

Monday, May 8, 2006

Paying Up

Toll-Road Sales

By **ANDREW BARY**

AMERICA'S TOLL ROADS, BETTER KNOWN for political patronage than for strong business and financial management, suddenly are hot assets. Already, foreign companies have paid rich prices for highways in Chicago and Indiana. And similar deals could be made over the next few years for the Ohio Turnpike, the Illinois Toll Highway, several toll roads around Houston, the Atlantic City Expressway and perhaps even the New Jersey Turnpike, America's best-known toll road, featured in the opening credits of *The Sopranos*. Private money potentially also could fund a multibillion-dollar toll bridge that would replace the aging and congested Tappan Zee span across the Hudson River, north of New York City.

The impetus toward privatization is partly financial and partly political. It's estimated that the nation might need to spend \$92 billion annually just to maintain increasingly congested U.S. highways and bridges, let alone improve or expand them.

Gasoline taxes, the traditional method of funding highway repair and construction, are no longer sufficient for the job, and raising federal and state fuel levies has become political dynamite now that gasoline has jumped to \$3 a gallon. If anything, lawmakers are looking to cut these taxes. The \$1.8 billion purchase last year of the Chicago Skyway and the \$3.8 billion deal last month for the Indiana Toll Road have opened the eyes of politicians, who didn't recognize that their toll roads could fetch such hefty sums. Both fetched a staggering 40 times trailing annual revenue and 60 times annual pre-tax cash flow. Just last week, the nine-mile Pocahontas Parkway, near Richmond, Va., was sold to **Transurban**, an Australian toll-road operator, for \$611 million -- 60 times last year's toll revenue of about \$10 million.

Making all this the more remarkable: The Pocahontas Parkway was struggling just a few years ago and the Chicago Skyway defaulted on debt in the early 1990s.

These deals highlight the financial firepower of large highway operators from overseas. Ironically, the largest private toll outfits are from Western Europe, hardly a bastion of free-market capitalism, while virtually all major toll roads in the U.S. are publicly owned.

America's toll roads and bridges have combined annual revenue exceeding \$6 billion. They obviously won't all be sold, but based on the prices paid in Chicago, Indiana and Virginia, they could be worth over \$200 billion. "This is just the beginning," says Philip Villaluz, a municipal-bond analyst at Merrill Lynch. "The shock value of these price tags is getting the attention of politicians across the country."

The lure for the investors is that, before maintenance costs are taken into account, the margins on toll roads can be 80% or more. But, ultimately, how well the investors do depends on the upfront cost of the roads, revenue growth and what they must pay in interest, maintenance costs and capital expenditures.

Two of Europe's biggest toll-highway operators, Spain's **Abertis** and Italy's **Autostrade**, recently announced a merger, creating a company with a \$30 billion stock-market value. They now have the wherewithal to bid on what they believe will be 25 U.S. road privatizations in the next three years. Sensing a lucrative opportunity, Wall Street investment bankers, led by Goldman Sachs, have descended on state capitals, trying to convince toll authorities and legislators of the benefits of privatization.

Not only are existing toll roads being sold, but states are asking private companies to build new ones. In Texas, a group led by Spain's Cintra will construct the Trans-Texas Corridor, a 316-mile toll road from San Antonio to Dallas that's expected to cost \$6 billion.

The buyers of the Chicago and Indiana highways, a partnership of Cintra and Australia's **Macquarie Infrastructure Group**, are betting that they will earn around 13% annually on their equity investments, through toll increases, higher traffic and better management over their leases' long lives -- 99 years in Chicago, 75 years in Indiana.

The upside for motorists is that the highways should be run better under experienced private operators, which recognize that if drivers are unhappy, they will seek alternative routes. The eight-mile Chicago Skyway didn't even have an electronic toll-collection system until the Cintra/Macquarie group took over, and the Indiana Toll Road still doesn't have one. Electronic tolls are very popular with drivers and account for about 60% of annual U.S. toll revenue.

"Private enterprise can do amazing things with an asset that has been poorly managed by the public sector," says Peter Samuel, who publishes TollRoadsNews, an online transportation Website. "The new owners in Chicago have done an amazing job." Traffic rose 5% and revenue increased 33% in 2005's final six months, boosted by a 50-cent toll hike to \$2.50 for cars that took effect early in the year.

Toll authorities often are inefficient because profit maximization generally isn't a top priority. Patronage also can be a problem. The Pennsylvania Turnpike has been riddled with it, and it has been evident at the Illinois Toll Highway. "It used to be that whoever was the governor's top fundraiser got to run the tollway," says Jeff Schoenberg, a state senator from the Chicago suburbs who helped lead the effort to reform the tollway's management.

Indiana Gov. Mitch Daniels, who championed the Indiana Toll Road sale, has been sharply critical of the state agency that had operated the highway. Once, he says, he asked how much it cost to collect a 15-cent toll. "This being government, nobody knew, and they finally came back to me and said it was 34 cents. My response was that we'd be

better off on the honor system," says Daniels, a Republican who was a federal budget chief in the Bush administration.

FOR MOTORISTS, privatization's downside is higher tolls. Investors won't buy roads without being assured that they can raise tolls over the years. But Chicago and Indiana politicians, aware of a potential backlash from voters, negotiated contracts that allow toll increases only at pre-determined dates or based on measures of inflation or economic growth.

The Indiana Toll Road is scheduled to soon have its first toll increase in 21 years. Indiana tolls, on a per-mile basis, have been among the nation's lowest. Public authorities usually don't boost tolls unless a financial crisis looms or when road expansion or upkeep appears impossible without an increase.

Paying Up -- Part II

MOTORISTS WON'T LIKE THE HIGHER TOLLS, but they probably will like the infrastructure projects that the road deals will help finance. Daniels called the transaction for the 50-year-old Indiana Toll Road a "Louisiana Purchase of our time" because the windfall will allow the Hoosier State to move forward with a host of highway and other projects "that would have remained on the drawing board for decades."

Politics plays a key role in determining which roads are privatized. The easiest to sell are those used heavily by out-of-state drivers, rather than local motorists. Two-thirds of the Indiana road's tolls are paid by out-of-state drivers, mostly truckers.

The Ohio Turnpike, New Jersey Turnpike and Atlantic City Expressway are good sale candidates because each has a high percentage of out-of-state users. The Garden State Parkway probably isn't as a good candidate because a high proportion of its users are New Jersey residents. Not surprisingly, tolls are much lower on the Parkway than the Turnpike.

Samuel argues that electronic-payment systems have made toll increases less painful for motorists because they no longer have to fumble for money and wait in long lines. The relatively modest charges appear monthly on credit-card statements amid many other items.

A New Jersey state legislator, Ray Lesniak, has called for the sale of a 49% interest in the New Jersey Turnpike Authority, which owns both the Turnpike and the Parkway. The state's transportation trust fund is running dry, and legislators are reluctant to raise Jersey's gasoline tax, even though it's one of the lowest in the country. "There's never a political will to raise tolls," says Lesniak, a Democrat. But he believes that state residents will accept higher tolls that accompany privatization if the increases don't surpass those in the cost of living. The Turnpike Authority may be too big and loom too large in New Jersey for an outright sale to fly politically, but such a deal could raise over \$20 billion,

netting \$15 billion after debt pay-downs -- a windfall that the heavily indebted state could use. Samuel thinks the Turnpike could be sold off in pieces, starting with its congested southern portion, which carries a lot of interstate traffic and needs to be widened.

PERHAPS A BETTER candidate for sale is the Atlantic City Expressway, which runs for 44 miles from Philadelphia to Atlantic City, New Jersey's casino mecca, and is heavily traveled by out-of-state gamblers. "If there is a deal in the country that works, this is it," says state Sen. William Gormley, a powerful Republican. The A.C. Expressway had \$74 million in revenue and about \$31 million in operating profits in 2004, the most recent year for which data are available. Gormley thinks a sale could net as much as \$4 billion.

The expressway is one of the few toll roads that has three lanes in one direction and two in most of the opposite direction. The rumor is that the casino industry felt it was more important for gamblers to have a quick trip going to Atlantic City than coming home.

New Jersey's new governor, Democrat Jon Corzine, has yet to take a strong stand on the privatization of any of the state's major toll highways. But, as a former chief executive of Goldman Sachs, he certainly understands the math.

The Illinois Tollway, which operates 274 miles of roads, had \$583 million in revenue in the 12 months ended in September, making it comparable in size to the New Jersey Turnpike. It could fetch \$20 billion, based on the price paid in Indiana. "The physical condition of the tollway is far superior to the Skyway and the Indiana Toll Road," says Schoenberg, the Illinois legislator. The Tollway already has an "open road" electronic toll-collection system that lets motorists drive through at highway speeds.

Elsewhere in the Midwest, Ken Blackwell, the Republican candidate for governor in Ohio, is advocating the sale of the 241-mile Ohio Turnpike, which has over \$200 million in yearly revenue and boasts a high percentage of out-of-state users.

In New York, state lawmakers and transportation authorities are wrestling with what do with the 50-year-old Tappan Zee Bridge, which is near the end of its projected useful life. Refurbishing the toll bridge, the critical link between Rockland and Westchester counties, could cost \$2 billion or more, and that would do little to improve its traffic capacity.

A new bridge could cost \$4 billion to \$12 billion, depending on its size and whether it carries a railway. The New York State Thruway Authority, which operates the bridge, could seek private money to build a new structure, in an arrangement like those for the roads.

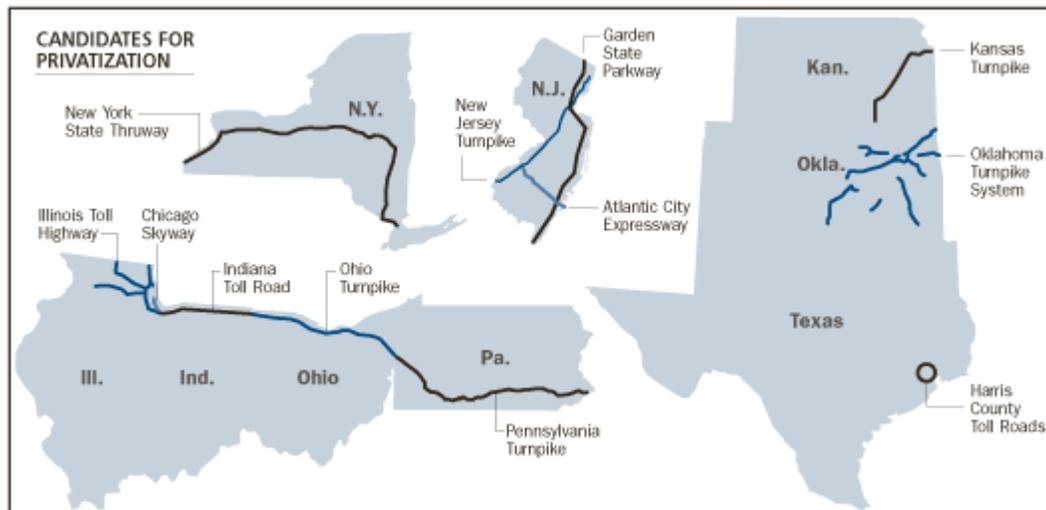
It will take years to determine whether the Chicago, Indiana and Virginia deals are winners for the buyers. Given the high prices paid, a sizable payoff may not occur for a decade or two.

"I was very positively surprised by the bids, particularly the winning one," Indiana Gov. Mitch Daniels says. Daniels championed the sale of the 157-mile highway that spans the state's northern area.

Daniels spent a lot of time convincing legislators of the time value of money and the benefits of getting \$3.8 billion immediately for the state. He thought the road, which isn't in great shape, is worth \$2 billion at most -- a view supported by an independent accounting firm. The talk is that the next highest bid may have been \$1 billion below the winning Cintra/Macquarie offer; results of the bidding are due to be released after the deal closes around June 30. Cintra and Macquarie have agreed to make up to \$700 million in capital expenditures over the next nine years, including \$200 million in the next three.

In Indiana, the annual interest tab on the \$3.3 billion of debt raised by the Cintra/Macquarie group will run at about double the road's annual revenue. To make the deal work, no interest will be paid for several years, but instead will be added to the principal during that span. By then, the investors believe, revenue will have risen enough to allow paying down the combined sum.

The good news for the Cintra/Macquarie group is that it didn't have to guarantee the Chicago and Indiana debt; the lenders accepted the road lease as collateral. Moreover, the group already has cut its exposure to the Chicago Skyway by refinancing that debt, allowing it to remove about 40% of its equity investment. Financial Security Assurance, the financial-guarantee company, is now on the hook for \$1.4 billion of debt, backed only by the Skyway lease.



The Indiana deal hasn't won a great reception from Australian investors. Macquarie Infrastructure Group (MIG AU) shares are flat this year. The group is managed by Macquarie Bank, Australia's largest investment bank.

An analyst at Goldman Sachs/JP Morgan, Alison Booth, has been critical of the deal. In a January research note, she said "it's difficult to see how this transaction is going to be value-accretive to MIG security holders." Her concern is that "increasing competition for new toll-road projects is resulting in monopolistic returns being competed away."

Stephen Allen, chief executive of the Macquarie Infrastructure, which also controls highways in Australia and Canada, says the firm paid a "fair price" for the highway and is in a "medium-risk, medium-return business."

Judging from the aggressive price fetched by the Pocahontas Parkway last week, there's no let-up in the demand for U.S. toll roads. With overseas companies writing big checks, state and local politicians may want to move quickly.

As Tony Soprano might advise: Take the money before they wise up.