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You pay a lot more

What happens when the city leases public assets to private investors?

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The price to park your car for an hour in the Millennium Park Garage has risen 31 percent, to $17, since the garage was leased to Morgan Stanley in 2006.

The cost to drive an auto across the Chicago Skyway is now 50 percent higher than it was in 2004, when Australian and Spanish investors paid $1.83 billion for a 99-year lease.

Could an $8 airport pretzel be next? How about a $10 luggage cart?

Those are real questions facing consumers as the city moves ahead on a landmark plan to lease Midway Airport to private operators.

Mayor Richard Daley has been ahead of the curve leasing public infrastructure such as the Skyway and underground parking garages as a way to raise cash. So it wasn't much of a surprise that in 2006 Chicago's Midway became the first large hub airport to apply under a Federal Aviation Administration pilot program to test privatization at five airports around the country.

The privatization of public assets has sparked a debate among academics and urban officials across the country about whether the leasing of bridges, roads and other infrastructure is a smart way to manage public resources over the long haul or just a desperate quick fix.

Because the phenomenon is so new, less has been said about what happens to consumers when they go from being taxpayers using public facilities to customers of a for-profit business.

It turns out they pay a lot more.

In the early years, price hikes by new owners are usually fixed and modest, experts say, but over the years, owners generally have more latitude to raise prices: Tolls go up, parking rates rise and the cost of using an airport takes off.

In Australia, for example, parking revenue at the nation's five major private airports has soared 77 percent since 2002, even though passenger counts only rose 41 percent. Now that country's consumer commission is investigating why it costs more to park at Sydney Airport than London's Heathrow.Meanwhile, in the case of Midway, the city has discussed a deal with the airport's biggest tenant, Southwest Airlines, to freeze the airline's costs for six years in return for its support of the privatization plan. If such a plan is finalized, the new owner would have to find ways to hike revenue other than raising the rent paid by airlines.

John Schmidt, the attorney representing the city on Midway, said there are ways the new operator can increase airport revenue without gouging travelers: cut costs and bring in more retail and dining options.

Private airports have five times the retail sales of their public counterparts, Schmidt said, and some have turned themselves into luxury shopping malls. "You'll be tempted to buy a Gucci handbag or a new computer. You have the advantage of captive markets."

Under the Skyway deal, no proceeds were spent on easing traffic congestion, which concerned transportation experts. Of the estimated $2.5 billion to $3 billion from a Midway lease, $1.2 billion would be used to pay off airport debt with the rest going toward underfunded public pensions and infrastructure investments. Bids from the five groups that passed city muster are expected in about a month.

Shortsightedness cited

Critics worry, though, that elected officials are selling the city or state's future revenue at a discount for a fat payoff today without imposing the spending discipline that would balance the budget.

"You're giving up the future returns. Each of these is a one-shot deal," said Jonathan Peters, a finance professor at the City University of New York. "Selling your assets is not a solution to overexpenditures. It buys you time but it doesn't solve the fundamental problem."

The debate is likely to heat up as state and city coffers experience shortfalls from the slowing economy, which is showing up in reduced revenue from taxes on retail sales, gas and real estate transfers. News of a $420 million shortfall in city revenue in 2009 already has some politicians calling for more infrastructure deals. In Springfield, Gov. Rod Blagojevich says the answer to the state budget crunch is simple: Let him lease the Illinois Lottery.

The argument in favor of such transactions is that government should take advantage of investor demand for assets to remove itself from non-essential services that can be more efficiently provided by private operators.

But State Sen. Jeffrey Schoenberg (D- Evanston), who has studied the proposed privatization of the Illinois Tollway, believes public officials are being outnegotiated and leasing too cheap.

Ninety-nine years is too long for a public asset to be leased, Schoenberg argues, because no one can see that far into the future. Few leases in Europe, for instance, run more than 40 years. He also thinks there should be formulas that allow taxpayers to benefit from the upside if deals pay off more handsomely than expected. Spain and others have insisted on such clauses in some of their asset leases.

In the Skyway deal, investors "covered their investment in a few years," Schoenberg said. "Therefore, everything else was gravy."

The real pain for Skyway drivers hasn't been felt yet, but when it is it will be intense, experts predict.

"The toll-escalation clauses are very aggressive. The real escalated portion comes later on," said Peters, the finance professor. In the early years of the lease, which is detailed in a lengthy concession agreement with the city, the amount tolls can be raised is fixed. Then, the owner gets to pick a formula to calculate toll increases, and one of them likely will allow for annual increases of more than 5 percent.

By 2017, cars will pay $5 to cross the Skyway, a 100 percent increase from 2004. By 2050, a Skyway trip could cost as much as $29.30, according Peters' analysis.

"The Skyway may look painless now but in 25 years or less, there will be people camped out in City Hall over these tolls," warned John Foote, senior researcher with Harvard's Kennedy School of Government. "In 25 years, the tolls won't be acceptable."

Lisa Schrader, a spokeswoman for Paul Volpe, Chicago's chief financial officer, said Skyway drivers saw "almost immediate improvements," such as the introduction of electronic tolling. She also pointed out that the Skyway had not had any toll increases for 12 years. "It was clearly underpriced by any standard."

Flexible spending

Mortgaging public assets is nothing new. When cities sell municipal bonds, that's exactly what they are doing—taking in money from private investors and paying them back with interest over time. More than 50,000 state and local entities issue municipal securities and more than 2 million separate bond issues are outstanding.

Yet municipal bonds have a drawback from a politician's point of view. The money raised usually goes for a specific purpose. The proceeds of a hospital bond offering would go to construction costs. A tollway offering would pay for upkeep or extension of the roadway.

A long-term lease, however, is usually not constrained in the same way. For example, Daley used the Skyway proceeds to pay down city debt and sock away $500 million in a permanent reserve fund that raised the city's credit rating and lowered its borrowing costs.

About $100 million was spent on social programs such as heating assistance for low-income households and transition assistance for felons..

"We were told to put some into human capital as well as hard capital," Daley told the Tribune's editorial board after presenting his 2008 budget. "People want to see something visually from the sale of assets."

Investors prefer long-term leases over bond offerings too, because once they take control of the asset they can raise prices, employ non-union workers and find other ways to boost financial returns.

Proponents of infrastructure leases say taxpayers also benefit because there are many functions private operators can perform better than government.

"Government should not be taxing its constituents to provide service people can get in the private sector," said Laurence Msall, president of the Civic Federation, which generally supports the city's privatization efforts.

Dana Levenson, the city's chief financial officer when the Skyway deal was done, agrees: "Parking garages, toll roads and any other municipal entities that have profit-making potential should be considered for outsourcing."

In 2007, after a little more than two years on the job, Levenson left the city payroll to join the Royal Bank of Scotland's Chicago office, where he is working on infrastructure deals.

Few deals match Skyway

The eye-popping price paid for the Skyway has cleared the way for dozens of sell-offs of public assets around the country. But few of those follow-on deals have come close to its favorable terms.

For instance, Chicago's second deal—the lease of the Park District's four underground parking garages—had a considerably smaller payoff and no safeguards for taxpayers on how high the new owner can raise parking rates.

The city would have reaped the same amount of revenue from the parking garages in 30 years even if it didn't raise parking rates as the new owner already has done. If the city had raised parking rates by 20 percent, it would have recouped its $563 million windfall in 25 years. If it had hiked rates by 40 percent, it would have earned the same half-billion dollars in only 20 years, and it would still own the garages.

Levenson said the lease saved the city the $65 million cost of renovating the East Monroe Street garage. Because the garages are not monopolies, the Park District was willing to give the winning bidder unfettered power to raise parking rates, he said.

Schrader echoes that, saying, "The concessionaire must keep rates competitive to drive traffic and increase revenues. In fact, rates now appear to be consistent and, in some cases, lower than surrounding areas."

The Park District is using $122 million of the lease proceeds to build five field houses and 50 playgrounds around the city. But expenses will rise because of the upkeep on the field houses, and the Park District's revenue stream has shrunk. Those two things could collide in the future as the facilities age, experts say.

The Skyway deal whetted the appetite of politicians nationally.

"After the Skyway, we got a bunch of phone calls from our clients saying, 'Can you explain how this works? We have lotteries and toll roads,' " said Mark Florian, the recently departed head of Goldman Sachs' public sector and infrastructure banking group.

Some politicians backed off because of public resistance. New Jersey Gov. Jon Corzine, a former Goldman Sachs investment banker, has declared that leases of public assets are off the table. Texas Gov. Rick Perry has signed a bill placing several restrictions on private toll roads that will make future deals much harder to do.

Investors like possibilities

Even so, pension funds and other institutional investors are eager to sink a share of their pension funds into infrastructure because it provides steady streams of cash with relatively little risk.

The Illinois State Board of Investment, which manages more than $11 billion in pension assets for state employees, is now devoting 5 percent, or almost $600 million, of its portfolio to infrastructure.

The fund is trying to hit an 8.5 percent annual return with a modicum of risk, said Bill Atwood, executive director.

"What managers are looking for is regulated assets. As long as you can be confident about the future of the revenue stream, you can predict returns," Atwood said. "People still need to drive and drink water, no matter what happens with the economy. It's not my job to worry about public policy."

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