Profit perspective

01/12/2006

Fluor's history neatly covers the past, present and future of US infrastructure finance. Its past projects include the Pocahontas Parkway, E-470 public highway and toll road, the JFK international arrivals terminal, and the SR 125 toll road. Fluor is among the developers of the I-495 Capital Beltway project, as well as the I-395 project, both of which are designed to reduce congestion through the introduction of high occupancy toll (HOT) lanes. It was also among the developers of the A59 in the Netherlands.

"We're looking at PPP projects around $1 billion" says Bob Prieto, senior vice-president at Fluor. "We would look at projects down to around $500 million but below that, it doesn't make as much sense for us to be players." Fluor also looks for evident political will, good legislation and a transparent procurement process. In addition, Fluor's perception of a successful PPP is one that comprises maximum infrastructure for the lowest cost, appropriate risk weighed returns and the protection of minority interests.

New or improved

Today Fluor's focus is on greenfield, as well as projects where a state subsidy of some kind will help a marginal project. "In the US PPP market greenfield projects is where the focus needs to be. We see them principally gravitating towards HOT lanes on existing road networks, and general purpose lanes where are there are gaps in the existing system. Within the next 12-18 months, we are going to see the marketplace recognising that this is a good investment area and responding by creating investment vehicles to provide greenfield development capital."

With the increase of interest in the US PPP sector, is it in danger of overheating? "Essentially there is more money in the market than projects", says Prieto. "But the hot money is really focused on the brownfield projects, because it can be put to work faster. The question has to be asked about the valuation for Chicago and Indiana – was it the right price? I think it was, but there's a lot of hot money looking towards long-dated assets. For this pool of capital buying existing assets is like buying a bond. Greenfield projects, however, are going to require something different"

Until recently, interest in PPP was in greenfield projects, and early US deals, unlike their European counterparts, primarily used non-profit structures. "I think you will increasingly see the states mature in understanding what lends itself to be a PPP and actually putting out greenfield projects for competition. This is hard because the evaluations are somewhat subjective – nobody is in a position to commit to hard numbers without doing a lot of work. The cost of developing one of these projects might be as much as 1% of constructed cost – so for a $1 billion project you're talking about $10 million dollars at risk. The state is really encouraged to work with someone as a partner, someone who has brought some ideas to the table, with demonstrated capability to get projects across the line and get them finished."

Fluor was the losing bidder on the TransTexas Corridor – proposing options for both a concession model and a not-for-profit model. "We thought that a not-for-profit model provided a better benefit to the state based on the analysis and modelling we did, but they chose a concession model. But we could have made either model work. However, for states looking to do their first greenfield PPP project, it may be politically easier to do the first one as a not-for-profit". Pocahontas was executed as a not-for-profit and it the first to be done under Virginia PPP laws, but has since been sold and restructured as a for-profit to Transurban.

The SR 125 toll road in San Diego was one of the first greenfield PPP projects in US to be financed with a combination of private equity and federal TIFIA funding. Fluor entered as part of a construction team managed by Macquarie. The project has experienced delays in construction, delays that Prieto puts down to the state's struggle to adjust.

"That adjustment will take time. Some of the states watched the SR125 and some of the earlier projects and have tried to create special units to oversee these very different kinds of projects. The states that have embraced PPP are making good progress to change their own organisation and to facilitate these units. As we look at PPP opportunities we don't focus on states that want to do one-off projects. Rather, we're looking at states that make changes in legislation, where there's political will and where they're willing to adjust organisations to make these projects successful".

TIFIA – a flexible friend?

Fluor, in a consortium with Transurban, has been selected to finance, build, design and operate HOT lanes on I-95 from I-495 to Route 17 in Virginia. DEPFA is financial adviser to Fluor and Transurban in connection with the projects. In the last week of November the involved parties spent time going back through assumptions of the financial model and "beating them up in a good way" says Prieto, trying to refine the structure further, and challenging the assumptions. Sponsor and adviser are looking at how TIFIA funding would improve the financeability of the project. "We have some options in mind, but there are long discussions ahead," says Prieto.

The TIFIA program is designed to fill market gaps and leverage substantial private co-investment by providing supplemental and subordinate capital and credit rather than grants. It covers up to 33% of the project cost, and the maximum term for repayment is 35 years after the project is completed.

Sponsors have long asked that the TIFIA programme revisit these original terms, in keeping with changes in the financial markets. When TIFIA was put in place, the longest term available on a bond was 35 years. Now much longer tenors are available. In addition, the concession model for PPP projects did not exist when the TIFIA legislation was approved. Prieto says "Equity players are having an effect on the amount of financing that investors are willing to loan against. Equity is in effect covering a very large part of the risk that debt providers previously covered through debt service coverage ratios that acted to limit available financial capacity in traditional tax exempt bond financing. This added layer of risk protection needs to be taken into account as one of the financing shares that TIFIA would have traditionally provided. Maybe the 33% share that TIFIA could provide should be revisited in light of this added equity risk cover. Perhaps TIFIA's share should be increased by whatever percentage of equity is there. For example if you had 20% equity participation, TIFIA would be allowed to increase from 33% to 53%".

Prieto is equally doubtful as to the value of TIFIA's maturity. "Now we're seeing 99-year concessions, is 35 years still relevant?" asks Prieto. "Before, TIFIA was subordinated to senior debt, and essentially together they comprised the whole transaction, maybe with a very small section of sub debt below TIFIA in a downside scenario. But now there's often a more significant amount of sub-debt below TIFIA, as well as equity, which is absolutely last paid out in the downside scenario. All of a sudden TIFIA isn't fighting for equal standing – equity and sub debt structures stand behind them. Therefore the extent to which there's this other higher risk money in the transaction suggests TIFIA should show a willingness to go beyond the 33%."

Pleasing with PABs

"Private activity bonds were a surprise in the transportation sector" says Prieto, "there was a lot of talk about them and then they appeared at the 11th hour – 11.59 actually. Some would say they appeared a minute after midnight, but that's another story. At first I thought they were a one-shot deal, but now I'm not so sure about that. The reason I say that is the assistance package the Federal government put together for Louisiana had a special allocation for private activity bonds. I think private activity bonds have been discovered as an answer to states financing their own solutions, rather than the Federal government writing them grant agreements".

Fluor's initial fear was that private activity bonds could not be used because they prevented sponsors from benefiting from accelerated depreciation. "But then when you get into it and see the ability to monetize the depreciation, maybe it's not so bad" says Prieto. "Private activity bonds offer the potential for more flexibility in their structure. But until the market moves to creating a wider range of differentiated products, maybe the stop-gap is taking some slices that on a project basis you can develop into a neat structure that is attractive to the marketplace".

"However I don't think we quite understand how to use private activity bonds in the PPP context. But the federal government is doing something here that the market likes. There have been smaller projects for years in the municipal realm, and states are now finding ways to use them for bigger projects."

Spending equity the old way

But Fluor prefers to contribute at the beginning of a project with development equity, as opposed to permanent equity, despite the changing nature of concessions. "Development equity is something we understand. We're taking a higher risk on very limited dollars. We're comfortable with taking and controlling the risk. However I think you'll see some interesting things happen with development stage equity in the US greenfield PPP market."

Prieto considers this development equity to be much more important to the US market than it has been in the European market, since gestation periods are longer in the US. "We have permanent equity stakes, but I don't think people buy our stock because we own lots of assets. Owning assets is not something we have to do, other guys can hold assets. Creating those assets through our investment of development stage equity and our knowledge of the market is what creates value. "

Virginia was one of the earliest states to promote PPP in transportation and infrastructure projects. Its 1995 Public-Private Transportation Act allows private companies to finance, develop and operate public transportation facilities. "The most common question we get from state DOT secretaries", says Prieto, "is what developers want when they go into public private partnerships. First and foremost, we need political will. PPP projects are difficult, they involve change and won't happen without it. Of the legislation we see, we like Virginia's, and we like what Louisiana passed and that was modelled on Virginia. I think things are moving forward in Pennsylvania also, with some good legislation beginning to develop."

The sale of the Pocahontas Parkway and its restructuring represented a shift to the concession model in Virginia, but Prieto considers the I-495 Capital Beltway PPP project to be Fluor's most important undertaking at the moment. The I-495 beltway opened in 1964 and was widened in 1977 to eight lanes. In 2003 a Fluor/Transurban consortium submitted a proposal to finance, design, build and operate the HOT lanes on the I-495, and in April 2005 Virginia signed a comprehensive agreement the with the proponents.

The project involves adding four HOT lanes onto the existing eight lane I-495 freeway at cost of roughly $900 million. Fluor takes the design-build role and Transurban will be the O&M contractor. The project will be structured as a for-profit concession, since Virginia chose this option, but the sponsors have not decided how the financing will be structured, or whether TIFIA or PAB funding will be used*.

"The I-495 development process in Virginia dealt with a lot of the institutional issues that needed to happen – changes in legislation and regulations. The I-495 had to work its way through this one step at a time but I-95/395 is the beneficiary. We laugh that they both may close on the same day".

The original May 2002 plan for the beltway involved substantial condemnations and attracted substantial opposition. "The initial environmental import statement would have taken out 300 surrounding properties. No one really liked that idea, the impact was too large and there was no money to build it anyway. We came forward with the option to add some HOT lanes onto the facility to increase capacity of the road. We reduced the configuration and converted express areas to HOT lanes so they are being paid for, and we also minimised structural loss, taking six or less properties."

Virginia has not decided whether to provide an operating contribution and to permit the use of private activity bonds and sub debt. "Whether equity or sub debt is used, the important thing is the way the project is financially enhanced to capture some of the value that traditional revenue finance can't capture – the bond guys are looking for a sufficient coverage ratio, or sub debt structures or equity that are willing to take that risk for premium return. The higher risk security carries a higher return."

----------Box 1-----------

On the chances of a not-for-profit comeback in the market:
"People have different financial objectives and are willing to invest in bonds that look very different to what bonds have traditionally looked like. For example in the tax-exempt bond market, maybe there will be 50-year terms instead of 35-year terms – and maybe not for 100% of the debt but for a significant piece. Perhaps the normal period of interest accretion through construction plus 6 months, should be extended to construction plus five years or ten years. Maybe pure bullet structures will be prevalent. I think you'll see some changes in what the bond market will be willing to do with regards to term and structure and also a willingness to be more aggressive. More importantly, not-for-profit structures may provide certain political advantages where public capital is invested alongside private capital or subsidies are provided."

Does increased liquidity breed increased innovation?
"It would not surprise me if there was considerable experimentation in the marketplace in terms of structures and appetite. It's an exciting time in the market because the last transportation bill gave us new tools, the financial models themselves are open to competition in terms of risk acceptance, and there's sufficient capital available. Creative and competitive environments are coinciding and we will come out better than anyone could have written down on paper five years ago."

On the limits of concession structures:
"At the end of the day, financing a large percentage of public transportation as public private partnerships is going to be a challenge. Most transportation facilities are not going to pay for themselves on a regular basis. New York's George Washington Bridge you can take to the bank, because the revenue streams are so strong they pay for themselves plus a few other things along the way. But not every section of road and very few sections of rail are going to be able to pay for themselves. There will always be the problem of maximising the financial capacity of whichever set of revenue streams you are able to cobble together."

On the limits of PPP
"Fast forward 15-20 years and I think you'll see 5-10% of US transportation needs being met by PPP projects. Out of those the majority will be operating as a shadow toll or an availability-type structure because of political considerations or because the numbers demand it."

On the next bumper concessions:
"The Tappan Zee and New Jersey Turnpike will be operating on a for-profit basis and a state may have paid others for the privilege of taking that on. Those may be the ones that are going to happen first but the market may be creating unrealistic expectations in terms of timing. My bet is within two years New Jersey will begin the process of PPP. Whether it's brownfield or greenfield, it will happen within the next seven years. And the new governor in New York will look at the Tappan Zee Bridge– I'd be shocked if there was no PPP within the next four years."

On who wins and loses from the pace of change:
"Things that were hard to talk about 10 years ago are now being talked about. Ten years ago you weren't talking about design-build on transportation project. Now on a big project you're looking at design-build and hiring general contractors. Now people are looking at value selections, not low-price selections so the thinking process is changing. But for a private company to stay in business it has to get risk more right than wrong. It's an opportunity for the public sector to capture the added value associated with PPP and for the private sector player to enhance his risk weighted returns. In turn the public gets enhanced facilities earlier and a decision process driven by sound transportation planning and economics, not just political gerrymandering of transportation dollars."

**This sentence originally read. "The project is likely to be owned by a non-profit 63-20 corporation and the initial financing will come in the form of tax-exempt bonds and sub debt from Fluor and Transurban". Prieto has asked us to clarify that the Commonwealth of Virginia has in fact settled upon a for-profit concession structure, and that, his earlier* *comments notwithstanding, the sponsors have not made a decision on the use of TIFIA or PAB funding for this section.*