -- the

75-year term is worth approximately, if you look at our analysis, is worth about $3 billion up front. So the combination of tolling and term aggregate about $9 billion in delta on a present value basis.

And then finally, just to highlight a little bit about the actual multiple -- and I referred to this earlier, but I just want to make sure it's considered -- when the Indiana Toll Road deal ultimately closed in mid-2006, that was a high tide.

The credit markets were frothy. People were able to get all kinds of deals done. The Governor, Mr. Daniels, received $25 million a mile for the Indiana Toll Road.

This deal has about the same. It is about $25, $26 million a mile for the Pennsylvania Turnpike in this market, to just show that this is a very attractive market to be doing a deal and that this value the Pennsylvania Transportation Partners has put forth is really incredible and reflects the precedent of transactions.

CHAIRMAN MARKOSEK: Chairman Geist, any questions?

REPRESENTATIVE GEIST: I thought a little while ago I was listening to a red herring presentation from a hedge fund.

Let me ask you just one basic question. If you add up all the numbers for what will be put into the turnpike -- all the projects you have to pay for, and I believe you said it was 10 years of $10 billion of improvements -- isn't the real number that you are paying for the turnpike at $24 billion, plus or minus, when you add that all up?

MR. COLLINS: That's right. Yes.

REPRESENTATIVE GEIST: Why hasn't anybody said that?

MR. COLLINS: I mean, I think what was reflected is that the capital expenditures weren't as studied in detail perhaps and certainly as much as Citigroup and Abertis did in this transaction.

There's an incremental 5.5 present value, just to make it apples to apples, that Pennsylvania Transportation Partners has committed as a part of this deal to really make the $12.8 an $18.3 billion deal for the taxpayers of Pennsylvania. And then there are incremental capital costs, as you say, that the concessionaire will be on the hook for.

So I think that's one of the things that we would like to have an opportunity -- this is the first time I have seen this report.

REPRESENTATIVE GEIST: Would it be possible from you and others that we could get a small report with bulletproof numbers? Bulletproof numbers.

MR. COLLINS: Yes.

REPRESENTATIVE GEIST: Now, we have had, as Joe said, probably a record number of appearances by you. You have reached rock-star status now in this field.

Let's get real numbers---

MR. COLLINS: Okay.

REPRESENTATIVE GEIST: ---and let's get numbers with -- my concerns about Act 44 without 80, what Act 44 without 80 can really generate, and because of what we have in there about the $450 million, et cetera, I am real concerned at what point you break the back of the turnpike, whether you get the deal or you don't get the deal. I'm very, very concerned about future funding of projects in Pennsylvania.

I've listened to so much stuff from so many people from so many different obliques, gotten so many letters with so much misinformation from people who think that they're lobbying the effort with fact that I think it's time that we really do get numbers that are bulletproof and answer questions in language of guys like me with the room temperature IQ.

I'm not a John Maher. I'm not a C.P.A. I don't teach at Penn State, and I don't do a lot of that. But I would like to get it just in plain English, without attacking anybody, numbers that any member of this committee, Republican and/or Democrat, can hang their hat on and numbers for those of us who are truly interested in funding projects in Pennsylvania.

I started out this morning saying I'm definitely committed to making P3s work all over this State. And I'm sure that Morgan is going to be back talking about Parkway East. They're going to be talking about Schuylkill. They're going to be talking about a lot of other projects that companies sitting here and other companies are going to be going after in the State of Pennsylvania.

So it's imperative -- absolutely imperative -- that we do this thing and do it right. There's just way too much politics going on about us, with us, and for us.

And there are those who are going to make a lot of money. There are those who think they're going to lose a lot of money. They are all kinds of parochial interests, but what we have to get through all of this is numbers that we can really rely on, and woe be it if you guys present numbers that are not right.

Thank you.

CHAIRMAN MARKOSEK: Thank you.

MR. FROMAN: Can I just add one comment?

There's much that I disagree with in the previous presentation, but there's one comment at the end that I very much would like to agree with, and that is, the $1.7 billion a year of Pennsylvania's transportation needs, there is no simple answer for.

The lease does not answer all of those needs. The tolling of I-80 does not answer all of those needs. The lease, we think, goes a long way towards answering them.

But the fact is that the needs of Pennsylvania are great. This is one opportunity that's on the table to bring in $12.8 billion to help fund those needs, but it's not the panacea and it's not the only answer or enough of an answer to all of Pennsylvania's needs. It just goes a long way towards addressing them.

CHAIRMAN MARKOSEK: Thank you.

Jordi?

MR. GRAELLS: I think that it will be one part of the solution. But it is a real solution, a tangible solution. It is money up front, just on the table. We have that. We are prepared to pay. That's one of the key things.

We're comparing apples with apples, but apples that we have here and apples that maybe somebody will bring to the table tomorrow or the day after tomorrow.

And we will, of course, provide you with evidence that this is a rock-solid proposal, the best of all possible proposals in our opinion, and, of course, something subject to your decision. And we will provide that as soon as we can.

MR. COLLINS: And we would just--- I'm sorry, Mr. Chairman.

CHAIRMAN MARKOSEK: Rob.

MR. COLLINS: I think part of the confusion is that and the reason that numbers have moved is that they are subject to the current market, and the defeasance costs will move.

There is a hedging mechanic. That was described earlier. That has been consistent with the precedent deals of the Indiana Toll Road and the Chicago Skyway.

The Chicago Skyway interest rates actually moved, they actually moved down between the bid and closing, so there was really no meaningful change to the $1.8 billion.

In the case of the Indiana Toll Road, as I said earlier, interest rates went up, and so instead of getting $3.85 billion, they got $3.8 billion.

I think the number that we can really focus on is that there is a commitment for $12.8 billion subject to that mechanic, subject to the defeasance costs, which we are pretty close to the last panel in terms of numbers.

And then away from that, it's really up to the Legislature on how you all would decide to spend, if it is $10 billion, and in our numbers it is $10.5 billion. I think that's the range to be thinking about.

And whether that's spent with the SERS investment plan -- that was not Morgan Stanley's idea, by the way. And for the record, that was something that came out of discussions as we have gone through this process. And when we saw the S&P 500 basically clip a 3.5-percent return in '07 and SERS post something north of 17 percent, we thought that was incredible investment performance and thought if they could help influence the custodianship of this investment, it would be in the taxpayers' interests.

But whether it's 5 percent or whatever assumptions people would like to make going forward, we believe that it does meaningfully -- it is meaningfully superior than Act 44 without tolling I-80, because when you look at $450 million a year over 50 years, the up-front payment can achieve that with the caps on tolling.

I think that's the essence of the proposal that we would ask the committee to consider.

CHAIRMAN MARKOSEK: Mr. Graells.

MR. GRAELLS: Just one comment.

We think that the value of this transaction is not significantly influenced by the market conditions. This is a deep analysis on the cash flows that we have learned, and this is not influenced by that.

So we think that if this deal would have taken place just 1 year ago, 2 years ago, the price, the amount, would have been very, very similar.

What there has been out there is more

difficulty to get debt, but, you see, whatever has not been put in with debt has been put in equity. So it's a different mix to come to the same price.

So probably this deal is the same value today, tomorrow, and the day before yesterday.

CHAIRMAN MARKOSEK: Thank you.

Before I recognize Representative Watson, this brings to mind a story of something President Harry Truman once said talking about hard numbers and economists, where he told his staff he wanted them to higher a one-armed economist, because that would give him a set of numbers and then he'd immediately say, "But on the other hand...." So I guess no matter whose numbers you have, there's always a second opinion.

Representative Watson.

REPRESENTATIVE WATSON: Thank you, Mr. Chairman.

Though I don't know how to play straight man to that or whatever.

My original question was to you, sir, but something that the gentleman from Abertis said kind of dovetails that. So at this time of disclaimer, yes, I'm an English teacher, schoolmarm originally. My grandfather was the stockbroker, the investment person, and I inherited none of that.

So I do plain speak and I want to know, but I want to make an analogy here, because you started by saying, oh, no, in this climate, this was a good deal and whatever. And I'm sitting here thinking at the time, well, sure, if I'm the buyer, much like if I wanted to go buy a house even in Bucks County now where I come from, I could get a better deal knowing I was going to live there for a long time because the houses, the prices, even of the new houses, are down, and they'll make a deal with me, especially on new construction, because they're sitting holding a lot, be they a Toll Brothers or any of the developers that you could possibly think of.

The gentleman here just said, no, this is a good deal now and it would be tomorrow and it was a year ago. I have trouble understanding that, a year ago, because I know -- and I can use my analogy of real estate, and this is partly, after all, real estate -- it was very different across Pennsylvania and the United States at that time.

I also know -- I happen to be married to a civil engineer who nightly talks about the price of steal and concrete, and that figures into your capital investment -- and I know what the deal would have been a year ago. It would have been, in that sense for you, better than it will be now or maybe tomorrow.

So I am going to echo what Chairman Geist has said. I want the numbers and I want the analysis in really plain and simple terms, because when I hear you just do that, I'm sorry, gentlemen, but that doesn't make logical sense to me. And I'm going to guess that I'm perhaps more representative -- and we keep referring to our resident C.P.A. and genius, Representative Maher, along with some of the other folks up here -- I'm more representative of the average Pennsylvanian who is also looking at this, and I will suggest to you, many of my colleagues who hopefully will have a chance to vote on this.

Thank you.

CHAIRMAN MARKOSEK: Thank you.

Representative Mike Carroll.

REPRESENTATIVE CARROLL: Thank you, Mr. Chairman.

Rob, a couple times during the testimony about this morning or this afternoon you mentioned the Indiana Turnpike and the miles, the mile per mile being about the same.

There has got to be more to the equation with respect to number of vehicles that use the roadway and how that factors in. And maybe I'm being a little bit parochial, but it seems to me that the Pennsylvania Turnpike has to be a more valuable asset than the Indiana Turnpike.

Can you shed any light on that for me?

MR. COLLINS: Well, the Pennsylvania Turnpike is a marquee asset. I think that some of the differences between the Pennsylvania Turnpike and the Indiana Toll Road are their acquired capital expenditures over time, which meaningfully impacts the value you would receive up front.

And so I think from that perspective, when you look at the transactions, you're right. The Indiana Toll Road is not a perfect comparable, but I think it's helpful to see what kind of up-front value Governor Daniels received in that transaction in an environment where people thought it was the peak of the capital markets in terms of ability to maximize debt and increase equity for up-front purchase prices.

And when you look at that, using just that metric, and it's not a terrific metric but it's one to consider as you all think about whether this is good value for the taxpayers of Pennsylvania.

REPRESENTATIVE CARROLL: Just in my rudimentary way, it just seems that the match should work in a little different way, that the Pennsylvania turnpike's value should be greater than the Indiana Toll Road value.

It just seems that considering the number of vehicles in the asset that we have, that there's more value there than the equivalent of the Indiana Toll Road.

MR. COLLINS: There is more traffic.

I think the facts are that in Indiana, the concessionaire can increase tolls so fast, and for every dollar they increase tolls, it's 100 percent cash flow.

In this case, the concessionaire is really restricted like never before seen in a U.S. toll road concession to keep tolls at 2 1/2 percent or inflation. And in the Indiana Toll Road, they have the ability to also increase tolls with economic growth of the State -- or excuse me -- of the U.S. as a whole, and that's a big difference.

REPRESENTATIVE CARROLL: And I don't want to put you on the spot, but the Chicago Skyway is about an 8-mile road. How does that compare with Indiana and with what's on the table here?

MR. COLLINS: The Chicago Skyway also has the same toll-road profile of the roughly 5.5 percent allowance in increasing tolls over time.

So it's exactly the same three-prong test of 2-percent CPI or the nominal GDP per capita, whichever is greater, every year that it will increase.

REPRESENTATIVE CARROLL: Thank you, Mr. Chairman.

CHAIRMAN MARKOSEK: Thank you.

Representative John Maher.

REPRESENTATIVE MAHER: Thank you, Mr. Chairman.

As you are putting together whatever data that Chairman Geist asked for, can I ask that you also provide what you believe, the calculation that you believe measures the present value of the status quo absent tolling I-80?

It just seems to me that that's an arithmetic question as much as anything else. There may be assumptions about what rates to apply for the discounting, but that's an interesting benchmark to measure, are we above water or below water?

On the assumptions about reinvestment, which has obviously become a point of some concern, I see your slides that this is a pro forma calculation. And for those who don't spend their time rolling around in spreadsheets, pro forma basically is saying, you know, assuming, with this assumption, this is what these numbers would look like. It's not saying anybody expects that the future would ever look like that.

And we have other terms that accountants use for when we think something is within a range of possibility or probability, such as a projection, or if we think this is really our best guess, a forecast.

Would you characterize the reinvestment assumptions that are used as a projection or forecast, or is it really just pro forma?

MR. COLLINS: Any work that we've done to just take historical data has been illustrative, and we've clearly cited our assumptions. And so we don't know what the future would hold, and so we would make everything as an assumption based on how the Legislature would choose to ultimately spend the up-front proceeds and invest it within certain guidelines, whether that's 5 percent, as I said earlier, or more aggressively in equities.

I think the full range of possibilities is open.

REPRESENTATIVE MAHER: And I'm guessing that with some of your clients, you do provide the wisdom of, here is your forecast of what you believe rates or the market will yield.

And I recognize that's always risky to do that, but I guess I'm asking, what is Morgan Stanley's forecast or Citi's forecast or Abertis's forecast of what reasonably could be expected as returns?

MR. COLLINS: I would just say from an investment perspective, Morgan Stanley does have an interest rate forecasting group, and so we do publish expectations of what the Federal Reserve might do, for example, with a fixed-income forecast.

So we do have fixed-income forecasts.

REPRESENTATIVE MAHER: Maybe you could include that with this package of information.

MR. COLLINS: Sure. I'd be happy to.

REPRESENTATIVE MAHER: And I'd then ask the question, let's say it is 12 percent, which would be, you know, great. Is that a number Morgan Stanley would be prepared to stand behind as sort of a guarantor?

MR. COLLINS: Well, Representative, what I was starting to say was, we don't project what the equity market will do. It's difficult to make a longer-term forecast on what will happen in the equity market.

I know our academics, Dr. Jeremy Siegel at the Wharton School, has published extensively on this and believes in stocks for the long run and an 8- to 12-percent range is actionable, but that's not something that Morgan Stanley does.

REPRESENTATIVE MAHER: And the challenge that we have is that obviously we, in terms of hitting this fork in the road as to whether or not this bucket of money would be something we could keep dipping into and never see the bottom of the pail, is a pretty important consideration.

And consequently, we do need to be essentially making ourselves -- we are being essentially asked to make a forecast, and I appreciate the peril involved with making these forecasts. So I suppose I'm asking -- and I know this transaction as structured doesn't include this -- but I suppose I would ask the question hypothetically, would Citi or Abertis or Morgan Stanley be prepared to stand behind what's been presented as this 12-percent pro forma so that the members of this committee who are being asked to fill this bucket, or allow you to fill the bucket, that we can be assured that we will be able to draw out on the target that's presented in your materials? Is there a way to arrange that?

MR. GRAELLS: As you know, it's not the role of the PTP, this company that we have formed between Citi and Abertis, to advise you on what to do with the moneys. It's your role, together with the Governor.

So we are not going to be able to advise you on what to do with that money.

REPRESENTATIVE MAHER: I'm not asking for advice; I'm asking for a guarantee.

MR. GRAELLS: You're not asking for advice---

REPRESENTATIVE MAHER: If we're supposed to believe this number, I would ask that you also believe the number. I don't think that's unreasonable.

MR. GRAELLS: Yeah, but this is not the basis of our bid.

REPRESENTATIVE MAHER: Well, I can understand from Abertis's perspective, so I'll go back and let me focus on Morgan Stanley.

If we are being expected to embrace this assumption, I'm asking, is Morgan Stanley equally prepared to embrace this assumption?

MR. COLLINS: I think---

REPRESENTATIVE MAHER: And if you are, then we have got something to talk about, I think.

MR. COLLINS: Right; it's a good question, Representative.

I think what we would ask the Legislature to consider is that Act 44 without I-80 tolling is $450 million a year as a promise to pay over time, and what recourse does the Commonwealth have if that payment doesn't come in?

REPRESENTATIVE MAHER: But that's not the people who are visiting with us today. I'm asking you---

MR. COLLINS: I understand.

REPRESENTATIVE MAHER: And it's really simple: Do you want us to rely on this expectation? And I'm asking, do you believe this expectation, because if you do, it wouldn't seem to be a very big deal to back it up.

MR. COLLINS: Right. We could come up with an investment portfolio for you. We can do more work on this, if you would like, that would take the up-front payment, the 10.5, $10 billion, $10.5 billion, and could talk to you about what treasury rates return you could actually invest that in to give yourself effectively more or less a risk-free investment over a long period of time.

REPRESENTATIVE MAHER: Well, I understand risk and risk free. It doesn't sound like you're really -- you're not really in the position to stand behind this assumption for the long term. We should embrace it, but you can't afford to take the risk if it's mistaken, but we should.

MR. COLLINS: We don't know what the future brings, so.

REPRESENTATIVE MAHER: Of course not.

MR. COLLINS: We are in the business of making up a forecast like that.

REPRESENTATIVE MAHER: I appreciate it. And there's an opportunity there.

CHAIRMAN MARKOSEK: Thank you, Representative.

If there's no other questions, I just had one quick one myself relative to the lease agreement on the tolls, the cap of the tolls at 2.5 percent or the current CPI.

What is the CPI today of the trailing

52 weeks? And I'm assuming we are taking the CPI over a year, or how does it -- is it the CPI that day, or do we have an average CPI over a certain amount of time?

And what has that -- if we were leasing the turnpike starting today, I guess is what I'm getting at, what would the percentage toll increase be? Would it be at the 2.5, or would it be at the CPI that is somewhere higher?

MR. COLLINS: It will be consistent with Act 44. It will go up 25 percent with either Act 44 or the lease in January. And so that would be the first year.

And then the second year will be a look-back at what CPI was, the latest 12 months, and that would either be 2 1/2 percent or CPI, which is greater.

CHAIRMAN MARKOSEK: Okay.

If we had the look-back today, assuming it was going into effect today, what would the look-back tell us? Give us---

MR. GRAELLS: Yes. Well, there's not going to be any increasing tolls until January the 1st, 2009.

CHAIRMAN MARKOSEK: No; I understand that. But I'm just using the hypothetical, what has the

CPI been in the last, and if we would have done this a couple of years ago and it were just going into effect today, what would the increase in toll be?

MR. COLLINS: We will have to follow up with you to give you a specific answer. It's in the area of 2 to 2 1/2 percent.

So I think what we do know is that asphalt prices have increased 25 percent over the last 12 months. It's been well reported in publications like the USA Today and others.

So what we believe, with construction costs that have increased 50 percent since 1999, that as those two elements of roadway construction continue to accelerate above and beyond inflation, even if, you know, if it was 3 or 4 percent today, that meaningful increase will translate into higher tolls under Act 44 than it would under this concession lease deal.

CHAIRMAN MARKOSEK: Well, it would still be higher tolls than the 2.5 under the concession deals as well. Is that correct?

MR. COLLINS: Right.

CHAIRMAN MARKOSEK: I mean, you don't know what it is, but if the trend is going like it has been going, it would seem to me that your CPI would be much higher than the 2.5.

MR. COLLINS: Well, Mr. Chairman, the CPI, because it's a national basket, doesn't necessarily focus on the roadway construction materials. And so most analysts that study construction materials and commodities and look at the price of oil as it factors in the price of asphalt continue to project that the costs of roadway construction will be double-digit increases, so meaningfully higher than what the expected current price inflation is for the rest of the country.

CHAIRMAN MARKOSEK: So how would -- I guess just thinking it through a little bit more, and I hadn't thought of this part. If that's the case, how do you take care of the road if you are paying a much higher -- but, you know, your tolls are capped. I mean, somebody's got to be losing money there.

MR. GRAELLS: We may go to make pavements, rigid pavements of concrete instead of asphalt.

CHAIRMAN MARKOSEK: I'm sorry. Say that again?

MR. GRAELLS: We can switch to concrete pavement instead of---

CHAIRMAN MARKOSEK: Asphalt.

MR. GRAELLS: ---going to asphalt.

We have choices, you know, and this is the way it has been. You know, in the seventies, after the war and crisis, there was a huge increase of the asphalt and gas, you know, things like that. That was the time of the rigid pavement, because it was, you know, substituting everything else.

So one thing, when the prices of gas and oil were down again in real terms, then it was switched again to the flexible pavement.

So we have a handful of opportunities to adjust and model how we are going to do the investments.

CHAIRMAN MARKOSEK: But if you can't -- just again, hypothetically, if you couldn't raise your tolls to cover this, I think steel was 49 percent in the first quarter, as I was told by Secretary Biehler very recently. If you have those kinds of costs and you are capped at CPI, could there be a situation where you go bankrupt?

MR. GRAELLS: No, because, you know, the concession market is self-regulating, you know, and when prices like now of asphalt and other materials go up, the demand from the public administrations goes down. So that makes the supply, you know, react with lower prices again.

But again, the materials is only one of the elements of the picture. The others are machinery and the personnel costs, wages. So they don't react all at the same time. And again, you have several alternatives to build the same thing with the same performance one way or the other.

So this is what is the essence of a concession. You have plenty of opportunities to provide the same service with different alternatives and to keep, you know, planning it all around.

CHAIRMAN MARKOSEK: Well---

MR. COLLINS: It is a risk, Mr. Chairman, that the concessionaire absorbs itself, nonrecourse the Commonwealth. If asphalt prices, if concrete prices, if costs of construction or labor increase the way they have recently over the last 12 months, you still have your up-front payments and you will be auditing the concessionaire to this contract.

So as long as the concessionaire is maintaining the road quality and has really continued to observe the 500-page operating standards manual and you audit them to that, that is the tradeoff.

And the Commonwealth itself won't have to increase tolls. There won't be another $5 billion of debt that perhaps the PTC will ask the Commonwealth to back stop as an obligation.

CHAIRMAN MARKOSEK: Well, that's comforting to know in years '73-74. If that occurs in years '12-13, now if you can't meet the parameters, we are in one of those situations I spoke of this morning where we're at a take-back mode, which I think will be ugly and messy, quite frankly.

I think for anybody here to say, well, if we don't follow this, you know, you get the road back, something tells me that that's not going to happen just quite like that. That would be an ugly, messy, legal mess, quite frankly. So just a comment.

Jordi, go ahead.

MR. GRAELLS: We were there in '73-74 already operating toll roads in Spain and in France, and that, well, we managed to get out of there. You know, we had to build roads at that time, significant sections, and we did it. We did it with, you know, these kinds of techniques of, you know, switching the type of pavement and bringing other materials, you know, going for the best solution that would preserve the value of our money.

CHAIRMAN MARKOSEK: Okay. Thank you.

MR. FROMAN: I guess the only thing I would add, to go back to what we discussed before, is this risk is now ours under the lease, whereas otherwise it remains the PTC's.

So to the degree that material costs rise more than CPI, their choice is -- as they're putting more debt on -- their choice is either to raise tolls much above CPI or reduce their payments to PENNDOT.

Those are the two choices that they face, where we would be required just to take a lower return on our investment.

CHAIRMAN MARKOSEK: Okay.

With that, I want to congratulate and thank all the testifiers here today. I want to especially say thank you to the members. Our committee members never fail to amaze me on how great a questions they have.

It's been compelling testimony. Irregardless of where folks are on this issue, I thought it was a very interesting, very comprehensive hearing, and we have more tomorrow.

At 8:30 tomorrow morning, we have the Commonwealth Foundation followed by the Turnpike Commission, which I think will be equally interesting and compelling.

And if Rob and Jordi and Mr. Froman wish to attend tomorrow again -- and we do have a public comment afterwards as well, which is somewhat rare. I think most of my colleagues will admit that here in our committee system, we don't usually see that. But we decided this was important enough to do that, and we will have a public commentary after that, too.

So Representative Maher, do you have a question?

REPRESENTATIVE MAHER: I appreciate the---

CHAIRMAN MARKOSEK: Excuse me. You need to come to the mike, please.

Representative John Maher, in case anybody in the room doesn't know.

REPRESENTATIVE MAHER: I'm very sorry.

I appreciate that the 8:30 a.m. time for tomorrow was established before we had the news of Tom Petrone's loss and before we had the schedule, which has us gaveling in tomorrow at 1 p.m.

And I was going to suggest, it's often difficult to move things up, but perhaps at the discretion of the Chair, perhaps you could consider having a start a bit later so that those who are hoping or attempting to make a roundtrip to Pittsburgh will have a fighting chance of being here for the hearing and maybe perhaps start at 10 or something so that---

CHAIRMAN MARKOSEK: Well, I think we could perhaps---

REPRESENTATIVE MAHER: It's just a suggestion. I know this is an important issue, and I know there are folks that would have liked to be here right now who aren't here because of the travel demand.

CHAIRMAN MARKOSEK: Well, how about if we---

REPRESENTATIVE MAHER: You can consider that and perhaps send us notice.

CHAIRMAN MARKOSEK: Well, I would just as soon make that decision now while we have folks here, because we have the one set of testifiers tomorrow morning at 8:30, and I don't know that, you know, we would have to -- if they are here at 8:30, you know, we would certainly like to honor their ability to get here. But I understand your problem.

We will sort of cut maybe part of the difference here and make it at 9? Is that okay?

REPRESENTATIVE MAHER: Whatever you do I think will accommodate many of our members.

CHAIRMAN MARKOSEK: If it's okay with the rest of the members here and Chairman Geist, we will say 9 o'clock?

REPRESENTATIVE GEIST: Joe, whatever you want.

CHAIRMAN MARKOSEK: Well, I'm trying to accommodate the members as well as the testifiers here, so let's just say, make it 9 o'clock and go from there.

REPRESENTATIVE MAHER: Thank you.

CHAIRMAN MARKOSEK: Thank you.

The meeting is adjourned.

(The hearing concluded at 3:15 p.m.)

I hereby certify that the proceedings and evidence are contained fully and accurately in the notes taken by me from the audio file and that this is a correct transcript of the same.

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Jean M. Davis, Reporter
Notary Public