

SENATE BILL 792 AND THE DEBATE OVER TRANSPORTATION CONCESSIONS

Background

Since the passage of comprehensive legislation in 2003, Texas has been in the forefront of experiments with transportation concessions. These public-private partnerships, called comprehensive development agreements (CDAs) under Texas law, allow a private entity to take control of and manage a toll facility for an extended period of time, typically in exchange for an upfront payment.

In its 2007 session, however, the Texas Legislature put the brakes on these developments with the enactment of Senate Bill 792. In brief, S.B. 792 accomplished three primary objectives. The bill:

- imposed a two-year moratorium on private equity comprehensive developments, with a number of exceptions, during which time a legislative study committee is to review the policy implications of concessions;
- required that a number of public interest protections would apply to those concessions that are allowed to go forward under exemptions, such as disclosure of financial terms, buyback provisions and similar matters; and
- allowed local and regional toll authorities in Houston, Dallas-Fort Worth, and other metropolitan areas to proceed with certain specific listed projects on a traditional basis, while providing a pilot program for “market valuation” of other potential projects.

It is important to recognize that S.B. 792 is a compromise bill and therefore by definition has elements that all sides in the debate can point to as a victory. For starters, the bill reflects significant differences in regional approaches to and acceptance of concessions. Several projects, mostly in the Dallas-Fort Worth Metroplex, were in advanced stages of development as potential concessions prior to the legislative session. These are exempted from the moratorium and will continue to be developed as concessions. Local elected officials (city councilmen, mayors, county commissioners, and county judges) in this area supported the exemptions, arguing that there was no feasible alternative way to finance the projects. On the other hand, Houston-area political and business leadership (in Harris, Fort Bend and Montgomery counties) strongly opposed concessions and pushed the largest possible sphere of new projects and operations by the local toll agency.

It is also important to note that but for pressure from Governor Rick Perry, a staunch advocate of concessions, the Legislature was prepared to impose even stronger limitations on CDAs. Governor Perry vetoed the first bill passed by the Legislature -- H.B. 1892 -- and threatened a special session if the veto was overridden, which it likely could have been. H.B. 1892 also imposed a moratorium on concessions, but established a much stronger language right of

"primacy" for local toll road authorities, superceding the state DOT's pressure for concessions. With enthusiasm for a special session low, legislative leaders and local interests negotiated S.B. 792, which tempered the local primacy right, at least on an interim basis.

What is to be made of this legislation in the context of state and national transportation policy? Who were the winners and losers?

The Players

To answer this question, it is necessary to understand the factors and interest groups that made CDAs a political issue. One was a loose collection of grassroots, anti-Trans Texas Corridor, anti-toll advocates who have criticized the Trans Texas Corridor since it was first proposed. Some of these individuals, however, often border on a "black helicopter" message and have little legislative impact other than to keep the issue stirred up. To the extent that their message is anti-toll rather than anti-concession, it flies in the face of general legislative acceptance that toll strategies will have to be part of solving the mobility crisis in Texas.

Other groups offered a more balanced critique of concessions that resonated with some legislators. This group of legislators, led by Sen. John Carona, Sen. Robert Nichols and Rep. Lois Kolkhorst, questioned the long-term policy implications of concessions, especially issues related to long-term public control, such as covenants-not-to-compete (or "developer rights" as these provisions came to be called), buyback provisions, control of toll rates, and similar policy issues.

A third and related factor – one that coalesced and became more and more instrumental as the legislative session went on – was strong criticism from independent business leaders and groups in Houston and Dallas who criticized the financial terms of concession agreements. (It was this perspective that led Sen. Carona to refer to concessions as "like buying a TV on a rent-to-own basis.")

A final factor was the set of interests united behind the local toll road authorities, especially the Harris County Toll Road Authority (HCTRA), who were working to preserve the ability of these entities to develop toll projects independent of the state DOT's push for concessions. Advocates for these entities see them as best positioned to build political support for toll strategies in the metropolitan areas. HCTRA enjoys strong political support from business leaders and from engineering and construction interests in the Harris County region. It could reasonably be argued that the legislative fight that led to the passage of S.B. 792 was triggered primarily by the state DOT's insistence during 2006 that HCTRA pay the DOT \$1.3 billion upfront and some unspecified share of future revenues before it could proceed with three pending toll projects. HCTRA and its backers chose to take this issue to the Legislature instead, championed by Sen. Tommy Williams and Rep. Wayne Smith. In the original filed versions, the primary intent of both H.B. 1892 and S.B. 792 was to provide local toll authorities "primacy" in the development of toll projects within their jurisdiction. Through parliamentary maneuvering, these bills became the vehicles for more programmatic changes.

CDA Moratorium – Or Not?

Since the end of the legislative session, some have argued that the battle against concessions fell short; that, in effect, S.B. 792 does not impose much of a moratorium and that the proponents of concessions “dodged a bullet.” This argument is mostly political spin.

While some projects under development will go forward as concessions, it is almost certain that, in the absence of a moratorium, the DOT would have solicited proposals for additional concessions or would have received unsolicited proposals for new projects. Most observers saw the demands TxDOT made of HCTRA in 2006 as a prelude to a CDA solicitation in Harris County. The S.B. 792 moratorium stops this possibility, as well as other potential solicitations in other parts of the state. Also, some of the potential projects that are technically exempted from the moratorium almost certainly have no chance of proceeding as a CDA even though they are exempt – for example, the proposed TTC-69 south of Corpus Christi. In Bexar County, the moratorium derails a pending CDA on US 281 and Loop 1604. And finally, the legislation takes two projects that would have been developed as concessions under previous law – SH 121 and SH 161 in the DFW area – and grants the North Texas Tollway Authority a right of first refusal on the projects. **In sum, it cannot be reasonably argued that the CDA moratorium in S.B. 792 is without effect.**

Public vs. Private Models for Toll Roads

Perhaps the most significant aspect of S.B. 792 is the idea of primacy, or a right of first refusal, to the local toll road authorities, including regional mobility authorities as well as HCTRA and NTTA. Although this might appear to be a state versus local issue, it is more accurately an issue that pits a concession model for toll roads against a more traditional public toll road authority model. The state DOT has a turnpike division that has done and can do publicly financed toll projects, but the leadership of the agency has in recent years been totally committed to the concession model. And while S.B. 792 gives the local toll authorities the ability to do comprehensive development agreements, they have, to date, shown little interest (especially in Harris County) in considering concessions.

The choice between the public authority model and the concession model was, and continues to be, the focal point of the Texas policy debate. Sen. John Carona, chairman of the Senate Transportation and Homeland Security Committee, worked very hard to get witnesses before his committee at key hearings to focus on this issue and provide empirical information, but his efforts were largely frustrated. Committee members and other legislators never really felt as if their questions were answered on matters such as:

- how the cost of capital compares in public versus private deal;
- what are the tax advantages built into a concession transaction;
- what is the magnitude of the risk premium paid to a concessionaire;
- how the public markets will receive a public entity seeking to finance an amount that is beyond the cost of construction and operation but that is supported by the revenue stream.

The study committee set up by S.B. 792 will continue to seek answers to these questions.

In S.B. 792, the Texas Legislature clearly established a preference for the public toll authority model, strongly recognizing a primacy right for local toll road authorities in the development of toll facilities in their jurisdiction. The compromises in this position insisted on by the Governor's Office were to (1) limit an unqualified primacy right to a specified list of projects and (2) insist that other projects undergo a "market valuation." The requirement for a market valuation, however, is sunset in four years, the same expiration date that applies to comprehensive development authority under current law.

The concept of market valuation is an interesting and innovative effort to bring into a public transaction what concession advocates see as one of the benefits of concessions – that is, the ability to extract an upfront concession fee from the concessionaire. In many ways, recent Texas transportation policy has been built on this premise. The policy, although not stated in this way, has been to identify the 20-25 most attractive toll projects in the state, to be as aggressive as possible in maximizing the toll rates, to lock up the revenue stream from these projects for as long a period as possible, to leverage this revenue stream to the maximum extent practical, and use that super-long term borrowing to fund current transportation needs in the absence of a fuel tax.

Those who disagree with this approach have argued that it surrenders public control over toll rates and transportation options for a period of time so long that the alternatives and options cannot possibly be fully anticipated. Opponents also argued that the transactional costs associated with this approach divert an excessive amount of the long-term revenue stream associated with a toll project, money that could otherwise be spent on transportation improvements. Advocates of traditional public approaches characterized the concession approach as the "high cost" way of building projects, as opposed to the traditional "low cost" way.

The notion of a market valuation of a toll project is that an effort will be made to estimate the amount of surplus revenues that can be extracted from a toll project at the front end. Under the pilot project set out in S.B. 792, the toll authority and TxDOT would agree on the terms and conditions for a market study and the entity – generally expected to be a third party – that will conduct the market valuation. After the valuation, the authority, if it chooses to exercise its right to develop the project, would be required to commit to construct on a time schedule additional projects, including free roads, equal to the market valuation or to deposit an equal amount into an account to be used by the DOT to construct additional projects in the region. If the authority chooses not to exercise that option, TxDOT may develop the project, but only on the same terms.

This idea will play out over the next several years. It is likely to be tested first on SH 161 in the DFW area and possibly on the Grand Parkway, an outer loop around Houston. The policy question will be whether it is appropriate or better to extract surplus revenue over the life of a project or to estimate that amount and (if feasible) extract it at the front end.

Public Interest Issues

The final piece of S.B. 792 that is important from a policy perspective is the list of public interest protections that the Legislature applied to future concessions. The DOT would probably argue that some of these requirements have been followed on concession agreements to date, but nevertheless the Legislature saw the need to give them statutory form. The new requirements include:

- a requirement that the Attorney General must review CDAs and determine that the proposed agreement is legally sufficient.
- a requirement that the Legislative Budget Board be notified of shortlisted proposers and receive, before the DOT enters into an agreement, a copy of the proposed agreement, a copy of the proposal submitted by the highest ranked proposer, and a financial forecast.
- a requirement that the state auditor review the traffic and revenue report.
- a requirement that toll project entities develop a formula for buybacks, or termination for convenience. The formula must be based on investments, expenditures, and internal rate of return on equity under the agreed base case financial model, plus a markup on that amount. This language was controversial in the latter days of the session and is likely to be revisited by the CDA study committee.
- a prohibition on a CDA containing a provision that prohibits construction or expansion of a transportation project (so-called covenant not to compete). However, the bill authorizes provisions under which the concessionaire may be compensated for loss of revenue for construction in a zone extending four miles on either side of the concession. Compensation is specifically prohibited for projects in the transportation improvement plan in an area, safety improvements, HOV lanes, or projects involving different modes of transportation, even if they are in the four-mile zone.
- a requirement for public disclosure of project financing information before a contract is entered into.

Summary

In the final analysis, although certain concessions in the pipeline will continue to be developed, it is hard to see S.B. 792 as anything other than a setback for the concession model. The Legislature explicitly directed that certain public toll authority projects go forward and provided a first option for public authorities to advance other projects subject to a requirement for a market valuation to look at the potential for surplus revenue.

But S.B. 792 did not resolve these issues in a final sense. A number of factors combine to ensure that these issues will be revisited in 2009 – the fact that the primacy right is limited to listed projects, the expiration of CDA authority in 2009 (2011 for certain projects), the sunset of the market valuation in 2011, and, of course, the sunset of the DOT in 2009. In many ways, the effect of the Legislature’s action was to carve out a two-year period in which certain projects will go forward as CDAs, certain projects will go forward as publicly-financed projects, and other projects will be subject to a market valuation. Beyond that two-year period, who knows?