

Private Provision of Highways: Economic Issues

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Abstract

This paper reviews issues raised by the use of private firms to finance, build, and/or operate highways — issues including cost of capital, level and structure of tolls, and adaptability to unforeseen changes. The public sector's apparent advantage in cost of capital is at least partly illusory due to differences in tax liability and to constraints on the supply of public capital. The evidence for lower costs of construction or operation by private firms is slim. Private firms are likely to promote more efficient pricing. Effective private road provision depends on well-structured franchise agreements that allow pricing flexibility, restrain market power, enforce a sound debt structure, promote transparency, and foster other social goals.

1. Introduction

Privately owned or operated roads, once common but largely phased out over the twentieth century, are making a startling comeback. Spain, Portugal, Italy, and France have recently converted their high-speed intercity expressways to mostly private systems. The UK and Finland, among other countries, have taken steps in that direction; Australia and Canada have important private road projects; and in Latin America, privately built and operated toll roads are quite common.¹

In the United States, privatization has moved more slowly, but nonetheless is gathering momentum. New roads have been privately financed in California, Virginia, and Texas, while existing public toll roads have been privatized in Illinois and Indiana, with other states sharply debating whether to follow suit. Much of this activity proceeds opportunistically, but in 2004 Texas adopted a plan (subsequently delayed) to systematically integrate private highway builders and operators into future highway expansion.²

¹See Joint Transport Research Centre (2008), especially sect. 2.5 and Annex. Gómez-Ibáñez and Meyer (1993, ch. 7-11) describe earlier experience.

² Forsgren and Macdonald (2005) provide a more detailed recent US history.

What accounts for this revival? The most potent factor is public-sector financial difficulties and, especially in the US, heavy reliance on a shrinking tax base of fuel purchases. A second factor is experience with privatization and deregulation of other types of public services such as electricity, water, and mass transit. A third is the desire to lower the cost of providing highway infrastructure. A fourth factor is urban congestion, the intractability of which leads policymakers to look for alternatives to “business as usual;” those alternatives include pricing, which in turn makes private provision more natural.

Virtually all the private-sector initiatives undertaken during the past century have been examples of a loosely defined category called “public private partnerships” (PPPs), roughly meaning arrangements whereby private firms are responsible for substantial parts of decision-making and finance, with overall responsibility and control exercised by the public sector.³ Examples of private decision-making roles within PPPs include design, finance, construction timing, setting of price schedules, charging and enforcement, public relations, and emergency response services. Each step toward such private involvement raises public concern about issues such as toll rates, market power, risk bearing, cost overruns, bankruptcies, use of revenues, and uneven application of tax provisions.

The purpose of this paper is to review the main economic issues involved in such public-private partnerships for roads. It does not seek a “winner” in some overall debate about privatization; rather, it is aimed at identifying the factors that determine whether any given private initiative is in the public interest, taking advantage of accumulating experience with highway PPPs in order to formulate some general principles. Nor does it attempt to cover issues that would arise in a more truly privatized sector, such as industry structure and competitiveness

— issues quite relevant for some other transportation industries such as railroads and air travel but that do not arise with PPPs. The paper takes a worldwide perspective; but in order to provide concrete institutional context, it focuses especially on the United States, where the requirements for maintaining and further expanding a network worth perhaps \$1.7 trillion are overwhelming the current financing system, built primarily around fuel taxes that raised just \$72 billion in 2007.⁴

2. Basic Issues: Capital, Financing, and Incentives

The most basic issues that distinguish capitalism as a form of economic activity are those governing disposition of capital and the resulting incentives on economic actors. Unsurprisingly, these same issues are at the heart of the cases for and against private road provision. They include the sources and costs of investment funds and issues of risk bearing, efficiency, innovation, and use of revenues.

2.1 Sources of funds

As noted, a prime motivator for private road provision is that the public sector is short of funds. In several cases, PPPs have dramatically speeded up desired investments. Is this a genuine advantage of the private sector, or is it just an accounting anomaly?

Ultimately, the availability of investment funds for infrastructure depends on the economy's savings rate and on decisions allocating those savings to specific sectors. One could argue that citizens desiring improved infrastructure should be equally willing to tax themselves

³ Standard & Poor's defines a PPP as "any medium- to long-term relationship between the public and private sectors, involving the sharing of risks and rewards of multi-sector skills, expertise, and finance to deliver desired policy outcomes" (Forsgren and Macdonald 2005, p. 46).

⁴ Small and Verhoef (2007), p. 112; US FHWA (2008), Tables MF-1, FE-9.

or to encourage private investment funds to flow from other sectors of the economy.

However, there are practical constraints on the public sector's ability to respond to citizens' investment priorities. Restrictions on debt finance may prevent state and local governments from borrowing, even to finance projects that would eventually pay for themselves through tolls. Instead, investment often depends on current tax proceeds, making it difficult to accommodate fluctuating investment needs. To some extent, such debt restrictions can be overcome through inter-governmental transfers from a higher level of government; but national governments also are politically limited, as illustrated vividly by the excruciating negotiations over recent re-authorizations of US federal highway programs.

The private sector, meanwhile, has sources of investment funds that are particularly well matched to road projects, especially pension funds and holdings of insurance companies. Managers of these funds seek long-term investments with relatively stable returns, preferably higher than those obtained from government bonds. Consequently, many have invested funds directly in infrastructure firms and thereby contributed importantly to the boom in private finance of road investments.

Thus, one can reasonably argue that the private sector is a legitimate way to expand the public's ability to finance desired road investments. A proviso is that the public sector could in principle provide such financing itself, and perhaps would do so through some political process if the private option were unavailable.

2.2 *Cost of capital*

An oft-cited drawback of private finance is that the private sector has to pay more for its capital than does the public sector. There are several factors behind this cost differential,

especially taxes, risk-bearing, and debt structure. In assessing them, it is important to consider all the social costs, not just the financial cash flows.

Taxes on capital

From the point of view of a state or local government in the US, the federal tax exemption of interest payments on state and local bonds is clearly an important cost saving, often highlighted in comparisons of public and private options. In 2005, this exemption was extended selectively to certain private road ventures as well, through the mechanism of tax-exempt Private Activity Bonds.

However, the tax-free status of a bond is not a social saving in comparison to taxable forms of finance. Rather, it represents a shift of certain capital costs from the project-specific account to a general governmental-revenue account. A social-cost comparison can be accomplished by subtracting from the private costs any tax payments included in them, inflated to account for the “dead-weight loss” of raising those tax revenues through some other means. This dead-weight loss is a measure of how much consumers must ultimately give up, due to higher prices and/or less efficient production, in order to finance each dollar of tax revenue at the margin. Empirical work suggests it is typically around 15 percent of tax revenue collected in the US, and 15 to 190 percent across various European nations with different marginal tax rates.⁵

Another important tax consideration in the U.S. is the existence of generous income-tax deductions for depreciation of private capital investments meeting specific criteria. In this case the provisions favor private finance, because the deductions are much larger than the economic

⁵ See Parry and Oates (2000) for a more complete discussion of dead-weight loss, and Small and Verhoef (2007, pp. 147, 177-178) regarding applications to transportation. For Europe, see Klevin and Kreiner (2006), especially Table 3, columns S5-S8.

value of depreciation actually experienced on the assets. Indeed, a major motive for the recent private purchases of toll-road leases in Chicago and Indiana was the ability of private investors to realize such depreciation deductions. In order to make a valid comparison of social cost, these private tax *savings* (again adjusted for dead-weight loss of raising public revenues) need to be *added* to the private cost of capital, just as tax *liabilities* need to be *subtracted*.

Risk-bearing

Road investments involve many unknowns regarding construction cost, operating costs, traffic levels, future regulations, and other key determinants of economic returns. The resulting “risk premium” raises the return needed to attract investors to markets for private capital. But does this difference mean that the public sector is inherently better at bearing the risks posed by unknown future events? To address this question, it is important to distinguish between pure (uncontrollable) risk and “controlled” risk, where the party has some ability to influence the events. (The latter is called “moral hazard” in the insurance industry.) We consider pure risk here, and controlled risk in Section 2.3.

Aversion to pure risk arises from problems created by being unable to predict the outcome of one’s affairs. For example, private individuals are risk averse when undertaking large investments if an unpredictable outcome may greatly affect their standard of living. Similarly, small firms are often risk averse because the managers’ or owners’ livelihoods depend heavily on the firm’s earnings. These risks are often reduced by pooling diversified projects, as in the case of a large firm or a diversified investment pool such as a pension fund. Even a small firm may show little risk aversion if its owners can diversify their portfolios elsewhere and its managers are rewarded for risk-taking.

The public sector can in principle diversify its projects almost infinitely. Thus the national governments of most developed nations can issue bonds with virtually no risk premium. (This is not true for many less developed nations, due to financial problems including past defaults.) But the same factors that limit direct government investments also limit governments' risk-bearing ability. Citizens are not necessarily prepared to give *carte blanche* to their elected leaders to cover cost over-runs or other adverse outcomes of risky projects, in part because they cannot be sure those leaders will always act in the public interest. Furthermore, in a federal political system, state and especially local governments are subject to considerable fluctuations in fiscal health due to national and regional economic factors. Even worse, project risks are often positively correlated with those same factors, as for example when a recession causes toll revenues to dry up just when local tax revenues are running short.

The need to monitor the actions of leaders is actually quite general in both public and private organizations, although its magnitude may differ between them. Suppose taxpayers or shareholders are well diversified in their overall investments, and thus not really concerned with the risk over one particular project. They would then like their managers to invest if a project's expected rate of return is greater than the applicable cost of capital. However, a typical project manager is much less diversified in terms of the portfolio of professional projects with which he or she is associated. If the project turns out to be a bad one, that manager's reputation may be damaged regardless of fault. Thus this individual manager may exhibit greater risk aversion than the stakeholders. Well-run organizations attempt to compensate for this effect through incentives to encourage appropriate risk-taking, but they are difficult to implement in such a way as to have just the right effect.

For all these reasons, there are genuine barriers to full diversification even by large government bodies, potentially causing citizens and/or officials to shun risks. The aversion to these risks is a social capital for publicly provided infrastructure, analogous to the private risks that raise the cost of private capital . However, unlike a private risk premium, this social cost is not reflected in the observed market interest rates, because it is borne by taxpayers rather than investors. It implies that citizens are not willing to fund every public project that would appear to be warranted using market rates on government debt — precisely as argued in Section 2.1. A calculation of the social cost of capital, for purposes of comparing public and private provision, should then include a “shadow value” reflecting this scarcity of funds.⁶ Note that this argument has nothing to do with how efficient the government is at allocating projects. If the government often chooses wasteful projects, a reform of its allocation mechanism might well result in a smaller total need for capital funds; yet even so, these capital funds are scarce in the sense that their social cost exceeds the applicable market interest rate.

Another way to view the same point is that the projects for which a given proposal competes for scarce public funds will tend to have rates of return that are higher than interest rates on government debt. It is these higher rates that constitute the social cost of capital for the project under consideration.

The current state of knowledge does not enable us to say whether this extra shadow value of publicly raised capital is as great as the risk premium required by the private sector. Thus, there is no *a priori* case that private capital is either more or less costly than public capital.

⁶ This view is similar but not identical to that expressed by Klein (1997) and Irwin (2007, pp. 65-66). They argue that the true cost of capital is the risk-free rate of interest plus a risk premium that depends only on the project-specific risk, not on who bears it. Their rationale is that governments achieve low risk premiums by forcing taxpayers to guarantee payment for the project under consideration, and that these taxpayers therefore bear project risks for which they are not compensated. But this argument need not apply to the entire project-specific risk; some portion of it is in fact diversified through the tax system. Thus there is no reason to assume exact equivalence between social and private costs of capital.

Debt structure

A private firm's mix of debt and equity, and the term structure of its debt, have important influences on the firm's cost of raising capital. A highly leveraged structure, *i.e.* one with a high rate of debt to equity, is cheaper for the firm but creates a greater chance of bankruptcy. This is relevant to the public interest because the public may be severely disadvantaged if a private operator goes bankrupt and the provision of an essential service is thereby disrupted. Thus both the initial debt structure and provisions for refinancing are issues of public concern.

Public entities also need to pay attention to their amount of debt, because it affects their credit rating and creates obligations for future taxpayers. This raises a question concerning the sale of a long-term lease on an existing revenue-producing road, as illustrated by the Chicago Skyway and the Indiana Toll Road. Such a sale converts future revenues, occurring over an extended period, into an up-front single cash payment. One consequence is that some of the risk due to unknown revenues is shifted to the private franchisee, an issue discussed in Section 2.3. Another is that the government receives a big block of capital funds in return for giving up future revenues — which is very similar to issuing debt, and indeed may be seen as a loophole in regulations restricting debt finance of state and local governments.

2.3 *Controlled risk factors*

When the outcome of a risk can be influenced by one of the parties involved with an infrastructure project, there is a considerable advantage in having that party bear the risk because it will then have an incentive to make efficient tradeoffs between adverse outcomes and the costs of avoiding them. For example, if a private firm bears the risk of cost over-runs, then it will work

to assure that its design and construction strategies account for the effects of unexpected events on costs.

The same example, however, illustrates the complexity of incentives. Some cost-cutting measures available to a private firm might reduce the quality of its product in ways that cannot easily be detected until later. Examples are legion in the construction industry: poorly mixed cement, inadequate steel reinforcing bars, substandard electrical wire or plumbing. A good franchising process will attempt to control this kind of undesired cost-cutting, perhaps through quality specifications, inspections, and the use of reputation as a selection criterion. Another way to control it is to combine construction and operation into a single long-term franchise so that the firm itself would suffer the consequences of poor-quality construction — thereby perhaps expanding the scope of the private sector within PPPs. If none of these control strategies are feasible, a cost-plus contract, rather than a PPP, may be the best available option even if it entails some inefficiency.

Irwin (2007) points out two important additions to the principle of assigning risk to the party best able to control it. First, even those events that are outside anyone's control can be handled in ways that make them more or less costly; a good franchise agreement will assign the risk accordingly. For example, a project designer may be able to minimize damage due to the risk of an earthquake, whereas the government may better be able to minimize the damage from economic fluctuations. Second, it is unhelpful for a private franchisee to bear a controlled risk if it lacks authority to implement efficient responses to that risk. Nash (2005) provides an example from UK road franchises, in which the franchisee was paid on the basis of the amount of traffic generated, thereby shifting the traffic risk to the private sector. But the government retained the power to build competing roads and restricted the franchisees' ability to build interchanges that

might generate traffic, thereby nullifying most of the potential incentive effects from shifting the traffic risk. As another example, some traffic risk may be effectively absorbed by a franchisee with authority to build a road in increments rather than all at once (Irwin 2007, p. 59).

This brings us to the question of who can best bear the risk posed by the fact that future traffic is only imprecisely known. Such imprecision arises from several sources. One is unknown competing services, which are most often under control of a highway authority. Another is land-use and tax policies, which are under control of local or higher-level governments. A third is the health of the local economy, which is under some limited control by both local and national governments through economic policies. A fourth is the fact that demand depends also on factors controlled by the operator, such as ride quality, ease of toll collection, and marketing policies. To complicate matters further, some such factors might be privately profitable but socially counterproductive: for example, political maneuvering to prevent competing investments. This brief review suggests that an ideal arrangement will allocate traffic risks in rather complex ways. Section 4 explores some ways to accomplish this.

Finally, there is the risk of political manipulation or changes in contractual terms, which are real possibilities unless contracts carefully specify the franchisee's rights. Spiller (2008) argues that politically motivated opportunism, especially as may be instigated by outside parties with their own interests at stake (*e.g.* competitors for the contract), require that public-private contracts be more complete and rigid than contracts between two private parties.

One advantage of the franchise process is that it creates the possibility for sophisticated allocation of risk through formulas or other provisions. For example, most franchise agreements limit future toll rates using a formula involving inflation and/or some measure of economic activity. Some specify sharing of any revenue surpluses or shortfalls compared to projections.

Others, especially in the UK, do not even use real tolls but compensate the franchisee using public payment of “shadow tolls,” *i.e.*, payments proportional to the amount of traffic. These schemes enable the public entity designing the franchise to allocate traffic risk in a rather flexible manner. By contrast, public operation places most traffic risk on future taxpayers and/or future users, with the mix depending on how toll rates will be adjusted; whereas complete privatization places traffic risk fully on the private firm and on any creditors or citizens who would suffer from a private firm’s bankruptcy.

2.4 *Cost efficiency*

One of the hoped-for advantages of private involvement is that private firms will be more efficient, thereby lowering the cost of constructing and operating roads. There are several possible reasons. Private firms have stronger financial incentives because costs come out of their own profits. They are less prone to political interference in economic decisions, and they operate under fewer rules regarding procurement, civil service, union bargaining, affirmative action, and so forth — which may serve valid social purposes but also impose some cost. Furthermore, because it can do business in many places, a private firm may reap economies of scale and scope, as well as amassing superior knowledge, in activities related to building and operating infrastructure (Vining *et al.* 2005, p. 202).

The evidence from other transportation industries that are heavy in infrastructure is mixed. Vickers and Yarrow (1991, p. 117) review studies of railroad efficiency, with findings ranging from no difference some efficiency advantage of private ownership. Caves and Christensen (1980) suggest that it is competition rather than type of ownership that makes the most difference in Canadian railroads. Similarly though less directly applicable, some evidence

from urban bus transit suggests that the types of management incentives used, whether by private or public owners, are the most important factors explaining cost differences (Perry, Babitsky, and Gregersen 1988).

In the case of private highways, does the evidence support this expectation of lower costs? There are some anecdotal examples — for example, in France in the 1980s, the private firm Cofiroute exhibited lower unit construction costs than its publicly owned counterparts (Gómez-Ibáñez and Meyer 1993, p. 201). However, there is little confirmation of such differences from systematic evidence.

Rather, there is some evidence about a related quantity, cost and time overruns. Allen Consulting Group (2007, Table 4.1) examines 54 Australian projects (25 of them in transportation) and finds that PPPs had smaller discrepancies between actual costs and those specified in the initial contract. There was also a small reduction in time over-runs (Allen Consulting Group 2007, Table 4.3). The problem with such comparisons is that the costs and times specified in the contracts were themselves probably affected by whether or not a PPP was involved. For example, public authorities may have been forced by the use of PPPs to more carefully specify the nature of a project, in which case smaller overruns reflect better estimates rather than cost savings. Furthermore, the possibility of overruns in traditional cost-plus contracts provides some flexibility to the public sector, allowing it to expedite contracting while design details are being worked out and to respond to unexpected changes in conditions during construction. As noted by Dewatripont and Legros (2005), some cost overruns can be expected as an equilibrium phenomenon even in an efficient contracting system.

Thus it appears that the conclusion of Gómez-Ibáñez and Meyer (1993) still holds: “experience provides only limited support for the enhanced [cost] efficiency of [road]

privatization” (p. 201). While they think some modest efficiency gains are likely, due to greater flexibility and innovation in design, they suggest that private roads might not achieve the kinds of efficiency gains seen in other sectors because the bidders are already strongly involved in public procurement, and therefore PPPs do not create any additional gains from experience or scale. Furthermore, public agencies can often take measures to better align public and private incentives through reforms of conventional procurement, thereby reducing the advantage of PPPs (Vining, Boardman and Poschmann 2005, p. 206).

2.5 *Innovation*

Private operators sometimes propose innovative solutions for difficult social problems that can also be viewed as business opportunities. For example, deregulated railroads negotiated long-term contracts that greatly expanded the types of service provided to shippers. Deregulated telecommunications firms accelerated the use of microwave relay stations for long-distance telephone communications, as well as building cellular networks and offering numerous data-transmission services.

Is there scope for similar advances in highway networks? On the face of it, highways may seem less ripe for innovation. Yet there are surprising examples of creativity. Cofiroute, a private French company with worldwide toll road experience, is completing the A86 outer ring road around Paris using a tunnel under the Versailles palace. In order to provide the most congestion relief possible at reasonable cost, the tunnel will be restricted to autos and will use narrow lanes and short overhead clearances, with a consequently low speed limit of 42 miles per hour.⁷ This

⁷ See Poole (2006, pp. 28-31) for discussion of this and other urban congestion-relief tunnels.

kind of breakthrough could be difficult for a public agency, bound by standards and protocols, to achieve.

The greatest innovations may come in the areas of finance and pricing. Real-estate developers might join a consortium in order to tap the revenue potential from enhanced access as a source of funding for a highway improvement (Engel, Fischer and Galetovic 2005). It was a private consortium that proposed and implemented the toll schedule for California's State Route 91 express lanes, the first US example of time-varying tolls for congestion management. Private firms have also promoted innovations in toll collection technology. As discussed later, pricing innovations could be an important contribution to efficiency in urban highway operations.

2.6 *Use of revenues*

How the public sector uses the revenues from PPP franchises is important to both the efficiency and the political viability of PPPs. From an efficiency perspective, the transaction creates economic value only if the revenues are used for socially worthwhile purposes. From a political perspective, the public usually wants to see a transparent link from revenues it provides (as users) to expenditures having wide support, and some mechanism for ensuring accountability of the effectiveness of those expenditures. (These requirements in fact appear to apply to any toll road — see Zmud and Arce 2008.) Depending on the location and circumstances, public opinion may favor expenditures targeted at other infrastructure provision, solution to transportation-related environmental problems, or tax relief.

There are also the same issues of long-run equity and financial propriety that are inherent in any capital funding plan. As already noted, issuing a long-term franchise is similar to issuing public debt; therefore it is legitimate to insist that some political mechanism be in place, as in

common when issuing debt, to direct the revenues to appropriate uses over a time period comparable to the duration of the lease. The lease of the Indiana Toll Road and the proposed lease of the Pennsylvania Turnpike appear to meet this criterion by putting funds into infrastructure accounts; the lease of the Chicago Skyway did not have comparable provisions. An even tighter restriction, namely that toll revenue be used only for investments in that same highway corridor, is sometimes suggested but would be inefficiently restrictive because there is no reason why the highest priority for investment should be in that same corridor.

2.7 *Other issues*

One concern sometimes raised about private toll roads is that users are already paying for roads through fuel and other taxes, and now are asked to pay again through tolls. This critique, which applies equally to publicly operated toll roads, is most applicable if the arrangement is structured so that tolls cover the cost of the road. In that case, any fuel tax meant also to cover road costs should ideally be refunded so as to create a more “level playing field” between the private and public sectors. However, the practical significance of the problem is small. User charges, including fuel and vehicle taxes, do not fully cover the cost of roads in the US, and certainly peak-period user charges don’t come close to covering the capacity cost of major urban roads. Furthermore, user charges (such as the fuel tax) can also be considered to be externality charges to compensate for the fact that drivers do not fully bear the costs of congestion, pollution, and motor vehicle accidents resulting from their individual decisions (Parry and Small 2005). Thus, it is somewhat subjective to argue that a given tax payment helps “pay for” the road on which it is generated.

3. Pricing

One of the most widely held views of professional economists about transportation is that the way users typically pay for public roads serves the public interest very poorly. Prices are much too low for highly congested roads and do not vary in a helpful way with time of day. One of the innovations accompanying private road provision has been some move toward pricing that takes congestion into account.⁸ This raises the question: can the private sector do a better job of designing and implementing efficient pricing structures? To investigate this question, we need to consider market structure and regulation, with special attention to priced express lanes.

3.1 *Market structure and pricing*

Some theoretical results are helpful as starting points. First, it is clear that a profit-maximizing road owner would use congestion pricing if possible. To be more precise, such an operator would vary prices by time of day according to changes in the marginal social cost due to congestion — that is, in a manner similar to the time-varying pricing that would maximize economic efficiency. The reason is that the owner has an incentive to make the road as valuable as possible to its users, as they are then willing to pay higher tolls; it can do this by offering good service quality, including low congestion. However, the profit-maximizing operator would add a markup to marginal social cost reflecting the same consideration as a monopolist in any other

⁸ The US Department of Transportation has given such pricing schemes high priority in its use of various demonstration programs authorized by Congress since 1990, the latest of which — the Urban Partnerships Program — offers large grants to local regions willing to try out some form of congestion pricing. See US DOT (2008a). For reviews of congestion pricing, including the rationale, see Small and Verhoef (2007, ch. 4) and papers in Santos (2004).

market: namely, the less users are willing or able to switch to other options, the greater the markup.⁹

In cases where there are no good substitutes for the road in question, the resulting high markups create problems for both efficiency and distribution. First consider efficiency. The relative price markup for profit maximization is equal to the inverse of the absolute value of the price elasticity of demand.¹⁰ It is easy to show that the welfare loss, as measured by the standard “Harberger triangle,” is then equal to the revenue under marginal cost pricing divided by that elasticity. If demand elasticity is only 0.1, for example, the welfare loss is ten times the revenue that would be collected under optimal pricing — which itself can be very large (*e.g.* Small 1992). As for distribution, captive users will be quick to point out that such pricing involves large transfers from them to the private operator (or to a government treasury if profits are captured through a franchise fee or a tax on corporate profits).

These observations lead directly to two policy conclusions. First, private operators are indeed likely to seek to implement innovative and beneficial pricing structures, as noted also by US GAO (2008, pp. 24-25). But second, private operation will often need to be accompanied by regulation to keep overall price levels from becoming excessive. Price regulation is discussed in Section 4.1.

Thus, it seems likely that in realistic situations, the private sector would often adopt congestion pricing in some form. In some situations, especially where a new road is being

⁹ See Small and Verhoef (2007, sect. 6.1.1) for a precise statement and demonstration. The situation is more complex when two or more private road owners compete; de Palma and Lindsey (2002) confirm that private operators have some incentives to introduce time-varying prices, but find that these incentives may be thwarted by fear of provoking a price cut by a rival. Also, some simulations have found that time-varying pricing enhances profits less than welfare (de Palma, Lindsey and Wu, 2008), mainly because high private tolls in unregulated cases eliminate most congestion. Adam Smith (1789) also cited the ill effects of monopoly pricing as the reason he opposed allowing the toll revenues from “a high road” to accrue to private parties; see Book V, Ch. I, Part III, Article I, second paragraph [1937: 682].

¹⁰ Small and Verhoef (2007), p. 193, equation (6.5).

financed privately, the public may accept novel pricing arrangements more readily from a private than from a public operator. These conclusions are nicely illustrated by the experience with several private toll-road franchises in Santiago, Chile, all of which operate with time-varying prices and appear to be relatively well accepted.

3.2 *Priced express lanes*

One innovative pricing opportunity is the private finance, construction, and operation of special express lanes that parallel a congested road and operate at higher speeds, available for a price which varies by time of day. In most cases these express lanes operate as “High Occupancy Toll” (HOT) lanes, in which carpools go for free (or sometimes at a reduced price) and other vehicles pay the toll. An example is the “91 Express Lanes” in Orange County, California, part of State Route 91; these express lanes were proposed, built, and initially operated by a private consortium under the first modern US legislation fostering private road projects.¹¹ Other examples include recently opened HOT lanes in Colorado, planned HOT lanes on the Washington Beltway in northern Virginia, and several projects in the Trans-Texas Toll Corridor for which proposals were solicited beginning in 2004. In addition, public agencies have opened HOT lanes in the San Diego, Minneapolis, and Seattle areas. The US Department of Transportation actively encourages such projects through its Express Lanes Demonstration Program (US DOT 2008b).

¹¹ The legislation was California Assembly Bill 680 (AB680), in effect from 1989 through 2002. See Sullivan (2006) for a detailed account of the 91 Express Lanes.

It is not entirely clear whether a priced express lane is socially beneficial relative to an unpriced lane of the same capacity.¹² But their adoption raises a further question: Might the existence of such express lanes lead toward a fuller application of economically-based pricing tools? More specifically, if PPPs or other private initiatives accustom motorists to the idea of paying extra for faster travel, and people see the implementation and charging technology working in practice, will they be amenable to more far-reaching pricing schemes? There is some evidence that they will. Public acceptance of nearly all pricing schemes has increased as people get used to them and see their effects (Zmud and Arce 2008). Following California's law soliciting privately built transportation projects in 1989, the state of Washington passed similar legislation and the state's transportation commission approved several proposals for implementation, including one that would gradually turn lanes on Interstate 5 into express lanes, one by one, until the entire freeway was priced. Although that proposal did not survive public scrutiny, it shows how far some political leaders were willing to go. Today, officials are going much further, exemplified by the mayor of New York City proposing a toll ring around all of southern Manhattan — clearly inspired by the success of toll rings in London and Stockholm. That proposal ultimately was approved by all but one of the necessary parties for implementation, the holdout being the New York State Legislature.

4. Franchising Arrangements

One of the main arguments for private sector involvement in road provision is that effective competition “for the market” can be fostered at the time a franchise is awarded.

¹² The answer, from a purely efficiency perspective, depends on how diverse people are: see Small and Yan (2001) or Verhoef and Small (2004). Diversity also may facilitate design of express-lane policies combined with more extensive pricing: see Small, Winston and Yan (2006).

Furthermore, the terms of the franchise can be structured to fine-tune the incentives, the degree of risk-sharing, and the division of economic returns between public and private sectors. Thus, the nature of franchise agreements and the procedures for awarding them are critical to obtaining public benefit from private participation. Such agreements involve technical matters of finance, and so require market sophistication within the public sector — something that is fostered by experience, creating one of the arguments for demonstrations and experiments.

Market power involves the same public policy issues for private toll roads as for any other industry, where such power is typically curtailed by anti-trust laws or regulated as in the case of electric utilities. Regulating a toll road is less complicated than an electric utility, but it still may challenge the capabilities of governments, especially in nations with weak tools of public administration. Thus similar basic questions arise; for example, should regulation specify prices, rates of return, performance standards, and/or required investments? To review all the resulting issues here would be prohibitive, but we can consider several that are most relevant for our topic. A central theme is the impossibility of anticipating all conditions affecting performance over the lifetime of a capital asset and the resulting vulnerability of the contracting parties to exploitation when there is “asset specificity” — i.e., when that capital asset has no value outside the relationship in question.¹³

4.1 Toll rates

Most road franchises specify maximum tolls, usually in terms of a starting value and a formula for growth. This practice has the advantage of removing future toll changes from the political process — at least, that is the hope — but it also has problems. First, it removes pricing

flexibility and so may prevent an innovative pricing structure. Second, it requires projections of a desirable toll rate, possibly far into the future.

Theoretical and simulation studies have found that the public benefits from toll roads are quite sensitive to the toll rate. This is especially true when there are unpriced close substitutes, which is common and is sometimes even required as a condition for allowing a road to be tolled. With unpriced close substitutes, setting the toll too low will encourage excessive overall corridor traffic, while setting it too high will encourage an excessive fraction of that traffic to remain on the already congested free roads. The desire to attract traffic away from these free roads is often a special concern, because they are likely to be highly congested arterials serving local traffic, affecting noise and pollution levels in densely populated areas and having a worse safety record than expressways.

An alternative to specifying the toll is to specify a maximum rate of return, as was the case with California's "91 Express Lanes," thereby giving the franchisee substantial pricing flexibility.¹⁴ While the history of rate-of-return regulation of public utilities is not entirely encouraging, one of its main problems—a tendency to encourage padding the capital base in order to increase allowed earnings (Averch and Johnson 1962)—is more easily controlled with roads than other types of utilities. This is because the capital stock of a road project is mostly in the road itself, whose characteristics can be specified readily. Thus, flexible pricing with an earnings cap remains a promising way to limit tolls within a private road franchise.

¹³ Gómez-Ibáñez (2003) and Guthrie (2006) provide excellent reviews of these issues as they pertain to infrastructure. Similarly, Laffont and Tirole (1993) consider the problem of relationship-specific assets to be central in analyzing optimal procedures for public procurement.

¹⁴ The regulation for the 91 Express Lanes required that any profits exceeding those allowed be shared with the State of California. This is different from typical rate-of-return regulation of public utilities, which uses the allowed rate of return just as an intermediate step in calculating specific maximum prices (Guthrie 2006, sec. 2.1).

4.2 *Profitability and subsidies*

A critical question for private highway finance is the financial feasibility of the initial investment. Under what conditions will building, operating, and pricing a highway be profitable?

One result is well known in the economics literature. If capacity is added and priced according to the theoretically ideal prescriptions of investment analysis and congestion pricing, then it will just pay for itself provided there are no scale economies or diseconomies in its construction.¹⁵ If road construction instead involves diseconomies of scale, as may happen in urban settings because of intersections and rising land costs (Small 1999), then the road would more than pay for itself. However, in the more common case where there are scale economies in construction, for example due to fixed costs resulting in more capacity than is strictly needed to handle the traffic, optimal congestion pricing will not cover the investment cost. Thus subsidies are needed if tolls are to be kept at efficient levels — especially for the lower-volume, less financially attractive roads that may be desired to encourage regional integration and economic development.

The postwar experiences of France and Spain illustrate well these theoretical findings.¹⁶ Both began building their motorway networks using franchises to private firms, with no public funds. This worked well for the most heavily traveled routes, but proved an inadequate financial base for continued development of the networks. Due to this and other factors, both nations partially socialized the networks during the 1970s, a process only recently reversed through new privatizations. The net result is that most of the motorway networks in France and Spain today

¹⁵ Small and Verhoef 2007, sec. 5.1.1. There is another technical condition, which is that congestion formation also shows no scale economies or diseconomies, that is, congestion is a function only of the *ratio* of traffic volume to capacity. Similarly, if heavy vehicles are charged the marginal costs they impose to users and the agency maintaining the road pavement, then under certain conditions these payments will just cover the pavement maintenance cost: see Newbery (1988).

¹⁶ Gómez-Ibáñez and Meyer 1993, ch. 8, 11.

are in private hands, but were built with substantial public funds. These experiences are consistent with a financial conclusion of Forsgren and Macdonald (2005):

“new and heavily debt-financed toll projects — absent an overwhelming demand profile ... — will require a significant level of public involvement and, perhaps, public investment, to reach investment-grade levels.” (p. 44)

4.3 *Transparency*

Most people believe that transparency is inherently valuable in public affairs. It also is needed to facilitate public acceptance of new arrangements. How do public private partnerships rate on transparency, in comparison with traditional public procurement?

On the positive side, the franchising process makes certain planning assumptions explicit. Expectations, commitments, and financial projections must be specified both to define bidding terms and to enable bidders to obtain third-party financing. An example is provided by the 2004 bidding process for a 99-year lease of the Chicago Skyway, which was preceded by the City of Chicago commissioning a first-ever detailed financial projection of the Skyway.¹⁷

On the negative side, the agreements themselves are highly technical and their provisions difficult to explain to the public. Some details may be proprietary and thus not made public at all. Private firms can bypass rules that would require a public agency to fully expose its decision-making. Even when the initial investment is publicly visible, subsequent private transactions, such as refinancing of debt or corporate buyouts of participating firms, may obscure accountability for specific decisions.

Thus transparency is not automatically promoted by private franchising, but it can be if it is an explicit goal. For example, the franchise can specify public availability of certain

¹⁷ US GAO (2008, p. 42); Bel and Foote (2009).

information; it can also specify conditions under which the sale or refinancing of a lease is permitted, as for example is the practice in France.¹⁸

4.4 *Other Public objectives*

The franchise agreement is a natural place to make specific any other public objectives that might differ from private ones. Examples include environmental practices, links to the larger road network, price stability, and worker protection. Some public objectives, such as safety measures and scenic values, affect private profitability and so will be considered automatically to some extent, but insufficiently if they involve spillover effects beyond what is reflected in users' willingness to pay.

Requiring the franchisee to meet objectives other than those that increase profits will naturally tend to reduce the value of the franchise to the private operator and hence the sizes of private bids for that franchise. This tradeoff is vividly illustrated by Bel and Foote (2009), who estimate the value of various provisions among the franchise terms on five recent road privatizations: two in the US (Chicago Skyway and Indiana Toll Road) and three in France (three parts of its motorway network). The two US franchises were won with bids of 60 and 63 times current earnings, whereas the three French cases had multiples between 12 and 13.¹⁹ They find that several factors accounted for this striking difference in contract value. Three of the most important were term length, allowed toll increases, and maximum leverage ratio — factors also highlighted by Forsgren and Macdonald (2005) as affecting franchise value.

¹⁸ Bel and Foote (2009); Joint Transport Research Centre (2008, Annex 1.2).

¹⁹ Earnings are here measured net of operating expenses but not of capital charges — specifically, they are “earnings before interest, taxes, depreciation and amortization” (EBITDA).

These three factors, plus alternate assumptions about traffic growth, are found by Bel and Foote to strongly influence bid price. Table 1 details their estimates, based on computing the present discounted value of future cash flows²⁰ and assuming that 97.3 percent of this value remains after transaction fees. Their base-case simulation uses assumptions aimed at explaining the actual winning bid for the Chicago Skyway franchise, whereas other simulations change key parameters in ways approximating their values in the French toll road auctions. As seen in the table, changing any one of the three key parameters has the effect of cutting the bid nearly in half; changing all three simultaneously cuts it by 76 percent (from \$1.83 to \$0.43 billion) and lowers the hypothetical ratio of bid price to earnings to 15. Accounting in addition for the higher cost of capital implied by the French limitation on debt leverage (debt no more than 7 times earnings) cuts the ratio to 12.5, a nearly exact match to what was observed in the three French concessions. Thus, it is plausible that these four differences between the US and French situations explain most or all of the differences in the resulting ratios of bid price to earnings.

Since three of these four parameters may be regarded as attempts to protect the public interest (through a shorter term length, lower tolls, and more secure financing), most of the difference between the French and US winning bids can be regarded as the cost to French taxpayers of these protections. Are these public benefits worth the costs? A full answer would require rigorous modeling, but it seems very likely that Chicago and Indiana leases will eventually lead to toll rates well above those that are either economically efficient or considered equitable by many observers. In any case, the information revealed by the bidding process facilitates public discussion of the question.

²⁰ Nominal revenues in each year are discounted to the starting year using a nominal annual cost of capital of 9.38%, which is a weighted average of 12.3% for equity and 8.00% for debt.

Table 1. Value of Chicago Skyway Concession under Alternative Conditions

	Value	
	(\$ billions)	multiple of earnings
Actual bids		
Winning bid	1.83	63.1
Second highest bid	0.70	24.1
French toll roads (average)	--	12.3
Simulated bids		
Base case (winning bid)	1.83	63.1
Individual parameter adjustments:		
(1) Term length (99 → 23 years)	1.03	35.6
(2) Toll growth rate (3.78% → 2.08%)	1.06	36.5
(3) Traffic growth rate (1.23% → 0.23%)	0.93	31.9
Combined parameter adjustments:		
(1)+(2)	0.72	25.0
(1)+(2)+(3)	0.43	15.0
(1)+(2)+(3) + debt limitation (cost of capital 9.38% → 11.71%)	0.36	12.5

Source: Bel and Foote (2009), p. 10 and Tables 3,4,5,8.

4.5 *Term length of franchise*

As shown in Section 4.4, the value of a franchise can be substantially enhanced if the franchise covers a long time period, *e.g.* 50 years or more. This is because the traffic growth expected over the life of the road results in much greater profits in later than earlier years. Indeed, almost every new toll road involves plans for a “ramp-up” period of many years in which tolls fail to cover operating expenses, interest, and depreciation. Thus, the ability to attract private finance is greatly enhanced by long term lengths.

But as discussed earlier, a long term makes it more difficult to specify toll rates. By the same argument, other conditions that may be part of a franchise — safety measures, capacity enhancements, maintenance standards, and conditions for adding competing capacity — are

more difficult to specify far in advance. How can anyone know what conditions will prevail, or what standards will be deemed appropriate, 75 or 99 years from now?

Another factor is the role of political decisions. A long-term franchise, if enforceable, has the advantage of minimizing political tinkering later on. But what is to prevent a future government from renegeing on the terms of the franchise? The court system offers some protection, but changing public interest might produce a consensus that the original terms have become outmoded. Furthermore, the public sector retains other powers, such as regulation and taxation, that can affect the profitability of the franchise. Thus, there is some political risk for the private operator that probably increases with term length.

An auction mechanism proposed by Engel, Fischer, and Galetovic (2001) avoids some of these problems by letting the term length of the lease depend on experience in a specified way. The specific proposal is to base bids on the “least present value of revenues” required. Consider for simplicity the case when a road is expected to be profitable. Instead of submitting bids based on toll rates or on annual profits to be shared, firms would bid on the present value of future revenues they would receive, with present value calculated using one or more interest rates specified as part of the bidding process. The firm proposing the lowest such present value wins the bid and is then allowed to collect revenues until that present value is achieved, after which the road reverts to the public sector. This type of auction reduces the impact of unknown factors in the distant future by letting the time period over which they operate be variable. Specifically, it maintains most of the desirable incentives of other franchise arrangements — to build cost-effectively, to provide good service, to keep collection costs down — but it allows the public sector to retain much of the risk due to unknown traffic levels and future allowed toll rates. If a future government wants to adjust the toll formula or build competing capacity, it can do so

without upsetting the franchise so long as the franchisee will still be able to earn enough to eventually reach the specified present value. (The same principle can be applied to an unprofitable road if the auction process specifies a specific form for public subsidies.) However, potential bidders have tended to discourage this type of auction because it removes much of the upside profit potential.

To summarize, there are advantages to both short- and long-term franchises, the latter probably involving more profit for the franchisee but also more risks for both parties. A variable-term contract, such as that offered in an auction based on least present value of revenues, is an attractive alternative.

4.6 *Monitoring, renegotiations, bail-outs, and transaction costs*

Monitoring franchisee performance is clearly important if a franchise agreement is to serve its purposes. Yet monitoring is one of the least studied aspects of PPPs.

Some practical steps taken by various agencies are described by US GAO (2008, pp. 49-51). These include requiring financial statements, formal oversight boards, assigning staff or independent engineers to measure performance, recording user complaints, issuing fines, and formal requirements for public information. Most of these steps involve verifying that the formal requirements of a contract are met, which requires the foresight to specify the performance indicators as well as the means to measure them.

But many important aspects of performance cannot be foreseen. Two conditions make this especially likely: asset specificity and complexity (Vining *et al.* 2005, p. 204).²¹ Asset

²¹ For example, in reviewing operation of public transportation, Preston (2005, p. 77) notes that franchising has been “more problematic” for rail than bus transportation, citing “greater scope of strategic game playing [which] in turn may be related to the greater technical complexity and capital intensity of rail” (p. 77). Highways are much less complex than railroads, but they do involve a similar degree of capital intensity.

specificity means that the project creates capital assets with little or no use other than in the relationship in question; it is characteristic of long-lived infrastructure. Asset specificity and complexity make it likely that unforeseen contingencies will arise and that one or both parties will be vulnerable to exploitation by the other due to lack of viable alternatives to continuing the relationship. As Vining *et al.* emphasize, transaction costs can then be so high as to more than offset any cost savings from private-sector efficiencies. For this reason, Hensher and Stanley (2008) argue that a formal auction of franchise rights is undesirable in such situations, recommending instead a negotiations-oriented process in which firms develop long-term relationships to the public agency through repeated transactions and a buildup of trust and openness with information. From the point of view of creating “value for money,” they state:

In contrast to auctions . . . , which are framed to *determine* the value of a product of service, negotiation is designed to *create* the value of the product or service.” (p. 1145).

Regardless of how flexible a franchise agreement may be, formal renegotiations often occur when conditions differ markedly from those anticipated by one or both parties. Reasons could include impending bankruptcy, unanticipated congestion, changes in political governance, or adverse publicity over some aspect of the public-private relationship. In Spain, renegotiations are said to be an expected normal part of the franchise process, allowing provisions to be “rebalanced” to reflect new information (US GAO 2008, p. 47). The UK government changed its mind about private operation of the Skye Bridge in Scotland, ultimately purchasing the bridge from the private operator. In the US, impending bankruptcy forced reconsideration of the terms of the Dulles Greenway concession in Virginia, and public outcry over a non-compete provision caused the franchise for the “91 Express Lanes” in California to be bought out by the local public

transportation authority.²² Such renegotiations can add substantially to the transactions costs of PPPs, which are already quite high — perhaps 3 percent of project costs as opposed to about 1 percent for public procurement (Välilä 2005, p. 109). This cost is a consideration both in designing a franchise agreement and in the prior decision as to whether public or private operation is preferable.

Engel, Fischer, and Galetovic (2003) argue that prevalent renegotiations of highway franchises prevented the realization of hoped-for benefits of PPPs in Latin America. Unlike the original franchise arrangements, renegotiations tended to take place outside of public view.

Furthermore:

Such renegotiations negate the public benefits of private highways by giving an advantage to firms with political connections, limiting the risk of losses, and reducing the incentives to be effective and cautious in assessing project profitability. (p. 131)

They attribute these renegotiations mainly to two factors. First, governments enacted and implemented PPP policies in haste, failing to have sound regulatory mechanisms in place beforehand. Second, the use of fixed-term contracts caused all the demand risk to be borne by the private party, which as we have seen makes it subject to factors outside of its control. A third factor, which may be endemic, was that highway plans tended to be made during economic booms, causing a systematic tendency to overestimate future revenues through extrapolation from recent trends. Guasch (2004) provides further details.

To summarize, transaction costs and the likelihood of renegotiations create important qualifications to the efficacy of public-private partnerships. They need to be recognized not only

²² As a result, the 91 Express Lanes are cited by Vining *et al.* (2005, p. 207) as “hardly a model example of partnership between the public and private sectors. Both parties exhibited opportunistic behavior and the transaction costs, including legal costs and negotiation costs, were enormous.”

in the drafting of a franchise agreement, but also in the process for choosing a franchisee and in the prior decision as to whether or not to establish a PPP. Otherwise, there is a significant chance for disappointment and ultimately high social costs.

5. Conclusion

We have seen that private involvement in providing highway services offers potential benefits in many situations, but to realize them requires considerable public involvement and sophistication.

One such benefit is a wider range of funding sources available for investments in highway infrastructure, due to fiscal and political constraints on governments and the availability of private funds seeking time profiles and risk structures compatible with toll roads.

Furthermore, private firms can usually react more quickly to opportunities than can the public sector, and thus can help when there is a backlog of needed infrastructure investments.

Another benefit is more efficient forms of risk-sharing. Through the franchising process, it is possible to specify terms that allow each entity to bear the risk it is most suited for and to give each party incentives to minimize the adverse consequences of unknown events. As for the remaining risk, there is no strong reason to believe that either the private or the public sector has a general advantage in bearing it, although one may have an advantage in specific situations.

A third benefit is that private firms may well realize some cost efficiencies relative to the public sector. But such efficiencies remain unproven and are probably less in highways than in some other sectors. Private partnerships do perform more closely to the original budgets and time schedules, which is helpful for planning and public assessment even though it does not necessarily imply lower costs.

A fourth benefit is that a private firm may introduce useful experimentation with pricing structures, specifically time-of-day variation in toll rates. Such experiments can provide valuable lessons provided the operator is given some pricing flexibility. This may well prove to be the most important benefit, because studies have shown that the crude pricing now typical of roads is substantially limiting their efficiency in meeting mobility objectives.

An important qualification to these benefits is that road services cannot plausibly constitute a competitive market, so the freedom given to private operators needs to be accompanied by some restraint on market power. Such restraint can be achieved by toll regulation, but doing so tends to eliminate desirable price flexibility and also requires unrealistic amounts of information about future conditions. A more promising approach is an auction that specifies a particular financial target, the amount of which is the subject of the firms' bids, allowing toll rates and the duration of the franchise to adjust to achieve the target that is agreed on. In either case the public authority is forced to choose, to some extent, between high prices that may harm the public and large payments that it may be able to extract from private firms. Furthermore, there is a danger that the transaction costs of setting up and monitoring an agreement can be excessive.

Other public concerns such as safety, environmental goals, service quality, and financial stability of the private provider can also be addressed in a franchise agreement. Indeed, a key challenge to the public sector is to structure such agreements so as to foster such public goals as well as meet both parties' financial needs. This requires that public agencies acquire the kind of business expertise to allow them to interact successfully with private parties in such matters. Given the potential benefits, it seems an effort well worth undertaking.

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