Infrastructure Privatization Can Still Be A Useful Model

By **Adam Giuliano** (February 22, 2021)

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The story of U.S. infrastructure is a tale of too much and never enough — too many aging structures, too much deferred maintenance, too little new construction and, above all, too little money.

Periodically, this gap between our infrastructure wants and needs sparks a national dialogue. This time, the conversation is guided by expectations for a rail-enthusiast president who promises to "build back better."

The spotlight falls on new public funding and new project construction. Approaches more closely associated with the last administration have exited center stage.

Perhaps most out of favor are infrastructure privatizations. In the U.S., a privatization typically refers to a contractual arrangement under which a public owner grants a private operator a multidecade concession and lease, or the equivalent, for a revenue-generating facility such as a toll road, public parking, a water system or even an airport.

In exchange, the private operator makes a significant, upfront payment. Despite the connotations of the term privatization, this arrangement is typically not a sale. However, while the facility never passes out of public ownership, the concessionaire-lessee functionally assumes many of the trappings of ownership, albeit subject to regulation through the contract.

Reflecting on my own perspective as an adviser to public sector clients on major infrastructure projects, and as a board member for a nonprofit news organization with a mission to inspire greater economic, environmental and social justice in cities, the discernible focus of the national conversation on innovative ways to fund and deliver critical infrastructure projects, thereby addressing areas in which we have historically not done enough, is likely the right one.

But such a focus, taken to the extreme, risks creating policy blind spots. We need to correct for such blind spots, including as they relate to approaches such as privatizations, which are now in the shadows. As I will argue in this article, just scratch the surface, and a combination of forces could reinvigorate privatizations in the near term.

This possibility may or may not come to pass, or even be desirable. But such uncertainty does not mean that the possibility privatization could reemerge should be ignored. The stakes are too great, given the nature of such arrangements.

Failure to prepare ourselves and clients for unexpected, but not entirely unlikely, unsolicited proposals for infrastructure privatizations risks leaving everyone, not least the public sector, flat-footed.

Six Degrees of Private Sector

Private sector involvement in an otherwise public infrastructure facility occurs along a spectrum. It is important to understand where privatizations fit along that spectrum.

To begin with, a public agency may retain responsibility for all significant aspects of a project, but still contract with the private sector for the supply of equipment or materials. Beyond this are a range of approaches where a public owner contracts for project elements such as design, construction and/or maintenance.

Progressing from there are what are commonly termed public-private partnerships, or P3s. An example would be procurement of a contractor to design and build, and then operate and maintain, a new facility, like a transit line. The private sector would contribute and arrange private finance, in exchange for either a scheduled government payment commitment or access to bankable project revenues.

Privatizations and P3s are sometimes lumped together, often by the media. For example, recently the New York Times wrote in the same breath about a 75-year lease of parking meters to private parties that retain the revenues and a 35-year arrangement for a private consortium to build and then operate a new rail project on the government's behalf on payment-for-performance basis.[1]

But as even a brief synopsis illustrates, privatizations and P3s are fundamentally distinct, when viewed as among several methods for delivering and financing new projects. Unlike the P3 approach, privatizations convert existing public facilities that resemble profit-making businesses into cash, and then turn those facilities over to private management.

P3s represent an ongoing contractual relationship, in which the public retains degrees of control, responsibility and accountability at all times throughout the project life cycle, generally exceeding the controls in historical privatizations.

A Song of Toll Roads and Parking Meters

In 2004, the city of Chicago ran a process to secure a private operator for the tolled Chicago Skyway. Consortia bid an upfront payment in exchange for a 99-year lease, entitling the winner to collect toll revenues and retain net profits. Chicago completed the transaction in early 2005, in exchange for a $1.83 billion payment.

The Skyway model became a template for several completed, and a still greater number of unsuccessful, privatizations. The rationales for Skyway-type transactions included the interrelated concepts of asset monetizations — accessing trapped value in a public asset — and asset recycling — using the unlocked value to support new public infrastructure investment — as well as quality-based arguments in favor of private management.

While Skyway-style privatizations never disappeared, their star faded. One transaction in particular, regarding Chicago's parking meters, became the lodestar for privatization opponents. Having been described as at best a "successful fiasco" and at worst a deal "Chicagoans love to hate," it spawned the equivalent of Godwin's law for infrastructure: If one debates, or writes articles about, private involvement in public infrastructure long enough, the probability that someone will bring up Chicago parking meters approaches 100%.

Why Privatization Matters Now

Having defined what privatizations are — and are not — and reviewed part of their recent history, the question remains why we should be talking about them at all at this moment. Several factors suggest privatizations could soon reemerge.

On the private sector side, the capacity and willingness to enter into such transactions never went away. Global infrastructure investors regularly raise between $50 billion and $100 billion per year for new investments. The sheer scale of the available capital exerts a gravitational tug on the market to create deal flow. Relatively low-cost borrowing rates — albeit typically not as low as public borrowing rates — have a similar effect. And proponents of private management continue to make their case that private can be better.

On the public sector side, the pandemic blasted a hole in state and local balance sheets. And those state and local governments shoulder three-quarters of the funding burden for transportation and water infrastructure — and an even greater share in other areas. At the same time, public agencies feel intense pressure to press ahead with infrastructure project delivery and related services, and to plug their non-infrastructure related revenue shortfalls.

Taken together, despite chimeric hopes for massive infrastructure stimulus, these factors create an environment that could be conducive to asset monetization and asset recycling type arguments in favor of tapping the privatization piggy bank. At the very least, these considerations may make it impractical to reject any privatization proposal out of hand. Ongoing public debate regarding prospective privatizations in cities such as Wichita, Kansas, and York, Pennsylvania, supports such a conclusion.

Many still remain skeptical about privatizations on principle. Whole advocacy groups are even organized around such skepticism. While acknowledging such perspectives, attorneys must follow their clients.

Many affected clients will have valid reasons for engaging with a particular privatization proposal. They will benefit from advice which is not merely reactive, but which reflects a measure of preparedness. Preparation requires an appreciation of what has come before and what is different today.

Study History, Don't Repeat It

Preparation begins with understanding past privatization practices, and how those might be reconsidered based on lessons learned, so as to avoid potential missteps simply because of precedent.

First, U.S. privatizations have often been styled using a corporate asset or business sale auction model to the extent possible within existing procurement laws. While functional, a process that speaks to investors more than stakeholders, and which emphasizes confidentiality, can engender skepticism among those stakeholders who need to understand and approve of the transaction.

Attention should therefore be given to revisiting how processes are run, building in aspects more common in other forms of public project procurements, and seeking ways in which to enhance transparency.

Second, prior privatizations structured around a single upfront payment generated criticism as "bad deals" when later private profits were compared to the initial payment. Fairly or not, the Chicago parking meters concession is frequently admonished on this basis.

As is already sometimes the case, public sector entities should consider the tradeoffs involved in valuing both the potential upfront payment as well as a continuing right to receive a share of revenues or "excess" profits over the long term.

Third, as a related matter, the use of funds paid by the private sector requires care. Trailblazing municipalities sometimes received criticism for how such funds were expended. Owners being asked to consider a privatization should be clear as to how funds will be used in a way that reflects policy considerations — particularly where asset monetization is motivated by revenue constraints and project funding priorities.

Finally, a survey of past privatization contract terms reveals provisions that accurately distill privatization theory, but which have proven to be problematic in practice. These would benefit from reassessment.

For example, privatizations have frequently generated criticism for so-called noncompete clauses. The theory behind such clauses is that the public party must be restricted from building a competing asset, such as a new road or transit facility paralleling a privatized toll road, as this would diminish project revenues unless compensation is paid to the private concessionaire.

While economically rational, such clauses are targets for public advocates, and should be the subject of increased scrutiny, even given the challenges doing so may raise with potential private counterparties and lenders.

To take a final example, privatizations promise betterments through private sector management of service delivery — but they also contain provisions that regulate service delivery. Prior privatizations, and a host of other experience, including from P3s and other contracted service arrangements, offers experience as to how to optimize these provisions.

While maintenance and operating specifications are highly technical, they have an outsized impact on how the public experiences privatized infrastructure. All parties would be better served by expanding the tent in terms of the perspectives and disciplines involved in preparing and vetting these provisions to ensure the public gets what it needs today, and into the future.

In With the New

Preparing for privatizations means accounting for history, without being bound by it. Today's policy debates need to be equally reflected in any efforts to prepare for and critically engage with any new privatization proposals.

The word equity conveys a different meaning today than it did even a year ago, let alone a decade or more past. We must consider how to apply diversity, equity and inclusion, and racial justice principles that have recently come to the fore, within the context of any privatization being offered for consideration.

Privatization agreements include a host of provisions that implicate diversity, equity and inclusion concerns — operational performance metrics, fare setting mechanisms, environmental standards, criteria for refurbishments or service expansions, labor, workforce and subcontracting criteria, customer engagement, and security and enforcement functions.

For example, in light of the past year, consider provisions that deputize a private concessionaire to engage local police and private security forces, enforce fare collection, and pursue violators and trespassers. Consider also provisions that dictate whether or not reduced fare programs will be mandated for certain facility users, or under what circumstances a private concessionaire could adjust the terms or areas of service delivery in an economically rational, but equitably problematic manner.

As much as the meaning of equity changes, it also stays the same. In a privatization, equity also refers to the private capital standing behind the concessionaire. Infrastructure funds, private equity and pension funds, as well as global or national companies with operational expertise, represent a natural wellspring for consortia pursuing privatizations.

Some critics object in principle to these types of participants. However, in practice, it is difficult to exclude an entire class of counterparty. We should instead focus on whether there are types of equity investors and partners that the public sector might proactively foster.

For example, there is a subset of investors certified as disadvantaged, minority-owned and women-owned businesses. How are they accounted for when structuring an infrastructure transaction? What about community sourced equity, cooperatives, crowdfunding and nonprofits? Even if in some cases such approaches are not fit for purpose, this needs to reflect a considered conclusion that can then be explained to stakeholders.

Similarly, labor, workforce and subcontracting arrangements represent other areas where a public owner might be able to legislate deal terms that reflect policy considerations in a manner that a private participant can embrace. Here, privatizations can take a page from more traditional procurements and development projects, including P3s, which also reflect a high degree of private responsibility. Such examples are relatively more numerous, and contemporary, than legacy privatization transactions, and therefore may provide additional templates.

Watchful Waiting

We cannot predict with certainty whether we stand at the cusp of an infrastructure privatization wave. But we can observe that the conditions exist for one. Given the stakes involved in even one misstructured or failed privatization, it would be imprudent to not prepare for this contingency, simply because we are also appropriately concerned with other infrastructure priorities, or distracted with anticipation of a coming swell of new infrastructure funding.

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[1] https://www.nytimes.com/2021/01/19/business/public-private-partnerships.html