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Immovable Objects, Unstoppable Forces

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Greengate's John Ryan argues infrastructure could be the perfect way for US pensions to plug their funding gap.

One way or another, large-scale infrastructure renewal and development will need to be a feature of the US economic landscape over the next decade. This widespread observation is fundamentally not a matter of political policy or economic theory – it is based on simple physical facts like increasing inefficiency, obsolescence, the effects of deferred maintenance, and the tendency of broken things to fall down.

But politics and economics are very much central to the question of how to pay for it all. There's a broad consensus among policymakers in the US that private-sector capital will be a necessary part of the solution. The idea is frequently invoked by politicians across the spectrum. But specific proposals often hit walls of fierce local resistance.

A common theme to such resistance is an appeal to a simplistic principle: private-sector financial investors are predatory outsiders who can't be trusted, and new or increased tolls or user-fees associated with infrastructure financing will mostly go to boost unfair profits. And so these walls become apparently immovable objects, impervious to logic or persuasion.

Yet in many of the same places, something like an unstoppable force is developing in the form of unfunded public pension plan liabilities. The size of these funding gaps is mind-boggling, and the potential impact is severe, near-term - and almost completely localized.

At the US state level alone, the Center for Retirement Research at Boston College estimates that when a realistic discount rate of 5 percent is used, state public pension unfunded liabilities are close to $2.7 trillion. Moody's, using a similarly realistic discount rates, estimates that state pension plans are only 48 percent funded.

Worse, in many places large pension funding gaps exist in an overall context of severe pressure on public sector budgets. The recent bankruptcy of Detroit may be an extreme case, and publicpension plans are only a part of its problems, but the example serves to concentrate other minds wonderfully.

Down Under Success - Social Privatization

Here's a thought experiment: could the force of the funding gap issue, if channeled into infrastructure-based financing transactions, also help break down resistance to non-traditional forms of infrastructure financing?

Recent experience from Australia, a leader in infrastructure private-sector finance, shows a possible path. The New South Wales government recently sold off 99-year leases to major port facilities to a private-sector consortium of local pension fund managers led by Industry Funds Management (IFM) in a $5.3 billion privatization transaction. To overcome initial resistance from the public, IFM successfully characterized its acquisition of the port infrastructure as 'social privatization', where the investment returns benefited Australian retirees - not (as Infrastructure Investor put it, on When antonyms collide) 'faceless, greedy fat-cats'.

Perhaps the same concept, when connected to the force of a serious funding gap issue, could work to overcome resistance in this country. If explicitly designed and advertised as social privatization, the sale of local infrastructure assets to local public pension funds in exchange for cancellation of some local public-sector liability seems less far-fetched. Yes, there will be new or higher user-fees on that infrastructure - but the payers will know that the transaction reduced their own public-sector liability, that their public services will be preserved, and that the user-fees are ultimately going to themselves or their neighbors.

A Simpler Path - Social Leveraging?

Is full privatization necessary to channel the force? Perhaps not. The primary purpose of a funding gap deal is not to improve infrastructure management or operations through privatization, but only to defease a defined long-term liability. Leveraging an asset with long-term debt is sufficient for this narrow purpose, and additional complexity probably should be avoided in a situation already filled with contention.

A 'social leveraging' transaction would still include a sale of a piece of local infrastructure – but to a publicly-owned trust. The trust would raise long-term debt from the public pension plan, and the proceeds of the sale would be recycled to the pension plan to reduce the funding gap. Incremental user fees or charges would be clearly traceable through debt service to retiree benefits, just as they are in a social privatization deal – but without the higher equity returns.

Of course, similar transactions are routinely done by US local governments, except that the long-term debt is raised externally, most often in the tax-exempt bond market. In cases where credit-rating levels and infrastructure asset types permit, this will still be the most cost-effective route.

But in the more extreme scenarios contemplated here, a significant amount of risk transfer to the long-term lender will be required. The local government may need to limit its fixed obligations under a lease or concession in order to avoid a ratings downgrade, and the available infrastructure assets may have uncertain revenues.

In these cases, a direct bilateral agreement between the public sector and the local public pension plan might offer the best (or only) deal. There are silver linings. Although bilateral private debt is expensive, the higher yield goes to local retirees, not 'fat cats', and transaction costs are low. If the project runs into trouble in future, the chance of successful work-out with a local relationship lender (as opposed to 'faceless' bondholders) is far higher. Customized optimizations, such as longer tenor, flexible amortization and inflation-indexed pricing, can be negotiated.

But the most important potential aspect of a successful social leveraging deal would be cultural, not transactional. New or increased user-fees for infrastructure will never be welcome – yet if clearly understood they can be accepted. A transparent transaction with local parties that addresses a very bad local issue in the least painful way might establish another principle: institutional investors are part of the solution, not the problem.

Once that principle is accepted, the old walls are breached. Infrastructure privatization and public-private partnership proposals that include outside equity and debt investors might then be judged on their actual cost-benefit merits -- and perhaps the real work of large-scale infrastructure renewal can begin.

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