Public private partnerships: A sea change in the US transportation sector

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The current growth period in transport PPPs may prove to represent a true sea change in US project delivery. Four factors support this possibility: the increasingly undeniable gap between needs and traditional resources; several important new policy initiatives; closing of key transactions; and investment by numerous jurisdictions in a long-term, sizable transaction pipeline. The next 18 months should reveal whether PPPs will secure a deep and lasting hold. Some observers are concluding that US conditions could soon yield one of the world's largest PPP markets.

Growing needs and resources gap

Blessed with a national fuel tax dedicated to highways and a federal tax exemption for interest income received on infrastructure debt, the US road sector has long enjoyed capital resources unavailable to other countries. Nevertheless, these traditional methods are grossly failing to keep up with need.

The continuing decline in real dollar value of federal and state fuel taxes, vocal resistance to increases in or even indexing of fuel taxes, relentless growth in vehicle miles travelled, widespread assumptions of "free" road entitlement, steady climbs in vehicle fuel economy, rising construction costs and higher percentages of deferred maintenance all are leading to ever-growing, breathtaking shortfalls in transportation improvements.

Against this backdrop, the US Congress passed in 2005 a six-year reauthorisation of the federal surface transportation programme (SAFETEA-LU). While providing a modest increase in revenues "turned back" to the states, the legislation makes no pretense of filling the funding gap. Operations, maintenance and modest renovation will consume most of the US$286.4bn funding.

Looking forward, urban areas can expect over-utilised highway systems, underdeveloped transit systems, deferred maintenance and a dearth of new facility development called for in transportation improvement plans. The result will be unprecedented congestion, unless new project delivery and financing tools are more broadly embraced.

Shock of recognition

The inexorable convergence of these forces has propelled what Herman Melville called the "shock of recognition". In the US transportation sector, it is a rapid realisation that (i) tax increases and pay-as-you go funding will seldom allow for delivering large capital projects; (ii) capital markets have a robust appetite for US transportation projects; and (iii) PPPs and user fees are essential, effective tools in the US transportation future.

SAFETEA-LU and the US Department of Transportation (USDOT) have helped set the stage for this realisation, offering new federal rules and procedures to promote PPP and harness private sector innovation. This federal support, combined with a positive industry response, has strengthened the hand of state and local government officials willing to embrace PPPs.

PPP financing

Significant developments in the last year position the US transportation PPP market to enjoy among the lowest financing costs found globally.

TIFIA

The Transportation Infrastructure Finance and Innovation Act (TIFIA) represents possibly the most advantageous mezzanine financing available anywhere for PPP transportation. With loan amounts equal to one-third of project costs, US Treasury rates, payment deferral up to five years after project completion and 1.1/1 debt coverage underwriting, TIFIA is emerging as the secondary financing source of choice for greenfield and reconstruction projects.

SAFETEA-LU improved TIFIA's suitability to the PPP environment, lowering project size threshold from US$100m to US$50m, expanding eligible project types, and authorising refinancing of long-term project debt.

Under current USDOT guidelines, fitting TIFIA into certain PPP procurement processes is difficult. The standard process entails an identified borrower filing a lengthy application disclosing detailed project information, financing, project management, operations and maintenance plans, and preliminary investment grade rating agency opinions for the

senior debt. After approving an application, the TIFIA Office issues a term sheet and form credit agreement, which are the basis for negotiations. Funding follows execution of the credit agreement and satisfaction of funding conditions.

This process was designed for an environment where the sponsor was financing the project itself or was selecting its private partner on criteria other than hard bids. The USDOT guidelines effectively preclude TIFIA participation in PPP competitions requiring hard money proposals and financial close promptly after award.

Seeking to include TIFIA in hard money competition, the Texas Department of Transportation (TxDOT) received in February 2006 a USDOT waiver of several requirements for three pilot projects. Based on a pro forma project finance plan, USDOT and TIFIA now will put in place for proposer benefit a conditional term sheet and draft credit agreement in advance of proposer selection, allowing proposers the option of including pre-arranged TIFIA terms in their proposals.

Private activity bonds

One of the traditional, and favourable, financing sources available to US transportation is the municipal tax exempt bond market. The governing rules generally permit tax-exempt financing only if there is no significant revenue sharing, no private equity and no long-term operating contracts. Thus federal income tax laws effectively preclude a project from combining tax-exempt financing and concession PPPs. State officials, faced with such a choice, have mostly opted for lower financing costs and required investment grade ratings, thus constraining the amount of capital a start-up revenue project can raise.

SAFETEA-LU modified this landscape. After more than 10 years of lobbying by PPP advocates, Congress authorised the US Secretary of Transportation to allocate US$15bn in tax-exempt private activity bonds (PABs) to qualifying highway and intermodal freight facilities. This enables PPP bond financing at interest rates near the lowest cost tax-exempt municipal financings.

In January 2006 the USDOT issued a public notice inviting applications for project allocations. Several states are currently preparing applications for this programme. To be eligible for PABs, projects must include Title 23 funding, triggering application of federal requirements.

Equity and bank sources

While the source of US equity investment to date is primarily European and Australian, that situation is changing. Goldman Sachs, Citigroup, Morgan Stanley and the Carlyle Group each have announced their intention to form equity investment funds focusing on the US transportation sector. In addition, Canadian and US public employee pension funds reportedly are evaluating US equity investments.

Project debt financing remains virtually an exclusive foreign play in the US market. Interest from international banks is substantial.

Federal depreciation and amortisation

Structured properly, PPPs offer investors in US projects accelerated depreciation and amortisation under federal and some state income tax laws, enabling them to shelter certain income and cash flow from taxation. The bulk of up-front concession payments and capital expenditures can receive 15-year accelerated depreciation in a properly structured PPP, and revenue sharing payments can be deducted in each year incurred. For PAB-financed projects depreciation is limited to the straight line method over 20 years.

Combining this benefit with PABs tax-exempt interest rates and low cost TIFIA mezzanine financing can produce financing packages yielding greater available capital than, and an overall after-tax cost of funds close to, municipal bond rates.

Federal regulatory programmes

The federal regulatory environment continues to evolve in support of transportation PPPs.

SEP-15

In 2004, USDOT's Federal Highway Administration (FHWA) established Special Experimental Project 15 (SEP-15), allowing Title 23, FHWA regulation and policy waivers to test new project delivery and finance techniques on Federal-aid projects. Areas of experiment include procurement procedures, contract terms, environmental review procedures, right of way acquisition and project finance.

TxDOT, Oregon and other states are already using SEP-15 to great effect for their PPP programmes.

Federal tolling programmes

SAFETEA-LU added new exceptions to the general prohibition on tolling federally-funded facilities:

- Section 129 authorises tolling to fund: construction of new non-interstate highways; reconstruction of existing toll roads; reconstruction and replacement of previously non-tolled bridges and tunnels on and off the Interstate System; and reconstruction of non-tolled non-Interstate federal aid highways.
- Express Lanes Demonstration Programme permits tolling to finance new lanes or manage congestion on existing lanes for 15 projects, on or off the Interstate System.
- Interstate System Construction Toll Pilot Programme permits tolling three new Interstate System facilities.

- Interstate System Reconstruction and Rehabilitation Pilot Programme allows tolling three existing Interstate facilities to gap-fund reconstruction.

State PPP activity

While the USDOT is facilitating PPPs, US project delivery occurs only at state and regional levels. Without political will at these levels, transportation PPPs cannot flourish. It is noteworthy therefore that state PPP interest is at unprecedented levels, with 25 states having PPP statutes and others with legislation pending.

Active projects

Texas' PPP programme is cutting edge in its ambition, scope and sophistication, actively competing for the largest globally. Ten major projects are currently under PPP contract, in procurement, negotiations or in preparation for competitive procurements. The list will grow.

They include Trans Texas Corridors 35 and 69, multi-billion dollar projects to create new multi-modal corridors across the state. In early 2005 the state selected Spanish concessionaire Cintra and local contractor Zachry as its TTC-35 strategic business partner and is negotiating its first concession built under it – SH 130 Segments 5&6 (US$1.0bn+). In March 2006 Cintra Zachry unveiled plans for a new 600-mile, grade-separated freight line in the TTC-35 corridor. In April 2006, the state issued a request for qualifications for its TTC-69 corridor strategic partner.

I-635 Managed Lanes (US$1.5bn), Loop 1604/US281 (US$1.0+bn) and SH121 (US$350m) are in active procurement. A procurement for the SH161 (US$700m) will commence in 2006. Procurement preparation recently began for the SH121/SH114 Funnel (US$800m) and IH820/35W, with procurement documents to be issued in late 2006 or early 2007. TxDOT will file soon PABs applications for the I-635, SH121, SH161 and others.

In the Houston area the Harris County Toll Road Authority, operating 83 miles of toll roads, is studying whether to retain, sell or lease its assets.

Virginia has one of the longest PPP histories, under which many projects arose from unsolicited proposals. VDOT recently granted to Transurban and Depfa Bank a long-term permit for the Pocahontas Parkway (Route 895); is negotiating a PPP for the Dulles Rail Corridor; is considering a PPP to reconstruct and add dedicated tolled truck lanes to I-81; is negotiating a PPP for the 56-mile I-95/395 HOT and HOV lanes project (US$913m); and approved transferring the Dulles Toll Road to the Metropolitan Washington Airport Authority, which may yet act on existing PPP proposals to lease that road.

In October 2005 Oregon and Macquarie signed a pre-development agreement for three highway projects at various stages of environmental planning and feasibility analysis. Macquarie has committed to advance much of the cost of the pre-development work in exchange for exclusive negotiating rights to implement concessions on those projects proving feasible.

Florida is pursuing an availability payment PPP for its US$1.5bn Miami Port Tunnel Project. In May 2006 the state short-listed three teams for an award scheduled early 2007.

The Tampa-Hillsborough County Expressway Authority is procuring a concession for a new US$200m limited access alignment and interchange at I-275.

Georgia is currently evaluating two unsolicited proposals for concessions: the I-75/I-575 Northwest Corridor improvements, including HOT lanes with variable pricing and mandatory truck-only toll lanes; and HOT lanes on GA 400.

Washington State is developing administrative rules under its new PPP legislation. The law, modeled after Oregon's, requires the State Treasurer to issue all project indebtedness and requires legislative approval of tolling. This leaves the door open for state-issued PABSs coupled with private equity. Separately, the State Transportation Commission oversaw a recent study recommending a statewide tolling and pricing policy as a new funding source and congestion management tool.

New legislation

The new law authorising the lease of the Indiana Toll Road also authorised a PPP approach to finance, build and operate the US$2bn I-69 extension. Indiana is planning soon to issue a PPP procurement for the I-69 extension.

The North Caroline Turnpike Authority is authorised to study and build up to nine toll roads or bridges. Projects currently in the environmental and feasibility study phases include the Monroe Connector, Gaston East-West Connector, Cape Fear Skyway, Triangle Parkway, Western Wake, Mid-Currituck Bridge and I-73/74 Connector. While NCTA anticipates that most projects will be financed using traditional toll revenue bond financing, it is exploring a PPP procurement approach to deliver the Mid-Currituck Bridge.

In neighbouring South Carolina, legislation was adopted in January 2006 authorising tolling to finance, construct and operate I-73, a proposed US$2bn 45-mile roadway between the Atlantic Coast resorts and I-95.

In March 2006 Utah became another state with

PPP legislation, allowing solicited and unsolicited proposals. Next steps are to adopt administrative rules. Several PPP projects are planned.

In May 2006, the California Legislature passed its first PPP bill since the 1989 law that gave birth to the SR 91 and SR 125 concessions. In connection with the largest infrastructure bond programme in state history, it authorised four PPP projects primarily designed for goods movement, two in northern California and two in southern California. The agreements are subject to approval by the California Transportation Commission and the Legislature.

Alaska adopted legislation in May 2006 granting PPP authority for financing and delivering the US$600m Knik Arm bridge in Anchorage.

Pending legislation

Among other states giving active consideration to the PPP market:

- New York is considering PPP legislation, including the concessioning of existing assets. PPP interest focuses on rehabilitating or replacing the Tappan Zee bridge.
- New Jersey introduced legislation to sell a 49% interest in state toll roads, while reserving operational control.
- Delaware is considering a concession for a greenfield highway connector known as the 301.
- The Missouri House approved legislation to authorize a PPP for a US$900m toll bridge in St. Louis crossing the Mississippi River, with action in the Senate still pending.

PPP project trends

Three types of PPP projects are emerging in the US market.

The first, and most visible recently, are long-term leases of existing tolled assets, seen by some government officials as solutions to funding deficits. The distinguishing characteristics of asset leases are (i) operations, traffic and maintenance history; (ii) fairly predictable cash flows and expenses; (iii) lower traffic, revenue and cost risk profile; and (iv) acquisition of a "going concern". The 99-year, US$1.8bn Chicago Skyway asset lease solved Chicago's budget crisis and catapulted its credit rating to solid investment grade.

Indiana followed suit, tendering a 75-year lease of the Indiana Toll Road, fetching a US$3.85bn offer.

Nossaman's Infrastructure Practice Group is a leader in assisting project owners with public-private partnerships, concessions, DBFO and other alternative delivery approaches for large transportation projects. Nossaman proudly advises more than 25 North American states and provincial governments setting the precedents for the next decade of infrastructure development and finance.

- Multi-billion: Trans Texas Corridor's 35 and 69 - Texas Department of Transportation
- $3 billion: Dulles Corridor Metrorail Project - Virginia Department of Rail and Public Transportation
- $2.4 billion: Intercounty Connector - Maryland State Highway Administration
- TTD $12-15 billion: Rail Transit Project - Trinidad and Tobago Ministry of Works and Transport
- $2 billion: Interstate 69 - Indiana Department of Transportation
- $1.5 billion: Miami Port Tunnel - Florida Department of Transportation
- Comprehensive Development Agreement Program ($1.5 billion IH-635/LBJ; $1.3 billion SH 130; $1+ billion SH 1604/281; $1+ billion IH 820/SH 183; $1+ billion SH 114; $700 million SH 161; and $350 million SH 121) - Texas Department of Transportation
- $1.2 billion: METRO Solutions Program - Houston Metro
- $1+ billion: Columbia River Crossing - Washington State Department of Transportation/ Oregon Department of Transportation
- CDN $600 million: Sea-to-Sky Highway Improvement Project - British Columbia Ministry of Transportation and Partnerships British Columbia
- Innovative Partnerships Program ($350 million: Newberg-Dundee Transportation Improvement Project; $300 million South I-205 Corridor; $300 million Sunrise Project) - Oregon Department of Transportation
- $323 million: Route 895 Connector/Pocahontas Parkway - Virginia Department of Transportation

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Figures for pending projects are approximate capital and financing costs.

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Approved in March 2006, the deal will fund a 10-year transportation improvement programme, including the I-69 PPP.

In May 2006 Virginia agreed in principle with Transurban and Depfa Bank on a long-term permit for the Pocahontas Parkway, with private assumption of maintenance responsibilities, new improvements and revenue sharing.

The second project type is the finance, construction and long-term operation of new facilities, or "greenfield projects". Because these are start-up facilities, they lack an operating history, have traffic and revenue projections of lower reliability, and pose greater risk prior to completion, traffic ramp-up and stabilisation than asset sales.

The third, "mixed concessions", entail the reconstruction or expansion and long-term operation of existing facilities. This risk profile falls between that of asset sales and greenfield projects.

Blending US and European innovations

US innovations, particularly in early PPPs and large design-build procurements, are expected to inform next generation PPP project delivery in the US and not just mimic the European experience. States like Texas and Oregon are endeavoring to blend together the best from both experiences. Some of the more noteworthy examples are:

- Unsolicited Proposals - Some state PPP laws permit unsolicited proposals, a tool Virginia, Texas and other states have used regularly. While it is challenging to create real competition, not to distort funding priorities or to divert administrative capacity, public officials are attracted to the innovation such proposals present.
- Pre-Development Agreements – PDAs engage the private sector as a strategic partner early in a project's life, to tap into resources, ideas, know-how and experience for project definition, financing and design. Texas, Georgia, Oregon and Virginia have PDAs in place. Selection is based on evaluation of conceptual development and finance plans and proposer qualifications. If a PDA project clears environmental, planning and financing hurdles, the parties negotiate an implementation agreement, which may increasingly take the form of a long-term concession.
- Best Value Selection – The typical European model for PPP tenders and awards is "best pricing". Many US PPPs will use "best value", which bases evaluation on pricing and other technical factors, followed by negotiation with the selected proposer. Technical factors may include ability to maintain surrounding existing traffic during construction.
- One-on-One Meetings – For US design-build procurements, there has been favourable experience with the use of one-on-one meetings with individual proposers prior to proposal submission. It enables frank exchange of information, ideas and concerns, improving decisions on risk allocation, contract requirements, design standards and other matters. Conducted with proper safeguards to avoid unfair competition and breach of confidential information, one-on-one meetings improve offerings, competition and proposal quality and minimise future disputes.
- Alternative Technical Concepts – This tool, utilised effectively in larger US design-build procurements, allows submission of alternative technical or design ideas not otherwise in conformity with procurement requirements. When coupled with stipend payments to losing proposers, the agency may adopt AltC's from losing proposers and negotiate them into the contract with the selected proposer. This procurement tool can produce better value for money in PPP procurements.
- PABs and TIFIA Financing– These uniquely US financing mechanisms should play a significant role in the US PPP market.
- Revenue Risk – Most of the US PPP projects will rely on toll revenues as the cash flow for project finance. An emerging US trend is exclusive open road tolling, which presents added revenue risk in the form of patronage loss by those without transponders and difficulty in collecting from out-of-state violators. Where these factors materially erode the financial model, public agencies may assume some of the open road tolling risk. Where project revenues are insufficient to cover a substantial portion of project costs, availability payment concessions are a real option. The Miami Port Tunnel project will be the first such concession, with applicability in Texas and elsewhere under active consideration.
- Risk Allocation – States are making such decisions based on each project's unique characteristics, the state's goals for the concession, prior US experience, lessons learned internationally and unique state and federal contracting law. States seek win-win scenarios, particularly for first-generation projects, but must demonstrate to constituents and traditional industry stakeholders value for money not otherwise achievable using conventional project delivery.

- Right of Way – The US approach for many greenfield projects is to place performance and cost responsibility on the private party, with the public agency using its eminent domain power where needed to complete acquisitions at private party expense.
- Renewal and Replacement – In European concessions, public agencies commonly take a passive role regarding concession term renewal and replacement scheduling and financing, relying on lenders to enforce and structure reserves for this work. Some US states may be more proactive, requiring their partner to schedule periodic renewal and replacement work, to fund reserves and to isolate reserves from debt repayment.
- Public Oversight – A major adjustment in business as usual for US agencies is PPP oversight of design, construction, operations and maintenance. They are responding to the demands of private investors and their lenders, with substantial sums at risk, to yield traditional public control in favour of more neutral means of assuring quality and compliance, with the private party responsibility for quality management, use of independent engineers to monitor, inspect and audit, and alternative dispute resolution procedures.
- Performance-Based Specifications – Another significant shift for US agencies is away from prescriptive design and construction specifications and toward performance measures and outcomes. The mix between prescriptive and performance specifications will likely vary among jurisdictions, reflecting individual policy decisions and will tend toward prescriptive in the areas of right of way acquisition, utility adjustment and environmental compliance, which are highly regulated.
- Property Taxes – Liability for property taxes, such as leasehold and possessory interest taxes, can have a material effect on concession financial models. The US trend is for states to provide property tax exemptions for transportation concessions.
- Public Sector Remedies – Contract termination is not a particularly useful PPP remedy for defaults that are less than project-critical. Unlike in many foreign jurisdictions, the assessment of monetary penalties may be unenforceable under US contract law. PPP contracts will therefore incorporate other tailored remedies including liquidated damages for listed violations; public agency step-in rights; appointment of receivers; and anticipatory breach with required assurances of future performance to address persistent violation.

Conclusion

The transportation PPP industry in the US faces many challenges. Some group or alliance will oppose virtually every PPP project, objecting to tolling, growth-inducing effects or other perceived environmental consequences. Nevertheless, policy makers, witnessing the success of the Chicago Skyway, Indiana Toll Road and Trans Texas Corridor 35 transactions, and facing no other solution to pent-up transportation demand, are compelled to consider PPPs. The momentum in this direction, not without fits and starts, is undeniable.

If one adds to existing deal flow the large number of projects soon to commence procurement and the potential list that could arise from new and pending legislative directions, one could easily conclude that the PPP sector will look even more robust in the next 18 months than it does today. Whether a sea change hits the shores of the US transportation industry will be known soon, but it is certainly possible that the US market could become one of the most prodigious PPP deal generators in the world. What is clearer is that PPP procurements and contract terms will become hybrids of other models, utilising features from international precedents, modified to reflect the US legal environment, US agency institutional biases and unique US financing tools.

Note:

* The views expressed in this article do not necessarily reflect the views of clients of the firm.

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