Can Virginia's new governor move PPP up a gear?

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The Commonwealth of Virginia is broadly regarded as having been the crucible for many of the United States' experiments with PPP, and paved the way with its 1995 Public-Private Transportation Act (PPTA). More recently, however, some large projects have been held up or, in the case of US Route 460, shelved. For Virginia, like other states, PPP debates usually centred on how much risk – and control – it should shift to private operators. But in the face of the credit crunch, projects are making much more direct demands on states' budgets.

The US-460 project, if restarted, is likely to cost around $2.5 billion, with the state share falling between $500 million and $1 billion. In September, the Virginia Department of Transportation (VDOT) cancelled Macquarie/Skanska and Cintra/Ferrovial/Earth Tech's bids for the project after its six-year highways budget shrank considerably and it was unable to commit to providing the scheduled public funding.

This issue of falling public revenues is a serious problem for Virginia's transport programme. In November, transportation officials said that they would have to reduce the commonwealth's six-year budget by $851.5 million, and the budget has already suffered $3.7 billion in cuts since spring 2008. In all, proposed spending has dropped to a total of $22.5 billion for 2010 to 2015, with cuts particularly affecting road maintenance ($277.1 million), highway construction ($255 million), administrative and support services ($115.2 million) and mass transit ($46.3 million).

But there are a number of deals in Virginia's pipeline, and state officials and private developers say that all of them can attract financing, given canny enough structuring and sufficient political will.

Lighting the tunnel

In 2008, VDOT issued a request for detailed proposals for its Midtown and Downtown tunnel and freeway project. The brief assumed no state contribution, and Macquarie, Skanska, Kiewit and Weeks Marine formed the Elizabeth River Crossings consortium to negotiate, as sole bidder, with VDOT.

Macquarie and Skanska's plans for financing the concession involve borrowing $1.2 billion, including $600 million of low-cost Transportation Infrastructure Finance and Innovation Act (TIFIA) subordinated debt, as well as raising $520 million of equity. The project schedule calls for the sponsors to have a comprehensive agreement with VDOT in place in the first quarter of 2011 and to close the financing in spring 2011. An interim agreement was signed in late October. Under the PPTA process, an interim agreement is an indication that commercial close is on its way – Midtown Downtown could well be signed in spring 2010.

However, VDOT is still wary of committing to a deal given the condition of credit markets, and says that it is monitoring Macquarie and Skanska's ability to raise sufficient debt and equity. The department, in its report on the financial strength of the bidding consortium, noted Macquarie's recent shift towards advisory work and away from taking a principal position on projects. The weakness of the infrastructure fund market, both unlisted and especially listed, has coincided with a reduction in the amount of leverage banks are prepared to apply to demand risk deals. A rebirth of commercial lender appetite for traffic risk should reduce the pressure on equity, and would put Macquarie in a position to close this deal.

The project involves modifying an existing tunnel, and building a new tunnel parallel to it, under the Elizabeth River. In 2007, VDOT estimated its cost at between $550 million and $1.225 billion. The Martin Luther King freeway part of the project will extend the road south, with a new interchange at I-264 (a four-lane limited access freeway), between the I-264 and the Midtown tunnel. The third part of the project includes modifications to the Downtown tunnel, which crosses the Elizabeth, linking Portsmouth with Norfolk.

Does I-95 indicate a funding gap?

In August, VDOT delayed commercial close on the $1 billion I-95/395 high-occupancy vehicle (HOV) lanes concession, blaming the troubled credit markets and the need for additional work on the project's scope, as well as environmental concerns thrown up by a lawsuit filed by Arlington County. Transurban (90%) and Fluor (10%) are preferred bidders. The concession involves rehabilitating and expanding 95km of HOV lanes between Arlington and Fredericksburg.

The project will be built in two sections. On the northern section, another 45km HOV lane will be added between the Pentagon and Dumfries. The southern section works will add two new HOV lanes another 45km south, to Spotsylvania County. Work on the northern section was due to begin in mid-2010, but this will be delayed.

The deal should get to market some time in 2010, but several factors will have to shift first. One obstacle is that Arlington County has filed a lawsuit against VDOT, challenging the veracity of the environmental studies for the project. The sponsors are looking at mid-2010 as a time when the credit markets may be more accessible, and are examining various options, including bank debt.

Another obstacle to getting the deal to market is the continuing negotiations between the sponsors and VDOT regarding the scope of the project. According to a source familiar with the process, balance is still being sought between the public and private sectors' expectations and abilities. So far, however, there is no indication that sponsors are looking for a cash infusion from VDOT.

On the I-95 financing, Fluor and Transurban may end up closing a deal similar to the one they forged on Capital Beltway, which closed in June 2008. That deal was the first in the US PPP market to use private activity bonds (PABs). The bonds (covered by letters of credit from DEPFA Bank, National Australia Bank, Banco Espirito Santo and Bank of Nova Scotia) were matched with an equal amount ($589 million) of TIFIA sub debt, with the rest of the funding coming in the form of a contribution from VDOT and sponsor equity.

But the pricing for letters of credit on PABs has risen dramatically since Capital Beltway – from around 120bp to more like 300bp. Without LCs getting cheaper, and in a market where monolines are still not in play, unwrapped PABs could be the way forward.

A deal with this blend of unwrapped PABs and TIFIA money has just closed, for Cintra and Meridiam's North Tarrant Expressway (NTE) managed toll lanes project in Texas.

The sponsors originally tried to put together a bank deal with Calyon, Banco Espanol de Credito and Banco Espirito Santo, among others. Cintra and Meridiam, together with a third sponsor, the Dallas Police and Firefighters' pension fund, decided instead to increase the equity portion and issue the bonds unwrapped. The sponsors have gained a strong enough rating to satisfy both TIFIA and potential bond investors, though bankers questioned whether the project's economics were solid enough to dispense with a bank or bond insurer.

The PABs, rated at BBB-/Baa2, priced in mid-December, although sources close to the deal managed expectations by describing the process as a market-sounding. The issue is an important test of investor appetite for BBB paper.

Republican renaissance

The probability that any of the projects in the Virginia pipeline will reach commercial and/or financial close has risen following the landslide election of republican Bob McDonnell as governor on 3 November. McDonnell's campaign featured a focus on the facilitation of PPP, particularly in transport, and he has said that one of his first acts following his inauguration in January will be to revive the US-460 project and put it out to the PPP market.

The project, however, will still need a substantial public contribution to keep tolls within politically acceptable boundaries. The I-95/395 project may get away first, and would be seen by the market as an early victory for McDonnell, but US-460 will require a more substantial deployment of political – not to mention physical – capital.

The new US-460 would run parallel to the current 460 from Suffolk to Petersburg. The road would run 88km from I-295 in Petersburg to Route 58 in Suffolk, and would be a two-lane divided highway built south of the existing road, with nine interchanges at towns and secondary roads.

The commonwealth's menu of options is the same unpalatable mix that gives hope to PPP fans across the US. Those in the Virginian projects market say that alternatives to PPP for getting projects away are not clear, and are shrinking. The only real alternative to PPP in light of falling state revenues and subsequent budget cuts is increased taxation, which is not a viable option in the current financial climate, with increased unemployment and the attendant increase in social payments.

Toll roads, managed lanes and other user-charge projects, financed in a similar manner to Capital Beltway model, offer one of the more politically acceptable ways out. For the projects in the Virginian pipeline at the moment, the sponsors' attitude is partly watch-and-wait. They initially wanted to see whether North Tarrant's financing crossed the line; now the issue is whether commercial bank appetite for traffic-risk projects returns sooner rather than later.

Projects procured on an availability-payment basis are being looked at as a possible route, but the structure looks to be attracting more political scrutiny than it did in Florida, home to both of the US availability deals to close to date. They have already attracted accusations of being indirect routes to increased taxation. But political will in Virginia is tending in the direction of the economic imperative of expanding infrastructure, so when it comes to availability projects, the buy-now-pay-later option could very well be chosen in some instances where demand risk is difficult to mitigate or price. Bank, mostly European bank, appetite for providing club debt on availability deals is back, but a big shift in fortunes will have to take place for the public money to back availability deals to materialise.