Aon Risk Solutions
Global Construction & Infrastructure

Getting to $1 Trillion: A Potential Tool to Revitalize American Infrastructure

3Q 2017

Empower Results®

Table of Contents

Getting to $1 Trillion: A Potential Tool to Revitalize American Infrastructure

Governments at all levels in the U.S. recognize the need for increased infrastructure investment and this was a key issue during the 2016 presidential election. Key issues for policymakers have not been whether to invest, but rather how to pay for that investment. Revenue-risk public-private partnerships, like toll roads, have been proposed as a potential solution that allows the public sector to offload development costs to a private partner. There is some concern, however, that there may not be enough revenue risk projects to support $1 trillion worth of investment, as the Trump administration suggests.

One strategy to bring in private financing to facilitate increased infrastructure investment without significantly increasing public sector spending would be to take advantage of asset monetization or asset recycling. In an asset recycling scenario, a state or municipality can take a revenue generating asset, such as an airport, and lease the operations and development rights to a private party in exchange for a lump sum payment. The government can then use that lump sum payment to retire existing debt and for further infrastructure investment.

Asset recycling would take advantage of the nearly $70 billion in dry powder (or unused equity) that is currently sitting in North American private equity infrastructure funds, with the possibility of an additional $40 billion when Blackstone Group completes its fundraising efforts for its North American infrastructure fund.[1] Additionally, this does not account for the capital in construction firms' development arms or other long-term infrastructure investors. The public sector can take advantage of some of this capital that is leveraged into hundreds of billions of dollars in investment, providing significant capital to invest in the development of new assets.

The Australian Experience

Australia was the first country to actively pursue this strategy. In 2014, Australia launched its Asset Recycling Fund intended to incentivize Australian states to explore asset monetization as a way to accelerate needed investments in economically significant infrastructure projects. The intent of the program was to incentivize states to participate in the sale of revenue generating assets. In the event of a sale, the federal government would contribute 15% of the assessed sale value of the asset to fund additional state investment.

1 *"Preqin Quarterly Update: Infrastructure Q1 2017," Preqin, 2017.*

For example, if Queensland were to sell an airport for A$500 million and planned to use A$250 million of that sale for new infrastructure investment, the federal government would kick in an additional 15% of A$250 million, or two installment payments of A$18.75 million each. The initial program budgeted A$4.2 billion for the program and made A$3.3 billion in awards to states that sold public assets over two years, implying a total of at least A$22 billion worth of infrastructure investment. These sales have included the A$9.7 billion sale of the Port of Melbourne that earned Victoria an additional A$877 million from the asset recycling program. New South Wales also participated in the program with a number of sales, including the A$6.6 billion sale of TransGrid. The sales earned the state an expected additional A$2.19 billion contribution from the federal government.

With the sales of these and other assets along with the federal contribution topping up the sale prices, Australian states have boosted their investment into new infrastructure assets. New South Wales committed to investing its asset recycling funds on the Parramatta light rail, congestion relief projects, and freight corridor highways.[2] Victoria is using funds from the port sale and the asset recycling top up to upgrade its regional rail network, among other investments.[3]

Potential Application of Asset Recycling in the U.S.

Asset recycling could allow states and municipalities to leverage their current assets into needed infrastructure investments. Pursuing a privatization agenda could help states and municipalities create more fiscal space as they could retire existing debt associated with the leased asset and provide governments with windfalls to be used to generate additional infrastructure investment.

Asset monetization has occurred to a limited extent in the United States, but without the explicit incentives from the federal government. For example, in 2006, Indiana leased the Indiana Toll Road for $3.8 billion to a consortium comprised of Cintra and Macquarie. The lease allowed the state to pay down the remaining debt on the ITR, make significant investments in other road projects around the state, and invest $500 million into the Next Generation Trust Fund for future road investments funded by the interest from the fund.

While privatization may be taboo in certain respects in American politics, these deals are governed by terms defined in their contracts. If the public authorities have competent advisors to ensure that public interests are being protected,

2 *"2017-2018 Budget Paper No. 2 – Infrastructure Statement," New South Wales Budget 2017-18*

3 *"Victorian Regional Rail to get $1.5 Billion Investment," The Australian, June 27, 2017*

these deals can tend to avoid some of the anticipated public backlash. John Schmidt, a partner with Mayer Brown, wrote, "the drivers on toll roads and bridges, the airlines that lease gates at airports and the shippers at ports can all be protected against increased tolls and other charges by the terms of the transactions or by separate regulatory controls."[4] These terms and other regulatory controls can also apply to labor contracts to protect current public employees.

Long-term leasing of public assets requires political champions who are capable of explaining to the public the facts of the lease. These include that the public authorities remain the owner of the asset, that the contract contains maintenance standards to ensure consistent asset quality, and that contractual language can regulate changes in user fees.

Much of the revenues generated by assets that would be candidates for asset recycling are currently restricted to use for debt and maintenance costs affiliated with that particular asset. For example, most public toll authorities cannot remit their revenues to support other infrastructure projects. The Ohio Turnpike and Infrastructure Commission was sued for issuing nearly $1 billion in bonds in 2013 supported by turnpike revenues to fund highway infrastructure projects that have a "nexus" to, but are off of, the Turnpike. The suit alleged that the Turnpike revenues constitute an illegal tax as the Turnpike Commission does not have the authority to impose taxes, however the revenues are funding projects that are not necessarily being used by turnpike users. This pending litigation creates uncertainty as the state begins to invest in projects around the Turnpike.

Asset recycling programs may find opposition similar to that of the Ohio Turnpike Commission's decision. Residents who may live near, or are frequent users of, assets that are part of an asset recycling program may be resentful of their user fees helping to support infrastructure investments that are in faraway places in the state. For example, residents in northern Indiana that frequent the Indiana Toll Road may be resentful of the state's Major Moves initiative that took proceeds of the ITR sale and invested in projects in every county in the state.

Notwithstanding, an asset recycling program provides taxpayers and governments benefits in addition to providing capital for new investments. One benefit is that the contracts can be written to require the private partners provide a defined level of service and maintenance through the term of the lease and minimum handback requirements. This contractual obligation of quality will often mean the private partner will be responsible for consistent maintenance through the term of the lease as well as providing capital improvements, and as a result politicians would no longer be able to defer maintenance costs.

4 *John Schmidt, "Recycling Assets to Meet America's Infrastructure Needs," Infra-Americas, July 17, 2014*

Key Challenges to Asset Recycling

While asset recycling has the potential to catalyze increased infrastructure investment, there are a number of challenges for this strategy to succeed in the United States. A useful example of the challenges associated with asset recycling has been the experience of the United States' Airport Privatization Pilot Program (APPP) over the last 20 years. In 1996, the U.S. federal government initiated a pilot program that would facilitate the privatization of some of the country's airports. As of April 2017, however, only four airports are in the program, while eight others have begun the process only to withdraw their application.

Though private airport operators have been used outside of the U.S., the APPP has found relatively little success over its history. The Government Accountability Office conducted an analysis in 2014 that identified a number of sources of the difficulty of the program. Chief among the hurdles to success have been higher borrowing costs for the private sector due to the lack of access to tax-free debt for privatizing airports and potential loss to state and local property tax exemptions. Additionally, long and costly application processes that ranged from 14 months to 84 months due to lengthy airline consent negotiations, public opposition, and external factors like the macro-economy have challenged increased adoption of the program.[5]

Another key challenge to a privatization agenda is the distributed ownership structure of American infrastructure as noted by the Congressional Research Service. Unlike many other countries, ownership of infrastructure generally does not rest with the national government but is rather owned by state and local authorities. This makes privatization programs more complicated than other countries as it would involve multiple stakeholders. For example in the airport privatization program, each deal requires agreement among four major stakeholders: airport owners (typically a state or local government), air carriers, private investors, and the federal government.[6] This distributed ownership structure can make a national program of long term leasing to the private sector more difficult to execute.

Even though the program has had little historical traction, there are currently two airports, Westchester County Airport in New York and St. Louis Lambert International Airport in Missouri, which are currently in the process of looking for private operators. If these privatizations proceed smoothly there may be an increased appetite for governments to monetize existing assets to help facilitate increased investments.

In addition to these two airports, other American airports have entered into, or are considering entering into, agreements with private partners that would not necessarily be classified under the APPP. The Port Authority of New York and New Jersey entered into a long term agreement with Skanska, Meridiam, and Vantage Airport Group to redevelop Terminal B at LaGuardia Airport. The Denver International Airport has reached commercial close with a Ferrovial-led team to redevelop the airport's great hall.

While the APPP is just one program in the United States intended to facilitate a monetization of assets to the private sector, the challenges it has faced may be illustrative for future endeavors in asset recycling. The U.S. federal government has developed a number of strategies that have been successful in bringing additional private sector capital to new infrastructure development. These programs have brought some of the cost of financing for public-private partnerships more in line with tax exempt financing; however, there are currently no programs that would extend similar tax preferences to the debt that would be required to facilitate any significant asset recycling program.

5 *"Airport Privatization – Limited Interest Despite FAA's Pilot Program," United States Government Accountability Office, November 2014.*

6 *Tang, Rachel, "Airport Privatization: Issues and Options for Congress," Congressional Research Service, February 3, 2016.*

Contacts

Peter Fogel
Risk Analyst
Aon Infrastructure Solutions
1.312.381.1797
peter.fogel@aon.com

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

www.aon.com

GDM000000

Empower Results®