SYRACUSE UNIVERSITY
MAXWELL SCHOOL OF CITIZENSHIP AND PUBLIC AFFAIRS

PAI 735 / ECN 635
State and Local Government Finance
Professor Yinger

CASE:
Private Highways?[1]

Introduction

Picos is a medium-sized, rapidly growing metropolitan area in the western United States. Its population grew from 435,020 in 2000 to 761,302 in 2020. One reason for this rapid growth was the success of two industrial parks established in the 1990s: Sagebrush Industrial Park and Saguaro Industrial Park. These parks have been able to attract a wide range of high-tech firms, and employment in the parks has grown steadily since their founding. Not surprisingly, this employment growth has spilled over into the service sector, other parts of the local economy, and the local universities.

Picos is noted for the beautiful mountains that lie to the north. Many of the people who have moved to the area want to live in the foothills of these mountains, and builders have steadily expanded the area's residential footprint into these foothills. A large share of this new housing is located in two residential developments on the area's northern boundary: Callipepla and Phacelia. These developments, which are located in the suburb of Pinnacle, are expected to keep growing farther into the foothills for many years to come. See the attached map of the Picos area.

This growth has created a major problem for Picos' city planners, namely, a highway

[1] This case was written by Professor John Yinger solely for the purposes of class discussion. The Picos metropolitan area exists only in his imagination.

network that was not designed to facilitate commuting from these new neighborhoods to downtown Picos, to the Picos airport, or to Picos' two industrial parks. Not surprisingly, the winding secondary highway that leads to Pinnacle is subject to severe traffic congestion.

As a preliminary step in addressing this problem, Picos County has acquired the rights of way for two highways connecting the new residential neighborhoods with the existing major highways. One right of way runs for six miles from Callipepla to a major highway with good access to employment, and the other runs for four miles from Phacelia to a point farther east on the same major highway. As shown on the attached map, adding highways in these rights of way would dramatically improve the commuting situation for many of Picos' new residents.

The Options

Picos County, which encompasses almost all of the Picos metropolitan area, is responsible for providing and maintaining all secondary highways in the county. County highways may have limited access, but they may not charge tolls. The major highways in the area are all interstates, which are the responsibility of the federal government. As a result, Picos County can only address its highway problem by deciding how to provide highways in the rights of way it has acquired.

One possibility is for Picos County to build and maintain limited access, no-toll highways in both rights of way. This option would require a county property tax increase to back the municipal bonds that would have to be issued to meet the project's cash-flow needs. These bonds would have to be approved by the county's voters.

This public option is supported by the Callipepla and Phacelia homeowners associations and the mayor of Pinnacle, The commuters in Callipepla and Phacelia prefer not to pay tolls, and the mayor of Pinnacle is glad to let taxpayers throughout the county help to pay for the project.

Moreover, these supporters of county-provided highways believe that the highways in Picos County have been well maintained over the years and that the Picos County Supervisors, who must stand for election every two years, have a strong incentive to preserve this reputation.

Another possibility is for Picos County to lease the rights of way to a private company and then allow the company to build and maintain one or both of the highways and to collect tolls. The toll revenue would be used to pay off the lease. As shown in Table 1, public-private partnerships (P3s) for highway projects are used by many different states. In the case of Picos' state, several companies appear to have the capacity to carry out the required highway construction and maintenance. Moreover, the state recently passed legislation to authorize private highways with tolls—and with a required referendum.

Some P3 highway projects, such as the Indiana Toll Road, failed to collect enough toll revenue for financial viability because the projected traffic did not materialize. In such cases, the contract has to be re-structured, usually at less favorable terms to the government. Most of these projects in Table 1 appear to be viable, however. Of course, financial viability does not prove that a private highway project made more sense than a public one.

The Picos Taxpayers' Forum supports this P3 approach. They argue that the county should take any opportunity to cut taxes or prevent tax increases. Moreover, this group believes that the money paid by the private firm to the county for the leasing rights could be used to further important public programs, such as pensions for public employees. The Picos Business Council also supports a P3 approach to these highways. They argue that it would save the taxpayers money because a private firm would be more innovative and because the firm's profits depend on providing highway services of sufficient quality that commuters are willing to pay the associated tolls.

The commuters in Pinnacle are skeptical of these arguments. They suspect that private companies, which have a type of monopoly, will set tolls to squeeze as much money out of commuters as possible. These commuters also do not believe that any contract can ensure that private highways will be adequately maintained.

The Picos County Supervisors have started to collect information on P3 highway projects. Some of this information came from scholars at Picos State University. These scholars urged the county to pay special attention to the terms of any contract they entered into with a private firm. These scholars also provided the county with a guide prepared by the Federal Highway Administration. Among other things, this guide says that

> The contractual agreement between the Department and the Developer, generally known as the Concession Agreement, lies at the heart of the P3 transaction structure.
>
> Traditionally, important contractual terms related to P3 transactions have included the following:
>
> - The term of the concession, which for highway projects have extended beyond 30 years and up to 99 years.
> - Requisite design-build specifications.
> - Requisite operations and maintenance standards.
> - Requisite hiring and employment standards.
> - Requisite pricing and costing of services to the public.
> - Supervening events, to a large extent defining the risk allocation in the contract.
> - Defaults and early termination of the contract.
>
> Because the Concession Agreement dictates the essential short and long-term dynamics of the P3 transaction, it is critical to the long-term success of the Project that the Department and the Developer are able to develop contracts that effectively exercise the intentions and priorities of the public sector.
>
> Source: https://www.fhwa.dot.gov/ipd/pdfs/p3/model_p3_core_toll_concessions.pdf
>
> The issue of tolls is particularly important. The Federal Highway Administration recommends that P3 highway contracts:
>
> - Expressly provide for the right of the Developer to establish, assess, collect, and enforce tolls on the Project and retain the related Toll Revenues free and clear of any interest of the Department in such revenue, subject to certain limitations set forth in the Concession Agreement and applicable law.

- Specify when the Developer’s tolling right takes effect and terminates or otherwise expires.
- Identify the users of the Project who are subject to tolls and set out the procedure for changing the classification of such users.
- Establish a procedure for changing the limitations on, or methodologies for determining, future toll rates.
- Specify the mechanism for toll collection and administration of the toll collection mechanism.
- Identify the circumstances under which the Department or others may suspend the tolling rights of the Developer.

Detailed provisions to cover all contingencies also need to be developed for the other contract terms. For example, the contract should specify standards for highway maintenance—and how they will be enforced. It should also be clear about the conditions, such as firm bankruptcy, that would turn ownership of the highway back over to the county.

The Decision

The Picos County Board of Supervisors has called a hearing to discuss the options for building and maintaining highways in the rights of way they have acquired. This is a preliminary hearing. The Supervisors want to know which options are preferred by various interest groups in the county—and why. They also want to hear the views of various groups about the contract provisions that are most important to ensure the success of the private highway option, should that be the option the county selects. Finally, they would like to hear suggestions for the type of information they should collect before they make their final decision.

You may, if you wish, prepare a brief (two-page) memo stating your views on this decision.

Table 1. Large P3 Highway Projects, 2018

Project	Location	Value ($B)	Type
Indiana Toll Road	Indiana	$5.73	66-year lease, toll
Chicago Skyway	Chicago, IL	$2.94	89-year lease, toll
I-635 LBJ Managed Lanes	Dallas, TX	$2.60	DBFOM, toll
I-4 Managed Lanes	Orlando, FL	$2.30	DBFOM, toll
Transform 66	Fairfax Co., VA	$2.10	DBFOM, toll
I-495 Hotlanes	Fairfax Co., VA	$2.07	DBFOM, toll
North Tarrant Express	Fort Worth, TX	$2.00	DBFOM, toll
I-595 Managed Lanes	Fort Lauderdale, FL	$1.76	DBFOM, toll
SH 130 Segments	Texas	$1.38	DBFOM, toll
I-70 East	Denver, CO	$1.24	DBFOM, toll
SH 2-- Toll Lanes	Pennsylvania	$1.01	DBFOM, toll

Source:
https://reason.org/wp-content/uploads/annual-privatization-report-2019-surface-transportation.pdf

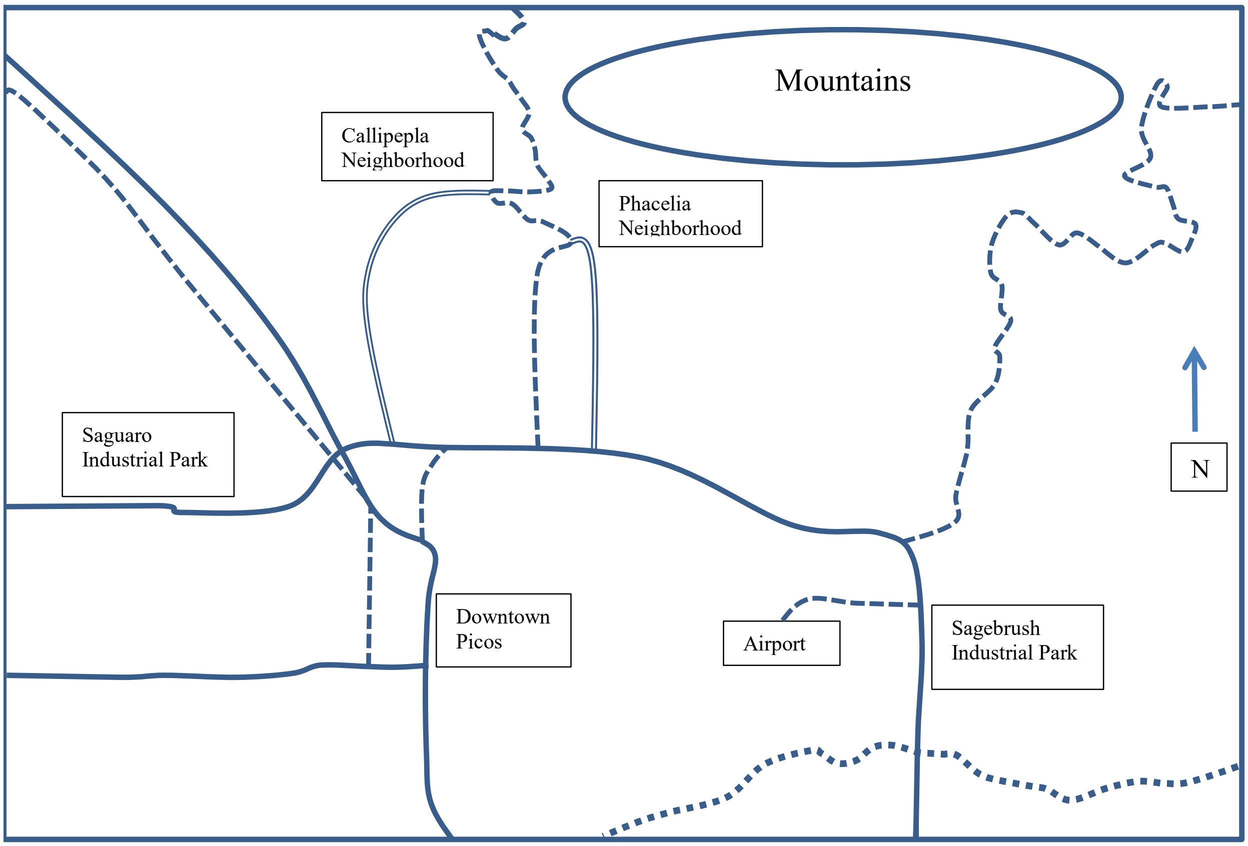
Note: See Appendix A for the definition of DBFOM.

Appendix A: The DBFOM Approach

With the design-build-finance-operate-maintain (DBFOM) concessions approach, the responsibilities for designing, building, financing and operating are bundled together and transferred to private sector partners. There is a great deal of variety in DBFOM arrangements in the United States, and especially the degree to which financial responsibilities are actually transferred to the private sector. One commonality that cuts across all DBFOM projects is that they are either partly or wholly financed by debt leveraging revenue streams dedicated to the project. Direct user fees (tolls) are the most common revenue source. Availability payments have also been used in this capacity. Future revenues are leveraged to issue bonds or other debt that provide funds for capital and project development costs. Often they are also supplemented by public sector grants in the form of money or contributions in kind, such as right-of-way. Private partners are usually required to make equity investments as well.

Source:
https://www.fhwa.dot.gov/ipd/alternative_project_delivery/defined/new_build_facilities/dbfom.aspx

The Picos Metropolitan Area



Major Highway
Secondary Highway
Cascade River
Right of Way

Scale: 1 inch = 3 miles