



# **Ten Myths and Facts on Transportation Public-Private Partnerships**

A joint report from the Buckeye Institute for Public Policy Solutions and the Reason Foundation

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## Ten Myths and Facts on Transportation Public-Private Partnerships

### Why This Report Matters to You

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During the last two decades Ohio government has grown at an unsustainable rate. General Revenue Fund (GRF) expenditures, for example, grew 41 percent over the rate of inflation between 1990 and 2009. This cannot continue if Ohio is to remain economically competitive with a lean and efficient tax and regulatory structure inviting to new business creation.

And as government grew, it took on numerous roles for which it is *not* well suited: from running tollbooths and rest areas to managing parking garages and golf courses.

Efficient and effective government should always be the goal, but in a time of tight budgets even as the public demand for core services remains high, it makes little sense to waste taxpayer dollars, or dig deeper into their pockets, when services can be better performed by the private sector.

This is the first in an anticipated series of reports outlining areas where “public-private partnerships” (PPPs) are a potential tool for more effective and efficient government. If Ohio is to explore this type of reform a great many myths and misconceptions must be cleared away so that taxpayers and policymakers alike have a clear understanding of the nature and structure of these partnerships.

Such partnerships must be designed to leverage Ohio’s wide array of assets in ways that maximizes the benefit to each taxpayer and focuses government on core functions.

Not every conceivable partnership will be wise or appropriate, but shutting the door prematurely to such options deprives the state of the flexibility it needs to navigate an era of austerity and greater demands for accountability.

A basic understanding of this issue will allow Ohioans to better judge future policy debates in a fair and intelligent way.

# **Ten Myths and Facts on Transportation Public-Private Partnerships**

By Leonard Gilroy and Robert Poole

## **Introduction**

In the last 25 years, over 30 states have enacted legislation authorizing the private sector financing of highways and other transportation projects. In some cases, states are pursuing such public-private partnerships (PPP) seeking to make improvements to existing state toll roads, and in others officials are pursuing private financing for new transportation projects to supplement declining revenues from traditional funding sources: federal and state fuel taxes.

Ohio joined this group of states in 2011 in passing a budget that authorized a potential long-term lease of the Ohio Turnpike to private investors. The legislation permits a lease term of up to 75 years, and requires any request for proposals and proposed business terms to be submitted to the legislature for approval before they are issued. That same year, the legislature enacted House Bill 114, giving the Ohio Department of Transportation (ODOT) authority to enter into PPPs for new-build highway projects, based on either solicited or unsolicited proposals, for any type of transportation facility.

Further, in March 2012, ODOT announced the formation of an internal Division of Innovative Delivery to identify alternative transportation funding solutions to help close an estimated \$1.6 billion highway funding gap. Among its early initiatives, the Division is exploring PPPs to modernize the Ohio Turnpike, develop non-Interstate rest areas, and establish a corporate sponsorship program for state-owned rest areas, bridges, interchanges and sections of highway. Further, the Division is also exploring innovative financing approaches for several different state transportation projects, including the Brent Spence Bridge over the Ohio River in the Cincinnati area, the Portsmouth Bypass in Scioto County, the Rickenbacker Intermodal Connector in Pickaway County, and an interchange for U.S. Route 36 and SR 37 on Interstate 71 in Delaware County.

At the outset of such a dramatic paradigm shift in transportation infrastructure finance in Ohio, it is useful to reflect on some of the myths and facts regarding PPPs that have arisen in earlier policy discussions in other states. Despite the fact that over half of the states now have some form of enabling legislation, PPPs remain a complex subject and one that's easily misunderstood. To help clarify this new policy tool in Ohio's toolkit, the following sections offer responses to ten of the most prominent myths regarding transportation PPPs.

## **Myths and Facts on Transportation PPPs**

### **Myth 1: PPPs involve the "sale" of roads to private interests.**

**Fact:** PPPs do not involve the sale of any facilities by governments to private sector interests. Some partnerships involve short-term contracts to design, build, and possibly finance a road or bridge. Others involve leasing existing government-run toll roads to private investor-operators, the most notable being Indiana's lease of the Indiana Toll Road to a private concessionaire for 75 years in return for a \$3.8 billion upfront payment. The most robust form—the long-term toll concession—still involves only a long-term lease, not a sale.

In typical PPP arrangements, the government remains the owner at all times, with the private sector partner carrying out only the tasks spelled out within the concession agreement and according to the terms set by the state. Done properly, these deals are truly partnerships, in which the state does what it does best (right of way, environmental permitting, policymaking, contract monitoring and enforcement, etc.) and the concession company does what it does best (design, finance, construction, operation, maintenance, marketing, customer service, etc.).

### **Myth 2: Private toll road operators can charge unlimited tolls in PPP deals.**

**Fact:** There are concerns that PPPs deals will lead to sky-high toll rates in future years, leaving the impression that tolls are uncontrolled. However, this is not the case. Most concession agreements to date have incorporated annual caps on the amount that toll rates can be increased, using various inflation indices.

Put simply, future toll rates are a policy decision and are determined by state officials upfront before a concession agreement is signed. In fact, those pre-determined toll rate caps are generally established very early in the procurement process, as they are a critical input to potential bidders' financial models.

It is important to note that those caps are ceilings; the actual rates a company will charge depend on market conditions. Before entering into any toll road project, a company (or a toll agency) undertakes detailed and costly traffic and revenue studies. A major goal of such studies is to determine how many vehicles would use the toll road at what price; too high a toll rate means fewer choose to use the toll road, which generally means lower total revenue. So the toll road must select the rate that maximizes total revenue. That rate may well be lower than the caps provided in the concession agreement.

That may seem counterintuitive at first blush, but retailers use analogous thinking. Wal-Mart and Best Buy, for example, face stiff competition in consumer electronics. For a given high-definition television, those firms may theory be able to charge

whatever price they want, but they may find that they would see higher profits and higher sales volumes by pricing that television at \$700 instead of \$1,000, for example. So even though they generate less revenue per unit at the \$700 price, the lower unit price can drive more sales, making overall sales revenues higher than they would be if those units were sold at a higher price (and had fewer willing buyers). Private toll concessionaires face similar pricing incentives, where the highest toll rate allowed under a concession agreement may not be the rate that attracts the most drivers to use the road.

That said, there are some cases, such as high-occupancy toll (HOT) lanes or express toll lanes, where the main purpose of value-priced tolling is to manage traffic flow. In those cases, pre-defined limits on toll rates defeat the purpose of traffic management. Those rates must be allowed to vary, as needed, to keep traffic flowing freely at the performance level specified. When such value-priced lanes are operated under a concession agreement, instead of limiting the toll rates, the agreement should limit the rate of return the company is allowed to make, with any surplus revenues going into a state highway or transportation fund. That is how California's original pilot program for long-term concessions dealt with the issue, and similar deals have been done in Texas, Florida and Virginia.

### **Myth 3: Government loses control of public assets in PPP deals.**

**Fact:** One of the prevalent myths about PPPs is that somehow government would be "losing control" of the asset as part of the deal. This is a fundamental misunderstanding of the nature of PPPs—namely, that their entire legal foundation is a strong, performance-based contract that spells out all of the responsibilities and performance expectations that the government partner will require of the contractor. And the failure to meet any of thousands of performance standards specified in the contract exposes the contractor to financial penalties, and in the worst-case scenario, termination of the contract (with government keeping any upfront payment the contractor may have paid).

PPP contracts are often several hundred pages long and usually incorporate a number of other documents (e.g., detailed performance standards) by reference. The public interest is protected by incorporating enforceable provisions and requirements into the contract to cover such things as:

- who pays for future expansions, repairs and maintenance;
- how decisions on the scope and timing of those projects will be reached;
- what performance will be required of the private company (i.e., operating standards, safety, maintenance, electrical and mechanical systems, and many other requirements);
- how the contract can be amended without unfairness to either party;
- how to deal with failures to comply with the agreement;
- provisions for early termination of the agreement; and
- what limits on user fees/rates or company rate of return there will be.

No detail is too small. For example, Indiana Governor Mitch Daniels wrote in a May 2012 *Washington Post* opinion article that the Indiana Toll Road lease “has a 432-page agreement that tightly controls everything from toll rates to how long the operator has to remove dead animals from the roadway.”

So government never loses control—in fact, it can actually gain more control of outcomes—in well-crafted PPP arrangements. State officials in Indiana have testified that they were able to require higher standards of performance from the concessionaire operating the Indiana Toll Road than the state itself could even provide, precisely because they specified the standards they wanted in the contract and can now hold the concessionaire financially accountable for meeting them.

**Myth 4: The timing is bad for infrastructure investment, given the sluggish post-recession economic conditions.**

**Fact:** In the wake of the fall 2008 financial crisis, some observers have wondered whether the turmoil in the financial markets would dampen private investors' enthusiasm for PPPs and infrastructure asset leases. Broadly speaking, the answer is no.

There is a general consensus in the finance community that infrastructure remains an attractive investment, and PPP projects have continued to advance in both the United States and globally since the credit markets crunch. Despite economic ups and downs, people are still going to drive, fly and consume goods. That means roads, airports, water systems and other types of brick and mortar assets remain good investment prospects over the long term.

There is strong evidence that the major providers of equity in PPP deals—including infrastructure investment funds, insurance companies, and pension funds--continue to be interested in infrastructure. In its June 2011 issue, *Infrastructure Investor* released its annual ranking of the top-30 global infrastructure funds. Over the past five years, these 30 large funds alone have raised a total of \$183.1 billion. There is no definitive estimate of the total raised by all such funds, but that sum very likely now exceeds \$200 billion. It is important to remember that these are equity funds, which typically provide between 20% and 33% of an infrastructure project's cost, with the balance raised as various forms of debt (bank loans, revenue bonds, etc.). At a conservative leverage multiple of three times the equity amount, the equity available from the top-30 funds alone in 2011 would finance \$732.5 billion worth of projects.

Public employee pension funds are also taking a growing interest in financing infrastructure (including PPPs), and examples abound:

- In 2010, CalPERS—the largest U.S. public employee pension fund in California—purchased a 12.7% equity stake in London Gatwick Airport from

Global Infrastructure Partners. And in 2011, California's other teacher pension fund, CalSTRS, targeted \$300–600 million for infrastructure investments.

- The Arizona Public Safety Personnel Retirement System is now seeking global infrastructure investments.
- Early in 2011, the Oregon Investment Council approved allocating 5% of its Public Employees Retirement Fund portfolio to alternative investments, including infrastructure.
- The Texas Employee Retirement System committed \$625 million toward infrastructure investment in fiscal year 2012.
- The Louisiana Teachers' pension fund committed \$1 billion to private asset investment in 2012, including \$75 million for infrastructure.
- The San Diego City Employees' Retirement System recently set an infrastructure investment target of 3% of its \$5.2 billion portfolio.

It makes sense that investors are looking beyond the immediate market conditions to the long-term view, as they are investing in long-term transactions and basing their bids on future traffic and revenue forecasts extending several decades out, not on what is happening now.

Further, given that interest rates are at near-historic lows, a strong argument could be made that the best time to pursue private sector infrastructure financing is now, given that any future rise in interest rates will make debt more expensive. Interest rates are not getting any lower, so there's no benefit in waiting. Locking in at current rates now would allow the state to capture more value from its PPP projects, avoiding the higher costs and lower values likely in the future when interest rates inevitably rise again.

The proof is in the pudding though, and perhaps the most significant indicator of PPP market conditions is that several high-dollar PPP deals have reached commercial and/or financial close since 2008, including:

- *I-595 Express Lanes* (Fort Lauderdale area, Florida): This \$1.6 billion project to reconstruct the I-595 expressway and add express toll lanes to it reached both commercial and financial close in 2009. The concessionaire will finance, design, build, operate and maintain the new lanes and will be repaid over 35 years through "availability payments" (or payments from the state based on delivering the lanes and keeping them "available" for users).
- *Port of Miami Tunnel* (Miami, Florida): In October 2009, the state of Florida reached financial close with the Miami Access Tunnel Consortium on another availability payment concession project to deliver a long-sought, \$1 billion pair of 3,900-foot tunnels to provide a direct link between Miami's seaport and I-395 and I-95 on the mainland, improving goods movement and eliminating major traffic chokepoints in the city.

- *North Tarrant Express* (Dallas-Fort Worth area, Texas): This \$2 billion, 52-year concession project that reached financial close in 2009 involves a combination of dynamically priced managed lanes and untolled lanes. The state is contributing \$570 million in public funds; the concessionaire will bring the remainder of the funding.
- *I-635 managed lanes project* (Dallas-Fort Worth area, Texas): Like the North Tarrant Express, this \$2.8 billion, 52 year toll road concession project will deliver a technically complex mix of new "free" (untolled) lanes and managed express toll lanes. The state is contributing \$445 million in public funds, while the concessionaire will bring the remainder of the financing to the table.
- *Indianapolis, Indiana Parking Meter Lease*: In November 2010, Indianapolis approved a 50-year, \$620 million lease of nearly 3,700 city parking meters. Under the lease, Affiliated Computer Services (ACS)/Denison Global Parking are responsible for meter system operations, maintenance and capital investment, and in exchange the concessionaire has paid the city \$20 million up front and a \$600 million share of ongoing revenues over the 50-year lease term.
- *Puerto Rico Toll Roads Lease*: In September 2011, the Puerto Rico Public-Private Partnerships Authority reached financial close on a 40-year, \$1.5 billion concession to improve, operate and maintain the PR-22 and PR-5 toll roads. The concessionaire—a consortium of Goldman Sachs Infrastructure Partners II (an infrastructure investment fund) and Abertis Infraestructuras (a Spanish toll concession company)—paid the Commonwealth a \$1.14 billion upfront payment, will invest \$56 million in initial safety upgrades and will make an estimated \$300 million in additional investment in highway maintenance over the life of the concession.

Additionally, in June 2012, officials at The Ohio State University announced that they received three private bids in a request for proposals for a 50-year concession to operate the university's parking garages, lots and parking permit program. The accepted bid was \$483 million, well over the minimum bid threshold on \$375 million set by university officials.

**Myth 5: PPP deals include "non-compete clauses" that prevent state and local officials from building nearby, competing roads.**

**Fact:** Whether the toll road is public or private, toll revenue bond investors are very unlikely to buy bonds for assets with unregulated competition from entities with the power to tax and build competing free facilities. Contractual clauses designed to protect toll road operators from the construction of new, parallel "free" roads have evolved over the years.



The approach has changed from an outright ban on competing facilities to a wider definition of what the state may build—generally, everything in its current long-range transportation plan—without compensating the toll road developer/operator. And for new roadways the state builds that are not in its existing plan and which do fall within a narrowly defined competition zone, the current approach is to spell out a compensation formula.

The idea is to achieve a balance between, on one hand, limiting the risk to toll road finance providers (of potentially unlimited competition from taxpayer-provided "free" roads) and, on the other hand, the public interest. All of Texas' PPP concessions to date have utilized this approach, as will any future projects under Arizona's 2009 PPP enabling legislation.

Two long-term lease transactions provide a useful illustration. For the Chicago Skyway concession, there were no protections for the private-sector lessee. Given that the roadway is located in a highly developed area of Chicago, it is highly unlikely that any competing, parallel freeways will be developed in the future.

In the case of the Indiana Toll Road lease, the concession agreement set up a narrow competition zone alongside the toll road. The state may add short, limited-access parallel roads (e.g., local freeways), but if it builds a long-distance, expressway-standard road greater than 20 miles long within a 10-mile competition zone, there's a formula for compensating the private sector for lost toll revenue if the concessionaire can prove the new road is causing a financial loss. However, it should be noted that this provision has not been a constraint on road building more generally, as Indiana is investing hundreds of millions of dollars from the proceeds of the lease transaction into new and expanded transportation infrastructure in the counties traversed by the Indiana Toll Road. In other words, the competing facilities provisions in the lease agreement are not preventing the state from making needed transportation investments across the state.

#### **Myth 6: PPPs involve selling our roads to foreign companies.**

**Fact:** A common, but often misunderstood, concern about any PPP is the potential that a foreign company will become the state's partner in operating a toll road, bridge or mass transit system. The potential is high that a foreign company might win the bid, and the reason is simple: because foreign companies have the most experience with PPPs. Countries like Australia, New Zealand, the United Kingdom, France, Italy, and Spain have utilized transportation PPPs for decades. Therefore, it is not surprising that the private-sector role in the provision of transportation services is more developed and mature outside of the United States.

In the early years of U.S. adaptation of the PPP concession model, states want to deal with firms that have extensive experience as toll road providers. The simple fact is that this is a nascent industry in the United States, because we have used only public-sector agencies to build and operate toll roads. Meanwhile, European and

Australian companies have decades of experience as world-class toll road providers. Thus, a responsible state government, wanting to ensure that the toll road is in experienced, professional hands, will weight prior experience very heavily in its selection criteria.

However, a domestic market is rapidly emerging in America. U.S.-based investment firms like Goldman Sachs, Morgan Stanley, and JPMorgan Chase have created their own infrastructure investment funds, as have many of their international peers.

In addition, U.S. union pension funds are attracted to investing in infrastructure because they see a good match between infrastructure assets that provide reasonably steady long-term income flows and the funds' long-term liabilities. Unions have already contributed to investment funds run by firms like the Australia-based Macquarie, blurring the line between foreign and domestic interests. Further, in 2009 the Dallas Police and Fire Pension System became the first public pension fund to serve as a direct equity partner with a private concessionaire in two concession megaprojects in the Dallas area valued at over \$6 billion total.

Regardless, it would be unwise to ignore international operators—and their experience and expertise—simply because they are foreign. Taxpayers should not be too concerned if a foreign company from Australia or Spain (like the consortium currently operating the Indiana Toll Road) wins the bid to build a new, privately operated highway in their state. First, any potential roads would remain the property of the state, in public ownership. Second, the terms and conditions of the contract would empower the state to seize control of the road should the company violate their contractual agreements. Third, a road is a fixed, nonmoveable asset. It is not as if a foreign company will be able to pack up this asset and ship it overseas. Finally, many foreign companies are part of the pension portfolios of many Americans (including labor unions), so any attempt to limit the participation of international firms in state PPPs would be counterproductive to many workers right here at home.

Furthermore, it is important to remember that even deals that involve 100 percent non-U.S. companies are very good for our economy. Attracting billions of dollars in global capital (and expertise) to modernize vital highway infrastructure is a large net gain for this country. Rather than investments and jobs going overseas, foreign entities are willing to invest their money domestically, creating jobs here in the United States. The further build-out and investment in our transportation infrastructure only makes the U.S. more competitive in the global marketplace. And we should not forget that U.S. subsidiaries of international firms tend to do the majority of their hiring locally, so fears of "importing foreign workers" are unjustified.

In effect, foreign investment in our nation's infrastructure represents the reverse of outsourcing—it's more properly viewed as "insourcing." The opportunity to "insource" significant amounts of foreign investment into a state should be embraced rather than avoided.

**Myth 7: Governments give private companies the authority to take private property through eminent domain in transportation PPP deals.**

**Fact:** There is understandable concern that toll road PPP might lead to private companies acquiring the power to condemn land for right of way. None of the over two dozen state PPP enabling acts has delegated any such power to private partner companies. Some, including Arizona's, expressly forbid it. The eminent domain power is always reserved by the state, in its traditional role of acquiring rights of way for public-use infrastructure.

**Myth 8: Government ends up holding the bag if a PPP project goes bankrupt.**

**Fact:** In the event of a corporate bankruptcy on the part of a private sector investor-operator, the asset would revert to the project lenders who, with permission from the state, would select a new operator. The lenders have strong financial incentives to continue to properly operate and maintain the road, lest they risk losing the value of their investment. It should also be noted that if the concessionaire needs to sell, get out of, or modify the contract for any reason during the lease term, final approval would rest with the state.

Startup, new-build PPP toll roads can face financial risks that existing toll roads may not, as they must rely on projections and assumptions about future traffic and revenue given the inherent lack of a historical track record of usage and toll revenue collection. In fact, a so-called "greenfield" PPP toll road in San Diego County (Calif.)—the South Bay Expressway (SR 125)—filed for bankruptcy in March 2010 and offers a good illustration of how such situations are resolved.

Opening in November 2007, the South Bay Expressway quickly fell victim to the Great Recession and southern California housing market collapse that drastically slowed development in the eastern portion of the county and led to traffic and revenue falling far below projections (approximately by half).

According to [TollRoadsNews.com](http://TollRoadsNews.com), the global financial firm Macquarie that had taken over the road shortly before the financial collapse put it into bankruptcy in March 2010, having written off its equity stake the previous year, and project lenders suffered losses in the Chapter 11 proceedings. But since tax dollars weren't used for the project in the first place, public funds were not lost in the bankruptcy.

In fact, the bankruptcy created an opening for the San Diego Association of Governments (SANDAG)—the region's metropolitan planning organization—to purchase the remainder of the South Bay Expressway concession at a significant discount. In June 2011, the SANDAG board agreed to purchase the remainder of the toll concession for \$345 million, roughly two-thirds of the construction cost, according to TollRoadsNews.com. But this was not a bailout using public funds: the

funds will come from a refinancing based on a more realistic estimation of the project's toll revenues over the remainder of the 35-year concession. Even with the bankruptcy, the project's costs continue to be fully borne by revenues paid by toll payers, not taxpayers.

It should also be noted that the South Bay Expressway did not shut down, continuing to operate and cover its operating costs through the end of its exit from bankruptcy in April 2011.

**Myth 9: PPPs should be avoided because they commit future generations when policymakers today cannot predict what the needs will be.**

**Fact:** State governments regularly make commitments that impact taxpayers for longer than 50 years. Bonding for infrastructure and changing public employee pension benefits are two examples. Because the capital costs for major infrastructure projects are so high, it is necessary to finance them over long periods of time.

But PPPs are not designed to be inflexible and static. It is entirely possible that changing circumstances will require revisions to a PPP agreement, and that is why all concession agreements have detailed provisions to permit changes during their term. Such provisions deal with, among many other things, negotiating and arbitrating disputes and employing independent parties to make fair financial estimates. The only limit to changes in the terms of the concession is normally that neither side should be disadvantaged financially by the changes.

Policymakers should also remember that along with long-term commitments come long-term benefits. In this case, using PPPs to deliver new transportation infrastructure that otherwise might lack realistic prospects for financing not only enhances the mobility of current and future generations, but it also benefits the state economy in the long run as well.

**Myth 10: A backlash after the Indiana Toll Road lease prompted Indiana policymakers to reject transportation PPPs.**

**Fact:** The \$3.8 billion lease of the Indiana Toll Road in 2006 represented a paradigm shift in infrastructure finance in the Hoosier State, and some policymakers and taxpayers expressed skepticism or "buyer's remorse" in the immediate aftermath of the deal. However, the more time that passes, the more comfortable that Indiana has become with the PPP concept.

Simply put, the "sky did not fall," and as the benefits of the Indiana Toll Road lease continue to mount—e.g., the ability to pour billions into statewide transportation investment that otherwise would not have had funding, modernization of the

Indiana Toll Road itself, and more—officials are increasingly recognizing the important role PPPs can play in keeping the economy moving.

The evidence is abundant. In 2009, both Indiana and Illinois enacted enabling legislation to permit the use of a PPP to develop the proposed Illiana Expressway toll road, a \$1 billion project connecting I-65 in Indiana to I-57 in Illinois. That same year, Indiana policymakers approved using a PPP for a \$4.1 billion joint effort with Kentucky to develop two new toll bridges across the Ohio River in Louisville; they also authorized the formation of a bi-state commission with Kentucky for the Ohio River Bridges project.

And the Indiana legislature passed legislation in 2011 granting the Governor and the Indiana Department of Transportation broad authority to designate projects as PPP candidates and solicit proposals from the private sector, without having to go back to the legislature for approval (the legislature had previously only authorized the use of PPPs for specific projects on a case-by-case basis). The legislation also explicitly permits the addition of toll lanes to existing non-tolled highways.

In essence, Indiana policymakers have broadened the scope of the state's PPP authority the more they've become familiar with this policy tool. Given such demonstrable support for PPPs after the Indiana Toll Road lease, the reality is that Hoosier State policymakers are increasingly embracing PPPs, not rejecting them.

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## **About the Buckeye Institute**

The Buckeye Institute for Public Policy Solutions is a 501(c)(3) research and educational institution whose mission is to frame the policy debate in Ohio by researching free market, data-driven solutions to Ohio's most pressing public policy issues. We focus of the issues of economic freedom and competitiveness, job creation and entrepreneurship, and government transparency and accountability.

Our vision is vibrant, flexible and competitive economic environment that allows Ohioans to pursue their hopes and dreams and makes Ohio a better place to live and work.

Nothing written here is to be construed as an attempt to aid or hinder the passage of any legislation before the Ohio legislature.

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