

Macquarie



TESTIMONY OF:

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BEFORE THE

LITTLE HOOVER COMMISSION

**“BENEFITS FROM INCREASING PRIVATE
PARTICIPATION IN CALIFORNIA’S INFRASTRUCTURE”**

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Good morning Mr. Chairman and members of the Commission. My name is Nicholas Hann, and I am an Executive Director of Macquarie Holdings (USA) Inc. Thank you for giving me this opportunity to provide testimony on the potential benefit to be gained by increasing private participation in the development of California's infrastructure.

I intend to cover the following today:

1. What is a Public Private Partnership and what benefits can it provide;
2. What opportunities exist for public-private partnerships and how have they been used in other states and countries;
3. Whether the existence of tax-exempt government debt rules out any benefits that might be achieved by a public-private partnership; and
4. What measures are necessary to implement public private partnerships effectively and how interested the private sector would be in entering these partnerships in California.

For those of you who may not be familiar with Macquarie, we are a diversified global financial services organization. In particular, Macquarie is recognized as a leader in the ownership, management, and development of over 110 important infrastructure assets around the world including an increasing number in the United States. We manage over US\$55 billion in equity investments in infrastructure.

We provide services to:

Industry	Users Served (As of March 31, 2008)
Airports	+78 million passengers per annum
Roads	+2.3 million cars per day
Water	+17.1 million households*
Electricity	+7.3 million households*
Broadcast Communications	+90 million people through electron infrastructure and print
Transportation Systems	Million passengers per annum: +2.7 Rail, +6.1 Ferry, +290
Car Parks	+390,000 car spaces
Sea Ports	+4.2 million standard container units handled per annum
Employees	+1,500 in USA, +77,000 across the business

** Includes sub-metering services*

Macquarie has operations in 25 countries with over 12,800 staff. We have 19 offices in the United States with over 1,400 staff.

We recognized as early as 1990 the potential of infrastructure as an emerging asset class that offers stable long term investment characteristics and benefits from a long term active management philosophy. Macquarie is a committed, long term investor in infrastructure. Our aim is to manage responsibly and profitably the assets in which we have investments. We take a partnership approach with governments, adding value through specialist strategic, commercial, operational, and financial expertise with a proven track record in enhancing the performance of assets over the long term.

There are a wide variety of public private partnerships and the model has flexibility to accommodate a range of objectives.

I will focus on three major types of transactions.

Type One. Where an existing asset, financed in part or in whole by user charges, is transferred to the private sector under a long term concession. This is the type of Public-Private Partnership which has been most common in the United States to date. Examples include the Chicago Skyway, the Indiana Tollroad and the Chicago Parking Garages. The private sector will typically make a large upfront concession payment for the right to receive user charges and takes on the costs and risks of operating, maintaining and expanding the asset over the life of the concession.

Type Two. Where the private sector takes on responsibility for the design, construction, operation, maintenance and financing of a new asset in return for the right to collect user charges for a defined concession period. The scope and the risks accepted by the private sector under this type of Public-Private Partnership are significantly greater than the transfer of an existing asset and the corresponding risks to government are substantially reduced. An early example in the United States is the South Bay Expressway (SR125) in San Diego California. Other examples include the Dulles Greenway, the Capital Beltway HOT Lanes project in Virginia and the LBJ Freeway (I-635) in Texas.

Type Three. The most common Public-Private Partnership internationally and is essentially the same as the second where the private sector takes on responsibility for the design, construction, operation, maintenance and financing of a new asset. The difference is that instead of collecting user charges, government makes annual payments to the private sector concessionaire in return for the services provided by the asset. These payments are typically known as Availability Payments because they are only made if the asset is completed, open for use, and meeting the performance standards required. Examples of this type of Public-Private Partnership in North America include the I-595 Corridor Roadway Improvements Project in Florida, the Sea to Sky Highway in British Columbia and numerous other highway, rapid transit, water treatment, public healthcare, courthouse, and public education projects in Canada. Macquarie is currently one of 12 bidding teams vying to be shortlisted for an availability style PPP over the new Long Beach Courthouse.

All of these Public-Private Partnerships share some common characteristics which differentiate them from pure privatization.

First, legal ownership of the asset remains with the government and the asset transfers back to the state in good condition at the end of the concession period.

Second, government establishes and regulates the service standards required to be met, the condition in which the asset must be maintained and handed back, and the user charges which can be levied. Government retains strong levers to ensure the public interest in the asset is retained.

Third, the private sector partner suffers deductions from its revenues and ultimately the termination of its concession rights if it fails to perform.

Additionally, these Public-Private Partnership types also share common characteristics for the investor.

They require a long term approach to the management of the asset in order to provide an adequate return therefore there is a significant focus on lifecycle costs of the asset. In other words, the private sector has to make decisions which optimize performance of the asset over the whole of its useful life not on an annual budgeting basis. This may mean investing more money in construction in order to reduce later maintenance requirements and it certainly means performing maintenance, rehabilitation and expansion works as and when required rather than deferring and allowing the asset or its services to deteriorate.

The ability to raise competitive long term financing for the asset requires a very thorough and robust approach to risk allocation. Construction completion risk is typically passed to a credit worthy

contractor providing a strong financial support package. Similarly operations and maintenance risks are supported by an experienced and creditworthy manager.

In the United States Public-Private Partnerships are usually thought of mainly as a financing instrument. To take the Indiana Tollroad as an example, the State did a study of what the highway would have been worth had the State raised tolls and operated it according to the provisions of the concession agreement used for the Public-Private Partnership. This study placed the value of the asset at \$1.8 billion, however the private partners, Statewide Mobility Partners, a Macquarie – Cintra partnership signed a concession agreement offering \$3.8 billion. How did this transaction liberate \$2bn of surplus capital for the State?

Simply put, the liberated \$2 billion resulted from placing the Indiana Toll Road in a market environment. The Indiana Legislature created a legal construct under which the State of Indiana was able to transfer legal property rights to whatever entity in the world placed the highest value on the Indiana Toll Road, in this case a partnership of Macquarie and Cintra. This new legal construct liberated the captive capital allowing Statewide Mobility Partners to pay more than twice the value the State placed on the asset. The partnership was able to find additional value in this asset for four reasons:

1. Financing: A debt-equity financing model allowed the Partnership to pay more for the asset than a traditional bond financing approach;
2. Higher traffic forecasts driven by better service and by the willingness of equity to take a longer term view on traffic growth than bond investors;
3. Better operations utilizing electronic toll collection methods to reduce costs; and
4. Lower maintenance costs by better utilization of existing infrastructure and through innovations and timely investment in operations and maintenance.

The traditional bond financing approach has layers of conservatism built into valuing the asset, and that conservatism tends to under-value the asset. In addition, bond covenants require a debt coverage ratio, i.e. that the revenues of the asset exceed debt payments by a defined percentage. This debt coverage ratio provides a cushion for investors, but it prevents that cushion from being used to help finance the asset. By contrast, a debt-equity model is able to use the equity investment as the cushion or assurance that those holding the debt will be repaid. As a result, the debt-equity financiers are able to free up more capital than those using traditional bond financing, producing a greater payment to the owner of the asset. The equity cushion also allows for more innovative approaches to revenue risk, to completion schedules, to operations and maintenance risks and to expansions.

The Indiana experience is in fact typical of the benefits offered by Public-Private Partnerships. It was the structure of the transaction which meant that the benefits were realized as a \$2bn surplus upfront payment to the State.

Benefits of Public-Private Partnerships have been recorded around the world. Studies in the United Kingdom which has completed approximately 650 Public-Private Partnerships show that:

- + 89% of Public-Private Partnership projects came in on time or early and no cost overruns on construction were borne by the public sector;
- + noting that 70% of conventional projects were delivered late and 73% ran over budget (Source UK Treasury); and

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- + Public-Private Partnerships achieved significant cost savings compared to conventional delivery
 - o 19% on capital costs
 - o 34% on operating costs
 - o 17% overall lifecycle savings(Source: UK National Audit Office Study of highway Public-Private Partnerships)

These results have been broadly replicated by studies elsewhere including Australia and Canada.

The benefits of Public-Private Partnerships really come from their efficiency as a delivery mechanism for infrastructure assets and the services which they provide. The essential building blocks of a good Public-Private Partnership transaction are:

- + the private sector must be responsible for the Design – Build of the asset under a single integrated contract. The government should provide as much flexibility as possible to the private sector in how to meet the required services. Government should concentrate on output specifications (the services the asset must deliver) rather than input specifications (the amount of concrete and rebar used to make the asset). This will allow for innovation to reduce costs and increase the speed of construction completion. The private sector will be responsible for completion on time and on budget;
- + this degree of flexibility in the provision of the design and construction must be accompanied by responsibility on the part of the Concessionaire for a substantial part of the operations and maintenance of the asset for its useful life. It is this element which essentially provides Performance Based Infrastructure – a warranty of the construction for the life of the concession. This also allows the private sector to optimize expenditure decisions over the life of the asset and to take responsibility for asset performance; and
- + transferring responsibility for operations is important because it incents the right design decisions to maximize efficiency. However, it is possible to draw a line between certain operations which can remain in the public sector and those contracted to the private sector partner. A good example would be public hospitals delivered as Public-Private Partnerships where all clinical services continue to be provided by the state while “bricks and mortar” services associated with the infrastructure are the responsibility of the private concessionaire. The criticism often leveled at Public-Private Partnerships by public sector unions is that the benefits come from reducing costs and benefits for operating employees. This is rarely a driver of Public-Private Partnership benefits.

In order to unlock these benefits, private sector financing is essential because it transfers to the concessionaire substantially the rights and responsibilities associated with ownership of the assets over the life of the concession. I contrast this with a simple contractual obligation. The State could in theory obtain similar benefits by entering into one or more long term Design- Build – Maintain contracts. A Public-Private Partnership ensures that all elements of the facility are integrated and there is no opportunity to ‘pass the buck” on risks. It also ensures that if something goes wrong there is an out of pocket investor and lender working towards a solution rather than just a contractual dispute.

These delivery benefits ensure that a Public-Private Partnership delivers value compared to conventional delivery *even though* the cost of private sector finance may be higher. This is why many governments worldwide are using Availability Payment Public-Private Partnerships in preference to government borrowing. In practice however, the overall cost of financing for a Public-Private Partnership is often competitive with other solutions in particular state or municipal revenue bonds. Any gap is narrowing as private financial markets become increasingly sophisticated in their analysis of Public-Private Partnerships and as new instruments such as Private Activity Bonds and TIFIA

loans in the transportation sector allow the benefits of public and private financing to be combined. The South Bay Expressway was in fact the first project to combine TIFIA loans with private equity. Private activity bonds which replicate the lower cost of tax exempt municipal bonds are also now available to finance transportation projects.

The effects of the current credit crisis have probably increased the advantages of Public-Private Partnerships as public sector budgets come under increasing pressure and as the credit requirements and pricing expectations of the tax exempt bond market increase. Public-Private Partnerships have not been unaffected by the crisis but transactions are still being done as the financial close of the I-595 in early March demonstrates. Indeed, the 595 project was oversubscribed in debt – a remarkable feat in the current economy – showing the strength of the public-private partnership model.

Creating the conditions for the successful implementation of Public-Private Partnerships is a challenging exercise as Public-Private Partnerships are complex transactions which require a change of mindset from conventional procurement. Some of the key factors which would assist in attracting interest from leading private sector developers and ensuring successful outcomes are:

- + Create a State Public-Private Partnership agency to act as a center of expertise and as far as possible a “one stop shop” for the interface between government and the private sector;
- + Use existing models and refine them for the specific needs of California. Do not reinvent the wheel as this is too expensive and time consuming. Use experienced advisors to ensure that solutions are practical;
- + The private sector is prepared to take on significant risk but not all risks, especially those which it has no means to effectively control or mitigate. Risk transfer should be appropriate and not excessive. In particular the risks associated with environmental approvals, permitting and land acquisition should be largely taken by the State; and
- + Develop clear procurement processes with defined outcomes. Disclose any affordability limits to the project. Evaluation criteria should be as transparent as possible and disclosed as early as possible in the process. Timeframes should be realistic and maintained.

There are two broad procurement mechanisms for selecting a Public-Private Partnership partner.

The Full Competitive Bidding Approach involves significant upfront financial and personnel from the public sector agency, typically with substantial consulting support, developing conceptual design and performance standards, commercial terms, traffic forecasts, draft legal agreements, and key financial terms. Private partners are then invited to respond to a Request for Proposals (RFP) on the basis of this information. The time period from project inception to securing the complete PBI Team is approximately 2 years, which includes 1 year for preparing the RFP and a further 9 to 12 months to obtain private bids and negotiate the final concession agreement. The cost of this type of procurement to the public sector may range from \$10 to 20 million, with an additional cost to each private sector proponent of \$1 to \$5 million to respond to the bid. The private sector’s RFP response costs can be defrayed by a stipend, payable by the public sector to the losing bidders. The competitive process can drive a virtuous circle of innovation and efficiency with each consortium made up of knowledgeable, experienced companies each looking over one another’s shoulders to ensure that fat is taken out of all aspects of the bid to maximize the chance of success against the other teams

The Preliminary Development Agreement Approach has a private sector development partner undertaking both the public sector “consulting” activities and the private sector development activities in conformance with governmental development and environmental regulations. The time

period from project inception to securing the remaining members of the PBI Team is approximately 18 months, which includes 1 year for preparing the project's entitlements and schematic design and 6 months to obtain competitive bids from design – builders and debt markets and negotiate the final concession agreement. The cost of this type of procurement is primarily fronted by the private sector (PBI Management Team). In this approach, private sector development expertise is brought into the project at an earlier stage, speeding up the process and reducing the procurement costs to the public sector.

Under both these processes the planning which is done is work which should also be done to support conventional delivery. One of the benefits of Public-Private Partnership delivery is that it forces planning to be done early and with a degree of rigor which is often otherwise lacking. This helps drive benefits in terms of delivery to the required standard, on time and on budget.

The choice of procurement method will depend upon the needs of the project, the resources and time available and the number of competitive bidders interested.

In summary the key advantages of Public-Private Partnership delivery for the State of California are:

- + Government sets the agenda, maintains ownership and maintains control at all times.
- + Access to private sector financing to implement the design and construction of essential infrastructure;
- + Accelerated financing and design and construction schedules providing earlier services and economic benefits;
- + Cost and completion certainty at a lower overall cost than conventional procurement;
- + A strong commercial focus on a successful and cost-effective outcome;
- + Long-term lifecycle approach to maintenance and rehabilitation of the facilities with cost risk transferred to the private sector;
- + Funding security for expansion and maintenance. Public authorities responsible for maintaining and improving facilities are subject to fluctuations in tax revenues and to uncertainty that come with legislative appropriations. As a result, lack of funding or other priorities may prevent those responsible for maintaining the infrastructure from addressing the needs of the facility in a timely manner. Delayed routine maintenance can lead to more serious and costly maintenance problems, further exacerbating the funding shortage. Concessionaires, on the other hand, have the resources and incentive to provide maintenance when needed because that is when it is most cost-effective;
- + Maximization of commercial revenue streams and ability to transfer revenue risk to the private sector; and
- + Economic development. By advancing projects not otherwise feasible or by generating cash payments, Public-Private Partnerships can significantly further economic development. The United States Department of Transportation estimates that \$1 billion in spending on road construction generates 47,500 new jobs; that \$1 invested in highways delivers \$4 in economic benefits and that between 1980 and 1991, highway investments gave rise to almost one-fifth of the increase in productivity in the U.S. economy.

Mr. Chairman and members of the Commission, thank you again for holding this hearing today and affording me the opportunity to speak to you on this important topic. I would be happy to take any questions you may have.