A New York Perspective on Public-Private Partnerships

Fiscal Policy Institute

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These remarks were prepared for “Partnerships for New York—Innovative Transportation Financing and Contracting Strategies: Opportunities for New York State,” a conference in Albany, New York. Handouts follow the remarks.

In thinking about today’s topic, I was reminded of something that Stanley Fink, the late, great Speaker of the New York State Assembly used to say to business audiences. He had a great respect for the profit motive of corporations, and the role that the profit motive plays in making our economy function. And he would frequently remind business audiences that he understood that they were not eleemosynary institutions.

I was reminded of Stanley Fink’s admonition about the non-eleemosynary nature of business corporations as I tried to understand the “pot of gold at the end of the rainbow” thinking that has lead many in the transportation field to support deals like the sale of the Chicago Skyway to a for profit entity or the possible sale of the Tappan Zee Bridge to such an entity.

In reality, private firms, of the type that have leased the Skyway for 99 years, exist not just to make a profit but to maximize their profits; in other words, such firms exist to maximize the return that they make on their investments. There isn’t anything wrong with that. It just means that we just need to keep that in mind when assessing their proposals. A profit-maximizing firm is not going to hand over $1.8 billion of capital (or $3 billion of capital or whatever the amount might be) up front for a 75-year or a 99-year lease on a piece of public infrastructure like the Chicago Skyway unless there is a stream of revenue attached to that asset that makes the return on that investment as good or better than other uses to which it can put its money.

And, if there is such a stream of revenue, it can be leveraged just as well by public borrowing as by private borrowing. In other words, a public authority could borrow $1.8 billion if it had a stream of revenue that would cover the debt service on $1.8 billion of bonds; and that $1.8 billion could be used for the same desirable public purposes as the $1.8 billion that the government could obtain by selling that asset, and its stream of revenue, to a private business for 75 years or 99 years or some other number of years.

But what about depreciation? How does that change the calculation? What does depreciation let a private firm do? It lets that firm reduce its taxes. But if a public entity does the borrowing and runs the skyway or the bridge, it does not have any taxes to reduce. So if depreciation is a major factor in this equation, it could mean that the depreciation is being used to generate losses that allow certain participants in these transactions to shield other income from federal and state income taxation. And, that in turn, would mean a taxpayer-funded subsidy for this type of transaction. If that is the case, then a critical question becomes, what other benefits are these types of transactions generating for society? And, are those benefits sufficient to justify much more substantial government subsidies than if the borrowing was done directly through a governmental entity?

So if the cash flow situation is not very different, what is the reason for considering the sale of a part of the public infrastructure to a for-profit business? Or, if the tax benefits of depreciation generate additional money (which is then divided in some proportions between the governmental entity selling the infrastructure component and the for-profit "partner"), what are the benefits to society?

I think that some of the organizations that are promoting deals like the Chicago Skyway deal are doing so because they see it as a way to reduce workers' wages and benefits. They certainly do not take the magnanimous position that the last speaker, John Schmitt, took on a living wage for toll collectors and prevailing wage for the construction trades. But if you look at the pronouncements of the Reason Foundation, which is a big advocate of these kinds of public-private partnerships, and which is quoted in the background papers for this conference, it seems clear that this part of the privatization movement is adamantly opposed to the concept of a living wage for toll collectors or the concept of the prevailing wage for the building trades.

I think that some of the support for these kinds of deals is ideological. There are some organizations and individuals who are for any and every kind of privatization as a way to discredit the public sector. Even though that is not the reason why lawyers like John Schmitt might support deals like the Skyway sale, the out-and-out advocates of privatization will then point to those deals as another example of the private sector being able to do things better than the public sector.

We have some examples here in New York that say that it is not that simple. Just look at the history of the past ten years, and compare what has happened as a result of the privatization of Stewart Airport with what has happened under the Albany Airport Authority, the public authority that was created to take over the Albany Airport from Albany County. Which airport—Stewart or Albany—has been more entrepreneurial? Which has increased service more?

Many advocates of deals like the Skyway deal say that a private business will be more customer-oriented. But I do not think you can say that the Albany Airport Authority and the Thruway Authority are not customer-oriented. In reading news articles about the Skyway sale, I read that some people were pleased with the new ownership because there were fewer potholes. When was the last time you saw a pothole on the New York State Thruway?

When I worked at the Rockefeller Institute of Government, in the early 1990s, we did a study of the large users of the Thruway Authority. The simple question we tried to answer was whether or not these large users of the Thruway thought that they were getting their money's worth from the tolls, whether they thought it was a good deal. They thought it was a good deal, that they did not mind paying the tolls for the quality of the road they got.

Quality improvements, such as the introduction of E-Z Pass, were a big deal in the sale of the Skyway. One of the big improvements that the private firm was going to make was the introduction of EZ-Pass Lanes. But the Thruway Authority is already pretty good at that—not just the EZ-Pass lanes, but high speed EZ-pass lanes at most exits and many such lanes on the Tappan Zee Bridge.

The performance improvements that have been made in the operation of the Skyway may be significant relative to that road's prior performance but they do not bring the Skyway to the current level of operation of the New York State Thruway. The Thruway Authority is already as well run as the Skyway ever will be.

If an organization is dependent on customers, it is not going to be less customer-oriented just because it is in the public sector rather than in the private sector. A lot depends on the people involved and their motivations. You can have public authorities, like the Thruway Authority and the Albany Airport Authority, that are very efficient, very well run, and very entrepreneurial and you can have public authorities that are not. And you can have private sector organizations that are well run and private organizations which are not. One of the problems with deals like the Skyway deal, is that once a contractor has been selected and given a long-term lease (like the 99-year lease in the Skyway case) you have a monopoly. Just because its called privatization, it does not mean that you have any of the benefits of market competition or very many of those benefits.

In preparing for this presentation, I reviewed materials relating to the privatization of Stewart Airport and talked to people who had closely monitored the process by which Stewart was privatized. My conclusion is that among the people who were on that commission, and among a lot of labor organizations involved, there is significant dissatisfaction with how that deal has turned out. There were promises made for an apprenticeship program (that was important to a lot of the building trades), but the money for that program has not been released. The Department of Transportation, for whatever reason, did not feel it necessary to put performance criteria into the Stewart Airport contract because the firm being given the lease was a profit-oriented firm (a British bus company) so, of course they would work to increase passenger boardings and air freight levels because that would increase profits. But that isn't how things have turned out in real life.

Another issue that arises with deals like the Skyway deal is the authorization of significant toll increases. There were no toll increases on the Skyway from 1993 to 2005. But the contract with the private firm authorizes toll increases every three years and then every two years, with the result being an increase in tolls from $2 in 2005 to $5 in 2017. But, and this is interesting, it could be more if inflation is higher during this 12-year period.

The Skyway was already a profitable operation even when depreciation was taken into consideration. For the last several years, the Skyway had about $20 million a year in profits on about $45 million a year in revenue. That seems like a pretty good profit margin to me. And this was before the toll increases that were imposed shortly after the sale.

I guess that means that with the toll increases, the Skyway will be even more profitable; and that this enhanced stream of revenue can be used to leverage a larger upfront payment or borrowing than could be leveraged by the existing revenue stream. So it is possible that one of the reasons for the sale of the Skyway to a for-profit entity is to allow for regular increases in the toll rates and thus to increase the market value of the asset. According to John Schmitt, the city of Chicago found it hard to raise tolls on the Skyway when it was operating that road. But, for some reason, the same government that was reluctant to raise tolls when it was running the Skyway, felt comfortable negotiating a contract in which it agreed that tolls could go up every three years and then every two years, and go from two dollars to five dollars. After peeling away the veneer, however, it is still the city of Chicago that is doing that, so maybe the cover of a privatization contract allows for that. I think it is quite an indictment of government accountability if that is the truth—that a government feels that it can only implement needed toll increases by saying that it is part of a contract with a private party.

Just as privatization may be a convenient way to avoid limits on toll increases, it may also be a way to avoid debt limits or to avoid increasing the amount of public debt outstanding. In reality, however, the stream of revenue is the same whether it is being used to leverage public bonds or private bonds. The same people are paying the tolls, but one way it is on the government's books as debt, and the other way it is not. Maybe that is a subterfuge that opponents of government debt find comforting but, if so, it shows the hollowness of their anti-government rhetoric. The sale of the Indiana Toll Road or of the Tappan Zee Bridge really amount to the borrowing of money through a private entity for public infrastructure improvements with the exact same toll payers paying the exact same tolls that they would pay if the money for those infrastructure improvements was being generated through a public authority or other governmental bond issue. From this perspective, these kinds of so-called "public private partnerships" are really ways to generate huge one shots with the responsibility for their repayment over time (with the equivalent of even higher interest rates) being "off the books."

Another argument that we hear is that these kinds of deals allow projects to get done faster. And why is that? Because of something called "design/build" which involves a single contract for both the design of a project and its construction. This gets to a concern that I have worked on with the Public Employees Federation which represents the professional employees in the New York State government: that there is not enough competition right now in awarding design contracts for state transportation projects; that New York State is not carefully evaluating the costs and benefits of doing highway design with state employees rather than doing it through "contracting out."

Design/build is a way to ensure that all design work will be done through contracting out; that it will not be done in house, regardless of the relative costs and benefits.

As a result, we see a really interesting development here in New York. The Public Employees Federation is advocating legislation to require cost-benefit analysis in the awarding of consulting contracts. Now just think about that. That is pretty interesting, that a labor union is advocating cost-benefit analysis in the awarding of contracts. When

Governor Pataki first took office in 1995, a big initiative of the administration was that the state should use cost-benefit analysis in reviewing new regulations. At that time, the Governor's Office of Regulatory Reform was big on cost-benefit analysis. But now, for some reason, the shoe is on the other foot and we have a labor union asking for cost-benefit analysis in the awarding of contracts.

Why is PEF doing that? I think it is a sense of frustration that goes back over 15 years to May of 1990 when the State Comptroller at the time, Edward V. Regan (Ned Regan), issued an audit report on the Department of Transportation's use of consulting engineers and he put out a very interesting press release. He said, "While increasing the size of government is not the answer to cutting costs generally, studies have shown that DOT can save money by increasing its engineering departments." He concluded, "The State Department of Transportation could save millions of dollars by reducing its reliance on outside engineering services for design, supervision and inspection, and instead increasing its own engineering staff."

But since then, the situation has gotten worse, not better. When that audit came out, the Department of Transportation responded by saying that it would correct the situation by ramping up the number of engineers on its staff. But then came the bad budget times of 1991, 1992 and 1993, and this initiative fell by the wayside. And in the mid and late 1990s, came another important piece of this puzzle—the "head count" game under which claims could be made about reducing the size of government by pointing to declines in the number of state employees, even if the work of some of those eliminated positions was now being done by consultants at a higher cost.

Ned Regan's successor as State Comptroller, H. Carl McCall, did two audits with the same conclusion. And then, KPMG did a study for the Department of Transportation in 2000 finding the same thing.

Last year, we (the Fiscal Policy Institute) applied the cost differential factors calculated in the KPMG study to the actual amounts spent by New York State on engineering and architectural consulting contracts. In the 2004-2005 state fiscal year, state agencies spent $331 million on such contracts. Our estimate based on the cost differential factors from the KPMG study was that the State could have reduced that cost to $204 million, a savings of $127 million, if it had sufficient numbers of engineers to do that work in-house. And this is only for the amount of such spending that is on-budget since we relied on data from the state accounting system in doing our analysis.

We would like to see more comparisons of the costs and benefits of public production and private production. Privatization theorists call for such comparison shopping but in New York State the outsourcing of highway design seems to be driven by other factors. If "design/build" becomes the way we do highway construction in New York State, then we will be guaranteed to have less competition both between public and private production, and among competing private providers.

Privatization without Competition

- The term “privatization” implies that it is a way to reap the benefits of the key element of private sector operations—***competition.***
- But if government activities are “privatized” without choosing the highest value alternative, the result can be increased rather than decreased costs.
- In practice, in most of the cases in which New York State contracts out for the performance of professional services, state taxpayers do not get the benefit of either reduced or higher quality work.
- This is particularly true in the contracting out for engineering design services in regard to transportation construction projects.

3 audit reports by 2 State Comptrollers and a study by an outside accounting firm all reached the same conclusion

- Almost 16 years ago, in May 1990, in issuing an audit report, *Department of Transportation: Use of Consultant Engineers* (Report 89-S-45), State Comptroller Edward V. Regan said that "The State Department of Transportation could save millions of dollars by reducing its reliance on outside engineering services for design, supervision and inspection and, instead, increasing its own engineering staff."
- But since then, the situation has gotten worse rather than better.
- In 1998 and 2001, Regan's successor as State Comptroller, H. Carl McCall, issued reports on the same subject with similar conclusions.
- A study completed in 2000 by the international accounting firm KPMG under a contract let by the New York State Department of Transportation found: "consultants are approximately 75% more costly than in-house design resources" and "approximately 50% more expensive than the cost of in-house inspection resources."

A 2005 study by the Fiscal Policy Institute attempted to estimate the fiscal impact of these differences

- We used state accounting system reports to identify the amount of money that the state spent on engineering consultants during each of the last four fiscal years.

- We then applied the cost differential factors from the KPMG report to estimate the amounts that the state government could have saved if it had the staffing necessary to do this work in house.

The FPI study examined expenditures for the capital construction object codes covering professional consultants

Object code	Description
71090	Capital Projects - Consultant Services - Architects - State Projects
71100	Capital Projects - Consultant Services - Engineers - State Projects
71105	Capital Projects - Consultant Services - Bridge Inspection
71110	Capital Projects - Consultant Services - Engineering Supervision
71115	Capital Projects - Consultant Services - Material Testing
71120	Capital Projects - Consultant Services - Other

New York State spending for engineering, architectural and other capital projects consultant services, 2001-02 through 2004-05

Expenditure types	2001-02	2002-03	2003-04	2004-05	4-year total
Architect Consultant Services - State Projects (71090)	$25,658,497	$22,363,468	$27,435,440	$26,240,104	**$101,697,511**
Engineering Consultant Services - State Projects (71100)	$127,776,493	$121,384,642	$128,234,612	$143,568,040	**$520,963,787**
Bridge Inspection Consultant Sevices (71105)	$10,915,321	$23,542,051	$19,240,843	$27,118,369	**$80,816,583**
Engineering Supervision Consultant Services (71110)	$56,057,395	$55,971,447	$61,014,980	$71,341,696	**$244,385,518**
Material Testing Consultant Services (71115)	$6,898,137	$8,213,828	$7,127,667	$7,842,079	**$30,081,710**
Capital Projects Consultant Services - Other (71120)	$34,973,580	$38,180,182	$21,785,428	$33,789,106	**$128,728,295**
Other Capital Projects Consultant Services (72340)	$482,984	$550,568	$509,341	$651,197	**$2,194,091**
Total	**$262,762,406**	**$270,206,187**	**$265,348,310**	**$310,550,591**	**$1,108,867,494**

Change from 2001-02 to 2004-05 in spending for consultant engineers and other capital projects professional services consultants

Expenditure types	2001-02 disbursements	2004-05 disbursements	Change from 2001-02 to 2004-05	
			$ Change	% Change
Architectural Consultant Services - State Projects	$25,658,497	$26,240,104	**$581,607**	**2%**
Engineering Consultant Services - State Projects	$127,776,493	$143,568,040	**$15,791,548**	**12%**
Bridge Inspection Consultant Services	$10,915,321	$27,118,369	**$16,203,047**	**148%**
Engineering Supervision Consultant Services	$56,057,395	$71,341,696	**$15,284,302**	**27%**
Material Testing Consultant Services	$6,898,137	$7,842,079	**$943,942**	**14%**
Other Capital Projects Consultant Services	$35,456,564	$34,440,303	**-$1,016,261**	**-3%**
Subtotal - Disbursements Reported with Capital Construction Professional Services Object Codes	**$262,762,406**	**$310,550,591**	**$47,788,185**	**18%**

Estimated savings from replacing capital projects consultants with state employees
(based on State Fiscal Year 2004-05 disbursements)

(amounts in millions)

Expenditure types	Actual consultant costs	Estimated state employee costs to complete same work	Estimated savings
Architectural Consultant Services - State Projects	$26.2	$15.0	$11.2
Engineering Consultant Services - State Projects	$143.6	$88.3	$55.2
Bridge Inspection Consultant Services	$27.1	$18.1	$9.0
Engineering Supervision Consultant Services	$71.3	$43.9	$27.4
Material Testing Consultant Services	$7.8	$4.8	$3.0
Other Capital Projects Consultant Services	$35.5	$21.2	$13.2
Subtotal - Disbursements Reported with Capital Construction Professional Services Object Codes	$310.6	$191.3	$119.2
Engineering Consultant Services Disbursements Reported Under "Other Services" (5699) Object Codes	$20.6	$12.7	$7.9
Total	$331.2	$204.0	$127.1

Skyway deal appears lucrative for private investors, Chicago
Once thought too high, $1.8B seems to be right

BY MARC CHASE and KEITH BENMAN
Times Staff Writers
This story ran on ***nwitimes.com*** on Monday, January 23, 2006

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The consortium created to run the 8-mile gateway to Chicago, Skyway Concession Co. LLC, does not give out figures on traffic flows or financial results, according to Avis LaVelle, a company spokeswoman.

The Bond Buyer newsletter, a publication of Thomson Financial, **put Skyway profits under city ownership at $20 million to $25 million per year in an article just after the winning bid was announced. And that was before tolls were increased**. (emphasis added)

For Immediate Release
Contact: Lisa Schrader
Phone: 312-744-1835
Wednesday, January 26, 2005

01.26 City Closes Skyway Concession Sale Transaction

Receives Payment For 99-Year Lease That Will Reduce City Debt, Create Reserve Funds, and Invest in People and Neighborhoods "But Long Term Financial Challenges Remain" Says Budget Director

The City of Chicago this morning closed the concession sale of the Chicago Skyway and entered into a lease with winning bidder Cintra-Macquarie Consortium, authorizing them to operate the tollway for 99 years. In turn, Cintra-Macquarie Consortium provided City of Chicago taxpayers a single $1.83 billion payment via wire transfer at the time of the closing.

* * *

Tolls for passenger autos on the Skyway are limited under the agreement to no more than $2.50 until 2008, $3.00 until 2011, $3.50 until 2013, $4.00 until 2015, $4.50 until 2017, and $5.00 starting in 2017, unless inflation is higher during that period, with later adjustments equal to the greater of 2% per year, the increase in inflation, or the per capita GDP increase.

Limits on commercial vehicles are comparable to passenger autos except that the agreement includes a congestion pricing provision, which permits a further 40% increase in daytime commercial tolls if the operator has a program in place for granting a reduction equal to that amount for commercial vehicles between the hours of 8 p.m. and 4 a.m.

New York Sun: Pataki Taking a Cue From Sale of Chicago Skyway
February 14, 2005 Edition
Section: New York

Pataki Taking a Cue From Sale of Chicago Skyway

BY BRIAN McGUIRE - Staff Reporter of the Sun
February 14, 2005

ALBANY - Faced with a giant projected budget gap and a wobbly credit rating, the city of Chicago decided to pull the trigger last year on a plan it had been contemplating for nearly a decade: the privatization of an eight miletoll road known as the Skyway.

* * *

"There are a lot of political challenges in New York," an official with the firm behind the Skyway deal, Chris Leslie, said. Mr. Leslie, executive director at Macquarie Securities, a Manhattan-based subsidiary of the Australian firm, said: "Our stance is that we are very well placed to handle something like this, but it's difficult for us to push because it's so complicated. We would certainly be interested in a transaction, but New York will be making the decision, not us."

* * *

<u>Meanwhile, Mr. Leslie at Macquarie said those contemplating privatization should not be overly optimistic about its potential impact. He said such a deal would generate revenue, but that he could not make promises about whether the transfer would make the state's transportation infrastructure more efficient. "I don't know that we'd be more efficient at running the Thruway," Mr. Leslie said. "I don't think there's any discussion about efficiency. That's not any part of the story as far as we're concerned."</u> (emphasis added)

TOLLROADSnews January 24, 2005

PRIVATIZATION

Chicago Skyway handed over to Cintra-Macquarie after wiring $1830m

* * *

The concessionaire expects to make major savings in costs. They will modernize toll collection by implementing an I-PASS/E-ZPass trnasponder tolling system. **Meanwhile toll collectors are being recruited with pay in the range $10 to $12/hour versus $20/hour more typical of state and city toll facilities.** (emphasis added)

TOLLROADSnews   December 29, 2005

Chicago CFO touts Skyway privatization benefits

Privatization of the Skyway was "a boon for this city," writes the City of Chicago chief financial officer, Dana Levenson in the Wall Street Journal (2005-12-29).

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<u>On taking over they immediately cut toll collection costs drastically by hiring labor at market rates ($12 to $15/hr) rather than bloated costs paid by the union-controlled city ($20/hr+).</u> Also within months they introduced electronic tolling. (emphasis added)

The Fiscal Policy Institute is a nonpartisan research and education organization that focuses on tax, budget, and economic issues that affect the quality of life and the economic well being of New York State residents.

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