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before the

**Committee on Transportation and Infrastructure
Subcommittee on Highways and Transit
U.S. House of Representatives**

on the

**Role of Innovative Contracting in the Delivery and Operation of Major
Transportation Infrastructure Projects**

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Chairman DeFazio, Ranking Member Duncan, and Members of the Subcommittee, my name is David Horner. I am the Chief Counsel of the Federal Transit Administration (“FTA”), an agency within the U.S. Department of Transportation (the “Department”). I greatly appreciate the opportunity to testify today about innovative contracting in the delivery and operation of transportation infrastructure projects, one of the most important trends in transportation today. Under the leadership of Secretary Mary Peters, the Department believes that innovative public-private contracting must play a central role in reversing the decline of system performance, while also improving overall transportation system safety.

Although innovative contracts are relatively recent in the world of public transportation investments, there is little question that their importance will grow over time as public agencies and elected officials seek to increase accountability to customers; stimulate innovation; reduce large operating deficits; and improve the accuracy of cost forecasts, among other things. While the need to improve performance forecasting under traditional procurement has received less attention than other challenges, it is no less important. The success or failure of innovative contracting should be judged by the degree to which it improves upon current methods of system delivery.

How we build and operate our transit infrastructure is a matter of increasing importance to the Nation’s transportation system. The Federal financial commitment to transit construction has been, and remains, substantial. Since Congress passed the Intermodal Surface Transportation Efficiency Act of 1991, FTA’s New Starts program has contributed in the aggregate approximately \$17.6 billion¹ to 44 projects. The average total cost of each of those projects has been approximately \$835 million.² Federal funding through the New Starts program alone, excluding other Federal assistance, has accounted for approximately 47% of those costs on average.³ That investment has been made in support of important goals: congestion relief, environmental benefits, mobility, and community-building. The return on Federal dollars expended on transportation should be scrutinized, particularly given the growing competition for resources at all levels of government. How transit projects perform—whether

¹ Expressed in year-of-expenditure dollars.

² Expressed in year-of-expenditure dollars.

³ See, National Transit Database. The Federal commitment to transit is not limited to capital expenses. In Fiscal Year 2005, for example, approximately \$1.5 billion of Federal transit assistance (or 25.5% of FTA’s \$5307 and \$5309 capital program combined) was expended on “preventive maintenance”—a category of costs eligible for Federal support that includes certain operating costs. FTA defines preventive maintenance costs as “[a]ll the activities, supplies, materials, labor, services, and associated costs required to preserve or extend the functionality and serviceability of the asset in a cost effective manner, up to and including the current state of the art for maintaining such asset.” See the *National Transit Database Manual* at <http://www.ntdprogram.gov/ntdprogram/Glossary.htm>.

they are built on time, on budget, and realize the benefits expected from them—affects the public's support for new projects and, more broadly, its view of the Federal transit program.

In the circumstances today, we should ask whether we should pursue new approaches to funding, building, and operating transportation services, including transit services. More to the point: given the widespread and acute deterioration of the surface transportation system, is it not time to experiment broadly with alternatives? For many years, the U.S. enjoyed substantial amounts of excess capacity along many sections of our transportation systems. That era is over. In the past 20 years, hours of vehicle delay and wasted fuel have each quadrupled. The cost of wasted time and fuel for travelers in 2003 was over \$60 billion. If we add the extra time people must allow in planning for congestion delay and the lost productivity associated with it, the annual costs rise to roughly \$170 billion. These costs have been growing at about 8% per year—almost triple the rate of growth of the economy. The extent, duration, and intensity of delay associated with these costs have all skyrocketed over the past two decades.

In my testimony today, I would like to describe how innovative contracting, commonly referred to as “public-private partnerships” or “PPPs,” can help transit agencies address the challenges of limited resources, project performance, and accuracy in forecasting. We think these methods of procurement, if widely adopted, will not only improve delivery of new transit capacity but contribute significantly to the general betterment of the Federal transportation program.

FTA's Public-Private Partnership Pilot Program. Before discussing the benefits of PPPs, I'd like to discuss the Public-Private Partnership Pilot Program (the “Penta-P” or “Pilot Program”) established by FTA in January 2007 pursuant to Section 3011(c) of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (or “SAFETEA-LU”). Through the Pilot Program, FTA is inviting project sponsors to experiment with alternative project delivery in order to identify more effective ways of building transit projects for the American public. As organized by FTA, the Penta-P serves at least two functions. The first is to study whether innovative system procurements realize the benefits ascribed to them. The second is to study how the New Starts program should take into account an expanded role for the private sector in major system procurements. FTA's recent publication in the Federal Register sets forth the terms of its Pilot Program and its objectives in detail.⁴

I am pleased to report that, in March, FTA received four applications for the three spots in the program allowed by statute: BART's Oakland Airport Connector, Houston METRO's METRO Solutions Program, the Denver Regional Transportation Authority's Fastracks Program, and the bus-rapid-transit (or “BRT”) elements of Georgia Regional Transportation Authority's I-75 Corridor.

⁴ *Notice of Establishment of Public-Private Partnership Pilot Program; Solicitation of Applications* (January 19, 2007) (72 FR 2583).

Given the experimental nature of the Pilot Program, FTA intends to designate as Pilot Projects those projects that exhibit high “demonstration value.” In determining the extent to which a project exhibits demonstration value, FTA will consider, among other things: (i) the number of project elements for which the private partner is responsible, (ii) the quality of risk allocation with respect to the cost and ridership of the project, as set forth in the public-private agreement, (iii) the extent to which equity capital and development proceeds are contributed to the project and the terms on which such capital is contributed, (iv) whether the project is part of a congestion mitigation plan that incorporates system-wide congestion pricing, and (v) the expected effects of the foregoing arrangements on (A) the speed of delivery of the project, (B) the quality of delivery and performance of the project, and (C) the reliability of the projections of costs and benefits associated with the project.

To encourage project sponsors to experiment with alternative delivery, the Pilot Program is offering project sponsors incentives in the form of adjusted ratings of cost-effectiveness and financial commitment, accelerated process, and other benefits. I would be happy to discuss them with the Committee.

Pilot Projects that are candidates for funding under FTA’s New Starts program will be evaluated and rated in accordance with the rating criteria of the New Starts program, as adjusted to account for their “demonstration value.” Accordingly, Pilot Projects that receive an overall rating of “Medium” or higher and a rating for cost-effectiveness of Medium or higher, as adjusted for their demonstration value, may be recommended to Congress for New Starts funding.

Funding recommendations and other final approvals with respect to a Pilot Project—together with any procedural or rating benefits received by the project under the Pilot Program prior to a funding recommendation—would be conditioned on the project sponsor and the private partner having entered into a public-private agreement that, in the opinion of FTA, safeguards the Federal interest. If the parties fail to enter into a satisfactory agreement, FTA will rescind the benefits received by the Pilot Project and remove the Pilot Project from the Pilot Program.

What are Transit PPPs? As applied to transit (and for purposes of the Pilot Program), PPPs are essentially a form of procurement for new capacity. Transit PPPs contemplate a single private entity, typically a consortium of private companies (a “private partner”), being responsible and financially liable for performing all or a significant number of functions in connection with a project. By agreement with the private partner, the project sponsor shifts final design and other short or long-term risks to the private partner, and the private partner receives the opportunity to earn a financial return commensurate with the risks it has assumed. In order for a PPP to work, the private partner must assume meaningful financial risk in some form—for example, through an equity

investment, liability for indebtedness, a fixed priced contract, a long-term warranty, assumption of ridership risk, or a combination thereof. As I will explain below, the effectiveness of a transit PPP depends on the scope of responsibility and degree and kind of risk assumed by the private partner with respect to the project.

Economic Benefit. Because substantially all transit assets are cash-flow negative (and transit PPPs rarely, if ever, contemplate the escalation of fares by a private operator to increase revenues), the financial opportunity for transit agencies is the *avoidance* of costs—an opportunity known as “subsidy-minimization.” The concept of subsidy minimization (and how transit PPPs differ from many highway deals) may be illustrated as follows: In the case of a transaction for an existing highway—a cash flow *positive* asset—the sponsoring agency asks the private sector “*How large a concession payment will you pay me?*” In the case of a transaction for new transit capacity—a cash flow *negative* asset—the sponsoring agency asks the private sector “*How small a subsidy will I pay you?*” Private operators then compete for the opportunity to provide service not by bidding up the concession payment but by bidding down the subsidy. The financial return to the private builder-operator, if any, is the difference between its cost to deliver and operate the system, on the one hand, and the system’s total revenues, including public subsidy, on the other. The public agency sponsoring the project may pay the subsidy to the private operator in the form of “availability payments” over a term of years, subject to the system being delivered and operated—made “available”—according to performance requirements negotiated and approved by the project sponsor.

The subsidy minimization model is being used with powerful effects for multiple types of infrastructure.⁵ In transit, perhaps the most compelling example of a transit PPP is the first minimal operable segment (or “MOS-1”) of the Hudson-Bergen light rail line in New Jersey.⁶ That project was delivered, and is now operated, by Washington Group International pursuant to a design-build-operate-maintain (or “DBOM”) procurement by the New Jersey Transit Corporation (“NJTC”). The partnership between NJTC and the Washington Group resulted in the project entering revenue service five years ahead of schedule at substantial cost savings—by some estimates, totaling approximately \$345 million—as against the cost that would have been paid under a conventional design-bid-build procurement.⁷ Nominal savings realized by

⁵ See, for example, the bids made last week by three companies to deliver and operate the Port of Miami Tunnel. Those bids came in 47%, 42%, and 7% below the maximum allowable bid to deliver the tunnel over 50 months, 47 months, and 42 months, respectively. “Miami Port Tunnel Bids Opened,” *Miami Herald.com*, April 4, 2007.

⁶ For a description of the project, see United States General Accounting Office, *Mass Transit: Status of New Starts Projects with Full Funding Grant Agreements* (1999: GAO/RCED-99-240), p. 23.

⁷ See *Report to Congress on Public Private Partnerships* (2004), U.S. Department of Transportation, p. 39.

expedited delivery alone amounted to approximately \$45 million.⁸ Estimated additional savings of \$11 million were realized by integrating design and engineering functions with construction services. Estimated savings of \$20 million were realized by the avoidance of claims and litigation typical in conventional procurements.⁹ Since the late 1990s, two additional transit projects have been procured as DBOMs: the second minimal operable segment (or “MOS-2”) of the Hudson-Bergen line and the JFK Airtrain.

Although there are few transit PPPs in operation in the United States today, several innovative procurements are in the pipeline. Among the most progressive is the procurement for the Oakland Airport Connector sponsored by the Bay Area Rapid Transit District (“BART”).¹⁰ With its request for proposals to be issued next month, the project contemplates a design-build-finance-operate (or “DBFO”) procurement in which the concessionaire will be responsible for substantially all aspects of the system’s design, construction, and operation and liable for approximately 50% of the project’s costs. Another innovative PPP, based on a DBOM contract, is the METRO Solutions capital program sponsored by Houston METRO.

Performance Benefit. Transit PPPs stand to provide other benefits in addition to economic savings. Principal among these are better project quality and the avoidance of delay attributable to claims and litigation. These benefits are derived from the allocation of risks to the private sector and its assumption of responsibility for multiple project elements, such that the private operator is concerned with a project’s performance over its lifetime. FTA’s forthcoming *Report to Congress on PPPs in Transit*,¹¹ now nearly complete, documents a number of these and other benefits based on surveys with transit agencies around the Nation that have used innovative procurements. We look forward to sharing our findings with Congress in the near future.

Improvement in Forecasting. If widely adopted, PPPs can additionally be expected to improve the quality of performance forecasts used to justify investments in transit and transportation infrastructure generally. The quality of projections of costs and benefits, specifically those expressed as ridership estimates, is important: With better forecasts, decision-makers may make better informed choices about the use of taxpayer resources.

Perhaps the most promising method for improving performance forecasting is the PPP. In particular, the private sector’s requirement for a financial return and agreement to assume risk for costs and benefits should

⁸ Id.

⁹ Id.

¹⁰ See <http://www.leafliott.com/Information/PDF/APM%2005%20Papers/40766-7723.pdf>

¹¹ The report is being prepared pursuant to §3011(c)(6) of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users.

discipline the preparation of performance forecasts. The reasons are intuitive. No contractor would offer to perform work for a fixed price (and thereby accept liability for cost overruns) unless it was confident that the estimated price of the project were accurate. Likewise, no private concern would accept ridership risk in calculating its financial return if it believed that the project's forecasted demand was likely to be inaccurate (however strong that forecasted demand might be). For these reasons, one preeminent economist, Professor Bent Flyvbjerg, has suggested that, absent other solutions to the problem of forecasting, no infrastructure project should receive public investment unless it is partly funded by private risk capital.¹² In the long-run, better forecasts will improve decisions to build transit, better serve the riding public and strengthen the justification for Federally-subsidized transit investment. More flexible authorizing statutes for transit authorities would provide them better ability to pursue these opportunities.

Legal Reform. In order to realize the benefits of PPPs for transit agencies and the riding public, limited reform of state and Federal law is necessary, particularly in the area of procurement. In evaluating PPP proposals, the government sponsors need to be able to take into account not just the proposed capital cost but also the value of commitments made by the private partner, risks associated with the proposal, and public policy issues. Under most State law applicable to transit today, however, government agencies must segment their procurements and award contracts on the basis of the "lowest responsible price." Bidders are also required to bid on precisely the same bid package. While these requirements can promote equality of business opportunity and financial stewardship, they stifle creativity and deter life-cycle-oriented proposals that offer lower total costs in the aggregate. The same laws also preclude the sponsoring agencies from engaging the *most qualified* contractor if it is not also the lowest responsible bidder.

Separately, with only limited exceptions, both state and Federal law require performance bonding well beyond what is commercially feasible for project sponsors (or required by private investors) and disregard the availability of other forms of security.

Conclusion. If evidence is needed that transit PPPs are more than a trend, the experience in the "transit-rich" United Kingdom is instructive. So effective has the PPP model become in that country that, under its *Private Finance Initiative* (or "PFI"), the UK Treasury requires government agencies to evaluate using PPPs to procure transportation infrastructure before using

¹² Bent Flyvbjerg et al., *How (In)accurate Are Demand Forecasts in Public Works Projects?*, 71 JOURNAL OF THE AMERICAN PLANNING ASSOCIATION 131, 143 (2005) ("The decision to go ahead with a project should, where at all possible, be made contingent on the willingness of private financiers to participate without a sovereign guarantee for at least one third of the total needs. . . . Private lenders, shareholders and stock market analysts would produce their own forecasts or would critically monitor existing ones. . . . The result would be more realistic forecasts and reduced risks").

conventional procurements.¹³ Clearly, our Nation faces challenges at the Federal, State, and local levels in addressing our mobility needs. Innovative contracting provides a means of meeting them. These approaches, however, are not merely stop-gaps in times of fiscal scarcity. They are, instead, solutions that represent significant improvements over conventional delivery models. In these circumstances, why would we not broadly experiment with alternatives?

Chairman DeFazio, Ranking Member Duncan, and Members of the Subcommittee, thank you for this opportunity to testify. I would be pleased to answer any questions you may have.

¹³ See http://www.hmtreasury.gov.uk/media/1E1/33/bud06_pfi_618.pdf. Typically under the PFI, the private sector designs, builds, finances, and operates facilities based on 'output' specifications decided by public sector managers and their departments—a role for the private sector far more expansive than is customary in the United States today.