Institutional Investing in Infrastructure

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PURPOSE

To provide tax-exempt investors with decision-making tools and information on the people, issues, ideas and events driving the institutionalization and globalization of the infrastructure asset class.

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by Emil Frankel

Political Due Diligence

Understanding the Politics Is the Key to Successful Infrastructure Investing

The growing shortfall in available public funds in the United States appears now to be creating significant activity in private investment in the nation's infrastructure and leading to the establishment of a growing number of private-public partnerships to implement these projects. Certainly, during the past several years there has been increasing interest in these investments and in the use of P3, but actual activity has been limited and largely confined to a few states.

Even now, much of this investment activity does not really represent new forms of private investment or new policy departures for the public sector. For example, many of these transactions have involved the purchase of marine terminals at the nation's largest ports. However, private companies have been operating these terminals under leases or concessions with public or quasi-public port authorities for many years, so these new private investments often merely represent fairly typical private-to-private transactions (albeit in a public or political setting). The same might be said about new private acquisitions of, or investments in, water and other publicly regulated but privately owned utility.

Transactions such as these might be a precursor to more activity — the environment for infrastructure investment may be changing. The fiscal challenges and the shortages of public investment capital in federal budgets and most state and local governments are creating strong incentives for the public sector to seek private capital for the restoration and preservation of existing assets, for the construction of new capacity and for the operation of transportation facilities. While this need provides increasing investment opportunities for pension funds and other private institutional sources of capital, potential transportation infrastructure investments need to be approached with much care.

When the private sector invests in public infrastructure, it is essential to establish the areas of common value and interest between the private and public sectors. Finding and articulating that "common ground" needs to be accomplished at the beginning of the process. The public authorizing environment — state and local elected officials, media and the public, generally — is not interested in, and probably does not even understand, the principles of risk and return, which are so important to underwriting specific transactions by institutional investors.

Beyond the normal financial and legal analysis and underwriting that should precede investments by pension funds, endowments and other institutional investors in these projects, there are almost always a range of political and community interests around particular projects and transactions. Those interests will determine whether potential infrastructure transactions will ever close and, if so, whether such investments will be successful and bring the projected benefits and returns. In a word, infrastructure investments need to be "politically underwritten," as well as financially analyzed.

Most institutional investors put money into infrastructure through commingled funds, organized and managed for this purpose. The general partners of these funds have generally demonstrated fairly sophisticated knowledge of the local political and community issues that are relevant to specific investments and project. However, those institutions which invest directly in transportation projects and/or have to make independent judgments about co-investing along with a fund in such a transaction often lack knowledge of the community and political hurdles that, in order to proceed with such projects, must be overcome.

Beyond the specific issues that relate to particular projects, the investment community also may lack adequate expertise in the broader federal and state public policy issues that establish the policy framework and the "rules of the game" under which specific state and local transactions are negotiated and implemented. Institutional investors, whether entering the infrastructure field directly or as limited partners in funds, should be aware of possible shortcomings in such knowledge and expertise and should make provision for filling this gap.

Private investing in public infrastructure (whether transportation projects or water utilities or social infrastructure such as schools, prisons and hospitals) is different from other forms of investment. This fact should be clearly understood by institutional investors before they proceed. Misunderstandings and mistrust can develop between the private and public parties to an infrastructure transaction because the language, terms and goals of the private and public sectors are very different when it comes to such projects. The sectors often have very different ideas about allocating risks, returns and benefits. These differences in culture and purpose explain why it is often so difficult to complete private investments in public infrastructure, to establish P3 to carry out these projects and sometimes even to negotiate these transactions.

The bottom line for private institutional infrastructure investments is that completing them and doing so on terms that make sense economically and financially are ultimately dependent on the support and approval of the relevant public "authorizing environments." And again, these authorizing environments often have little interest in, and may not understand or even care about, what the private sector needs and wants from these infrastructure investments.

Even if a governor or a state budget agency or a state transportation department is sophisticated about financial transactions and is well advised by financial and legal experts, a transaction may sometimes fail when a legislative body and/or the public at large gets involved because they become convinced that a valuable public asset is being "given away" to private interests, or that private investors are enriching themselves at the cost of taxpayers or public users, or that public employees will lose their jobs. The political failures of some transactions, such as the rejection by the state legislature of the long-term lease or concession of the Pennsylvania Turnpike, provide examples of an inability to establish common interests and purposes among the private and public sectors.

If these transactions are to be completed and, ultimately, if they are to be successful for the private investors, it is essential that the private parties accept and build upon what the public sector has to gain from the investment of private capital or from the establishment of a P3. It is also critical that the public understand and accept what it has to gain from the infusion of private capital and/or from the application of operational skills in carrying out public purposes. ❖

Emil Frankel is a senior adviser to **Crosswater Realty Advisors** and a visiting scholar at the Bipartisan Policy Center, a Washington, D.C.–based think tank. He served as Assistant Secretary for Transportation Policy of the U.S. Department of Transportation from 2002 to 2005 and as Commissioner of the Connecticut Department of Transportation from 1991 to 1995.
