Privatization: Chicago Parking Meters, LLC

Dr. Michael Tucker
Professor of Finance
Dolan School of Business
Fairfield University, Fairfield, CT 06824
mtucker@fairfield.edu

Abstract

In late 2008 a Morgan Stanley consortium submitted the winning bid for a 75 year concession on the revenues from Chicago's 36,000 parking meters. The sale of the parking concession was motivated by Chicago's need for money to close a budget gap. Privatization of Chicago's parking did not please everyone. Alderman Scott Waguespack calculated that the city was giving up $4 to $5 billion in projected revenues. Just what the future revenues would be and what discount rate to apply to them to calculate their present value were contentious issues. The analysis requires calculating gains to the winning bidder and second guessing Mayor Daly's decision to make the sale.

Prologue

On December 2, 2008 Chicago Mayor Richard Daly announced the winning bid in the second round of bidding for a 75 year concession for the revenues from Chicago's 36,000 parking meters. Morgan Stanley's consortium won with a bid $1.156 billion The deal holds the concessionaire responsible for upgrading the antiquated one meter one space parking with state of the art pay stations that accept credit and debit cards as well as coins and bills. Each pay station will monitor six or seven parking spaces by 2011 which could also mean more parking spaces per block. In the midst of a budget crisis, the city gets a onetime payment that Daly promises to partially invest in an annuity to cover losses of parking meter revenue. Parking meters will also be upgraded at a cost to Morgan Stanley and its partners of $10 million per year for three years. An equal number of meters will be installed each of the three years of the upgrade and each subsequent upgrade.

Meters will be replaced by pay stations, an upgrade that has been too costly under Chicago's budget constraints. Coin operated meters partially explain why parking rates went unchanged for twenty years. Raising the rates would mean more coins, filling meter banks more quickly and jamming the mechanism unless the city hired more unionized meter collectors. The concessionaire, in exchange for over a billion dollars and the promised upgrade, gets to raise parking rates according to a schedule of substantial hikes through 2013 after which further increases are limited to inflation. In projecting the value of the deal, inflation is estimated to be 3% by the various analysts modeling the value of the concession. Is this a good deal for Morgan Stanley, holder of 50.1% of the concession and its two partners, Germany's Allianz Capital (25%) and Abu Dhabi Investment Authority (24.9%)? Some Chicagoans are outraged and think it was a revenue giveaway. It didn't help those with suspicions that the fix was in that the new spokesperson for Chicago Parking Meters (CPM), Avis Lavelle, was a former aide to Mayor Daly.

Privatization Debate

Privatization advocates assume market efficiency will drive down the cost of government services. In order for market efficiency to be effective there have to be a large number of potential bidders. Very large contracts frequently have few bidders and they are often national companies. These bidders may realize economies of scale unavailable to governments.

In difficult economic times when tax increases are politically impossible and economically unwise even as budgets are squeezed, governments have been turning to selling off income producing assets. By August 2010, there were thirty-five privatization deals in various stages of agreement with an aggregate worth of over $45 billion. "There's probably $100 billion in domestic capital alone that's being raised to invest in these transactions, and when that's

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leveraged with debt, you're probably looking at up to $400 billion in money that's ready to go to work," says Dana Levenson, Chicago's former chief financial officer and now an investment banker at Royal Bank of Scotland.

Chicago is not new to privatizing public assets. Not everyone sees such sales as the solution to red ink. Moody's, a major bond rating agency, is not sanguine about the efficacy of asset sales: "We view these asset sales as 1-shots …that create structural budget imbalances in future years, but that may be necessary actions to bridge the time gap until revenue stabilization or growth returns," says Robert Kurtter, a managing director at Moody's. Elliot Sclar author of *You Don't Always Get What You Pay For: The Economics of Privatization* doesn't see privatization as much of a fix either; "At some point, you're going to run out of things to sell. And it's not a long-term solution. It'll get you through the next election cycle, and that's all it does."

After the Revolutionary War private investors built a 66-mile toll road, Philadelphia-Lancaster Turnpike for $465,000. The first half of 19th century saw 600 toll roads constructed. The second half of 19th century saw further construction with 100 toll roads in California alone. The toll road building boom ended with the advent of the automobile and stricter government safety regulations making construction unprofitable for private interests in the US. Private money was still welcome elsewhere. France passed legislation in 1955 that led to 3,400 miles of toll roads.

Between 1820 and 1899 New York City went back and forth between public and private street cleaning. Public street cleaning kept the streets clean but was expensive. Privatized cleaning was less expensive but the streets were dirty. Each time cleaning was deemed too expensive, city councilors would want to try again to write the perfect contract. No one ever found a way to write that perfect contract. In 1892 Chicago concluded that "there are few if any redeeming qualities attached to the contract system."

The US Department of Transportation estimates that worldwide there have been 1,100 public-private deals in the last twenty years for over $360 billion. Privatization in the US has lagged. Tax fee financing i.e., municipal bonds, is available, in the US but not in other countries prompting US states and municipalities to borrow and build. More recently, maintenance of infrastructure has taken a back seat to other rising expenditures such as Medicaid, education and pensions. Privatization while appearing to be selling out to some also offers a solution to decaying US infrastructure. Once in private hands, investors may be more likely to maintain assets than when they are public goods vying for limited public funds.

Facing fiscal constraints, Indiana's governor Mitch Daniels auctioned off the 157 mile Indiana Toll Road for $3.8 billion in a 75 year leasing deal. Mayor Daly took notice and in turn auctioned of the Chicago Skyway, the Illinois road that leads to Indiana, for $1.8 billion on a 99 year lease to Cintra Concesiones de Transporte (Spanish) and Macquarie Infrastructure Group (Australian).

Investors have been willing to pay high prices for government income generating assets. In part this derives from more optimistic private analysts' projections. The consortium that won the Chicago Skyway concession estimated 3% annual revenue growth while Chicago saw only 1% annual growth. That 2% difference led to a private valuation of $3.8 billion which made the $1.8 billion price a steal. Motivated to make their projections a reality, within three months of concluding the deal, electronic toll collection was installed along with additional toll booths reducing wait times and increasing traffic flow.

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Privatization opponents fear asset sales will lead to price hikes and even price gouging. Concession agreements strictures typically place limitations on increases though there may be initial increases such as those built into the CPM deal. With private dollars at risk there is also incentive to increase traffic and reduce downtime by running operations efficiently since most toll roads or parking meters have alternatives.

The alternative to privatization is taxes. Public opinion seems to tilt toward privatization and tolls versus gas taxes with 52% favoring tolls and only 21% higher fuel taxes for road construction according to an American Automobile Association survey.

Use of proceeds from privatization is a major issue. Short term use of the money has been criticized, e.g., money to help the elderly pay current heating bills. Longer term use has also come under criticism when it has been used to fund public pension funds. Some opponents want the money raised from privatization dedicated to specific uses such as toll road money used to improve transportation for example. Selling assets may also distract from or postpone the need for public fiscal restraint.

What's the CPM Concession Worth?

According to Scott Waguespack, Alderman from Chicago's 32nd Ward, Morgan got too of good a deal. He was one of just five of the fifty Aldermen on the City Council who opposed the parking meter concession sale. His December 3, 2008 analysis showed the city was giving up $4 to $5 billion in projected revenue. Cash flows from the perspective of the city exclude taxes and obviate depreciation. EBITDA is effectively cash flow for a municipality as long as capital expenditures are subtracted out when they occur. While Alderman Waguespack did subtract the initial $10 million per year to upgrade antiquated parking meter to pay stations in 2009-2011, he left out any subsequent upgrades. The parking stations' manufacturer estimates they have a life of seven years. Even with maintenance to extend their lives, the pay stations would need replacement every ten years beginning in 2019 with costs stretched out across three years in each case as with the first upgrade. Of course, each successive upgrade would also cost more under a 3% assumed annual inflation rate.

Waguespack's analysis of revenue from the meters follows the city's assumptions (Table 2) which is a rough estimate at best but a good basis for comparing valuation from the city's perspective versus a private buyer. The parking meters are located in six zones with different rates. To calculate the revenue for 2008 from each zone first the cost of one hour of parking is multiplied by the meters employed then the total is summed and the percentage of this revenue by zone is calculated. For example, zone 6 generated 36.8% of 2008 parking revenue. A total of $23.8 million system wide was generated in 2008 which translates into $8.462 million in revenue for zone 6. Future revenues through 2013 can be calculated using rates by zones as shown in Table 1. Beyond 2013 further increases are limited to CPI, assumed to be 3%, by the concession agreement.

In 2008, after operating costs the city had income from meters of $18.9 million exclusive of parking tickets. Compliance was at 75%. With the city's ten existing ticket writers motorists took more calculated risks. The city plans to add five more ticket writers which could bring compliance to 85% or higher. Under the concession agreement the city retains revenue from parking tickets. The concessionaire has the right to also issue tickets. The net effect of more tickets, besides a welcome addition to city revenue, will be to increase compliance.

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Competition from off street parking is limited since it is considerably more expensive particularly for short term parking and free parking spaces are few. Higher parking rates could motivate greater use of public transportation at the expense of inconvenience for short trips that would be more time consuming. Waguespack assumes some impact from the major price increases with loss of revenue shown as an elasticity factor at the bottom of Table 2. Zone 6, the more outlying areas of Chicago, would see parking meter utilization decline to 70% from 2008 levels under this likely conservative assumption.

Determining an appropriate discount rate is an area of contention that depends on who is doing the analysis. Waugespack used a 3% discount rate, the same as the assumed inflation rate, and came up with a valuation billions greater than the Morgan Stanley consortium paid for the lease. He reasoned that the revenue flow was about as risky as a long-term US Treasury Bond. Considering Morgan Stanley's cost of debt capital (Table 3), Waugespack's discount rate may have been on the high side. Morgan Stanley however, indicated the lease purchase was financed with equity capital from investors in a private equity fund. On July 19, 2010 the CPM consortium floated a debt offering memorandum for $500 million in ten year financing which was later withdrawn. The anticipated rating on the debt was BBB- which would mean an interest rate of 5.6%. Chicago currently has outstanding tax free municipal revenue bonds supported by lakefront parking with 2021 maturity that have a yield to maturity of 2.426%.

As a follow up to Waugespack's analysis, Chicago's Inspector General's office did its own study that was released in June of 2009. The IG estimated the value of the concession to be $2.13 billion. On June 30, 2009, Blair & Company, the firm hired by the Mayor's Office to advise the city on the lease of the parking concession disputed the IG's analysis noting that the analysis used revenues and not free cash flow combined with a low discount rate and an underestimation of future capital expenditures. In their 2008 analysis, Blair & Company had come up with multiple scenarios using free cash flow, assigned probabilities to them and arrived at a valuation of $650 million to $1.2 billion to the prospective bidders. The IG used a discount rate of 7.06% which was categorized as a *very low* risk discount rate even though the report from which the rate was obtained specifically suggested parking revenue should be categorized as *low* risk with a discount rate of 8.26%. Blair argues for a risk premium of 5.5% to 9.5% ending up with discount rates ranging from 10% to 14%.

Since the parking meter approval many in media have condemned the lease as a giveaway. Some of these pundits simply added the 75 year stream of revenues to arrive at multi-billion dollar headlines while others came up with more conservative but still high differentials between value and the sale price.

Chicago's 2011 budget as proposed has a $654.7 million deficit, 20% of total spending. In 2010 unpaid employee furloughs amounted to $520 million to staunch the red ink. The proceeds from the meter sale helped in 2010 but they will be insufficient for 2011 since they are now down to the $100s of millions.

Chicago's Aldermen under fire for the CPM sale have vowed to go slow on any further sales of city assets. The media reaction could inhibit other deals as well. The New Jersey Turnpike and the Pennsylvania Turnpike sales seem to be dead at least for the time being.

Any future asset sales will continue the valuation debate. Governments and private investors appear to be using different assumptions in coming up with valuation. Combine very real differences in analytical approaches with political agendas and valuations can vary a great deal.

Michael Tucker, Dolan School of Business, Fairfield University, mtucker@fairfield.edu
Case ID 030202

Table 1
Projected Rates through 2013 by Zones

Year	zones 4, 5, 6	zones 2, 3	zone 1
2009	$ 1.00	$ 2.00	$ 3.50
2010	$ 1.25	$ 2.50	$ 4.25
2011	$ 1.50	$ 3.00	$ 5.00
2012	$ 1.75	$ 3.50	$ 5.75
2013	$ 2.00	$ 4.00	$ 6.50

Table 2
Parking Meter Revenue for 2008

Zone	6	5	4	3	2	1
Rate per hour 2008	$ 0.25	$ 0.50	$ 0.75	$ 1.00	$ 1.50	$ 3.00
Number of Meters	23,877	6,280	558	3,992	12	895
Single Use Rev (one time use one hour per year)	5969.25	3140	418.5	3992	18	2685
Share of single rev use	36.80%	19.36%	2.58%	24.61%	0.11%	16.55%
Share of proj $23m rev '08	$ 8,462,976	$ 4,451,773	$ 593,333	$ 5,659,706	$ 25,520	$ 3,806,691
Elasticity factor	70%	90%	95%	90%	95%	98%

Table 3
Morgan Stanley Capital Structure and Cost of Capital Constituents

Market Cap	32,424,000
S-T Debt	370,115,000
L-T Debt	182,810,000
Preferred	9,597,000
tax rate	19%
pre-tax cost of s-t debt	0.76%
pre-tax cost of l-t debt	3.55%
pre-tax cost of preferred	.1046
Rf	0.0253
Rm	0.1153
Beta	1.91

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