SENATE COMMITTEE ON COMMERCE, SCIENCE, AND

TRANSPORTATION'S SUBCOMMITTEE ON SURFACE TRANSPORTATION AND

MERCHANT MARINE INFRASTRUCTURE, SAFETY, AND SECURITY

HEARING ON:

"REBUILDING THE NATION'S INFRASTRUCTURE: LEVERAGING INNOVATIVE

FINANCING TO SUPPLEMENT FEDERAL INVESTMENT"

TESTIMONY
OF
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Good afternoon, Mr. Chairman, Senator Blunt and members of the Subcommittee. It is my pleasure to be here this afternoon.

My name is Perry Offutt. I am a Managing Director in the Investment Banking Division of Morgan Stanley and am the Head of Infrastructure Investment Banking for the Americas. My group focuses on innovative transaction structures to utilize private capital to invest in infrastructure projects. Many of the projects on which I work are structured as public-private partnerships (defined below). I work with both public and private sector clients.

For example, I am advising or recently advised on the following transactions:

1. Meridiam / Skanska / Vantage on their potential bid for the LaGuardia Airport Central Terminal Building Replacement Project (RFP issued August 2013, ongoing)
2. The Ohio State University on its $483 million parking concession (public-private partnership closed in 2012)
3. Potentially privatizing the sewer system in Nassau County, New York to realize operating efficiencies and improve system integrity (studied in 2011 and 2012)
4. OHL Concesiones / Morgan Stanley Infrastructure Partners on their bid for the concession of Puerto Rico's PR-22 and PR-5 toll roads (public-private partnership bid submitted in May 2011)
5. City of Indianapolis on concession of City metered parking system (public-private partnership closed in 2010)
6. Citizens Energy Group on $1.9 billion acquisition of Indianapolis water and wastewater system (sale closed in 2011)
7. Morgan Stanley Infrastructure Partners on its acquisition of NStar's district energy operations (sale closed in 2010)

As a financial advisor focused on public-private partnerships, I appreciate the opportunity to share my perspective on how federal funds can be used to partner with private investment to supplement current infrastructure funding and increase overall investment into US infrastructure projects.

Public-Private Partnerships

A Public-Private Partnership ("P3") involves a long-term lease (not a sale) of municipal assets (the "Concession"). The specific terms regarding how the asset is operated and maintained are included in a contract between the public agency/government and a private sector entity (the "Concession Agreement"). The government retains ownership with a right to reclaim the assets if the private operator does not meet certain standards. Under such an arrangement, some degree of risk and responsibility is transferred from the public to the private entity.

Due to the many safety and security concerns associated with operating core infrastructure assets, it is essential that all potential private partners undergo an extensive evaluation of their qualifications. Such an evaluation is typical in P3 processes. Traditionally, the procuring government entity will issue a Request for Qualifications ("RFQ") that requires private operators to submit a response listing their qualifications in the areas of design, construction, operations and maintenance, as well as describing their ability to finance construction and improvements as necessary. In order to be considered as a bidder for a P3, a private party needs to pass all criteria in this qualifications phase.

Consequently, the government can screen which private bidding groups are able to submit a final bid for a P3 project.

While these processes can often be very complex and time consuming, we at Morgan Stanley believe that a well-constructed P3 transaction can truly be a win-win-win for a government entity, the private sector and the end users.

Private Capital Available for P3s

Morgan Stanley estimates that over $250 billion of private capital has been raised globally to invest in infrastructure projects (of which over $75 billion has not been invested). This capital is attracted to these investment opportunities given the potential to achieve long-term stable cash flows and attractive risk-adjusted returns for the project. Many of these investors (typically pension or infrastructure funds) have the ability to invest in various geographies around the world and across various infrastructure assets (e.g., transportation, regulated utilities, contracted power / energy and telecommunications). In order to mitigate potential macro-economic risks, many investors also tend to focus on jurisdictions with stable economic and regulatory environments so the US is an obvious area of focus.

Attracting the private sector as a partner can (i) leverage public funds, (ii) deliver a superior outcome for the project and (iii) shift risk (e.g., construction and operations) to the private sector. The private sector can often build a project more quickly and at a lower cost; drive efficiencies over time by introducing technology solutions; and develop incremental revenue sources by delivering additional services.

Given that private capital also frequently evaluates opportunities outside US infrastructure, it is important to demonstrate that a US project is commercially/financially viable and has political support in order to attract interest from prospective private investors. However, it is important to recognize that because of investors' return expectations and desire for stable cash flows, some projects do not lend themselves to P3s on a standalone basis.

For example, the construction and operation of a typical transit project does not generate sufficient fare revenues to cover ongoing expenditures. In these cases, some form of "availability payment" from the government entity is required for the private investors (debt and equity) to earn an adequate risk-adjusted return. As part of the Concession Agreement, availability payments (similar to pass-through tolls) are agreed to be paid (often subject to annual appropriation) to the private entity as compensation for its responsibility to design, construct, operate and/or maintain a roadway for an agreed upon time. These payments are based particular milestones or facility performance standards.

The following is an example of a P3 transaction that utilized an availability payment structure:

In October 2009, the Florida Department of Transportation ("FDOT"), in conjunction with the City of Miami and US DOT, reached financial close for the Port of Miami Tunnel and Access Improvement Project. This P3 project involves the construction of a tunnel under the Port of Miami at an estimated project cost of approximately $900 million (financed with public and private capital). The winning bidder (Meridiam and Bouygues) proposed providing equity upfront plus helped arrange $342 million of senior financing with project finance banks. Other funding was provided by a TIFIA loan. In addition, FDOT pledged to make "milestone" payments throughout the construction process, followed by availability payments following completion. These payments from FDOT helped provide the winning bidder with comfort that, despite uncertainty around the total traffic in the tunnel, the government was willing to serve as a 'buffer' for future traffic risks. Depending on the specific projected cash flows of the project, this may or may not be needed.

In the above example, the availability payments from FDOT de-risked the project enough for the private sector to secure both equity and debt financing for this important infrastructure project. In addition, this project is an example of how Federal capital can be leveraged (only 1/3 of the project costs were financed with TIFIA financing).

Another challenge facing some US P3s is convincing the private sector that there is sufficient political will to complete the P3. Given the high costs to reach a binding bid (i.e., significant due diligence costs), private capital focuses early in the process on the regulatory/political approval process. If there is not perceived to be adequate political support or a clear path to gaining required approvals, many private investors will decide not to prepare a bid. Consequently, any additional Federal support (both monetary and political) would be very helpful to minimize this risk.

Current Need for Significant Infrastructure Investment

Earlier this year, the American Society of Civil Engineers (ASCE) reported that $2.2 trillion would be needed over the next five years to raise America's infrastructure from its current "poor" rating to a "good" rating, which is required to ensure reliable transportation, energy and water/wastewater systems. For example, the Federal Highway Administration (FHWA) estimates that to eliminate the nation's bridge deficient backlog by 2028, we would need to invest $20.5 billion annually, while only $12.8 billion is being spent currently. Such projected shortfalls are quite troubling. No one wants another bridge to collapse, as did the I-35W Mississippi River Bridge.

When you compare the percentage of GDP that the US is spending on infrastructure relative to emerging markets, the ASCE's conclusion is not surprising. For

example, between 2000 and 2006, the total public spending on infrastructure in the US was less than 2.5% of GDP versus China, which spent almost 10%.

Unfortunately, there currently is no specific plan in place to address the magnitude or the immediate urgency of this problem. Leadership from the Federal government could help attract significantly more private capital to a greater number of key infrastructure projects.

Given limited additional debt capacity at state and local levels due to significant existing debt and large pension liabilities, the Federal government's presence is critical to support some of these essential projects. However, it does depend on the location and complexity of the project; the tax-exempt market and existing programs (e.g., TIFIA) are effective funding sources for many projects.

Ideas to Consider

Various types of infrastructure projects need funding, ranging from improvements of high cash generating "brownfield" projects (i.e., existing operating assets) to investments in social services that are not focused on profitability (e.g., public transit). In order for the nation to finance such a wide range of projects, sponsors need to have access to a large variety of public and/or private financing alternatives. Therefore, at Morgan Stanley we see the benefits of programs that provide grants, low-cost loans (e.g., TIFIA and RRIF loans) and loan guarantees. In many cases, public capital from Federal, state and/or local sources can be leveraged with additional capital from the private sector. This can be done while also promoting a healthy tax-exempt bond market.

While many states and local governments are already pursuing initiatives to address the US infrastructure crisis such as implementing P3 legislation, the Federal government can also play a critical complimentary role. Specifically, the Federal government should develop a long-term plan for development and maintenance of the country's infrastructure as has been done successfully by other countries. An "infrastructure finance authority" would be a key part of such a plan. This independent organization could help facilitate and financially support (via loans and loan guarantees) projects of national and/or regional significance that would otherwise not be completed.

Thank you very much for the opportunity to testify here this afternoon on this very important topic. I would be glad to answer any questions that you may have.