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Transport report: Austin's powers

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The headline transactions in the US public-private partnerships market have so far come from the Midwest and two coasts of the United States. California, Chicago, Indiana and Virginia persuaded New York's lending community to take transport assets seriously. But Cintra, the most successful sponsor so far in the US market, bases itself in the state capital of Texas, Austin.

The Chicago Skyway and Indiana Toll Road attracted impressive bids, Virginia's experiments with concession structures have been useful, and California closed the first for-profit construction financing. But the scale of the work that Texas has in mind would likely dwarf these deals. Texas envisages two wide multimodal transport corridors of up to 1,200 feet each across the state, as well as three additional one-off concessions, and a number of other state- and city-run projects.

The Texas Department of Transportation, or TxDOT, made a serious impression on the US infrastructure market when it announced a predevelopment agreement with Cintra and Zachry for the TTC-35 project. TxDOT selected the developers on 16 December 2004, after a competitive process. Cintra-Zachry's bid for the project included $7.2 billion in expenditure on a 600-mile road between the state's borders with Oklahoma and Mexico.

Master blasters

The agreement does not have an equivalent in current European or American practice – concessions are usually identified and packaged before being bid out to the private sector. Cintra-Zachry's proposal for the TTC-35 includes a set number of projects, but the predevelopment agreement does not commit the two sides to pursuing them.

The private sector's role is both more and less expansive than that of a concession holder. One adviser familiar with the creation of the predevelopment agreement called the role that of a "financial adviser on steroids." The C-Z consortium can work with the state of Texas on preparing sections of road for possible concessions, either tolled or untolled, but the state does not have to accept these proposals.

Texas was not the first state to make provision for the for-profit operation of toll roads – California's AB680, and resultant, albeit flawed, slate of road deals takes that honour. But Texas has frequently taken a lead in funding its roads with new structures. "Texas has traditionally been a pay-as-you-go state, with tax dollars funding design-build contracts," says Phillip Russell, director of the Texas Turnpike Authority Division of the Texas Department of Transportation. "In the 70s and 80s we looked at funding roads with increases in the gas tax, but in 1997 the legislature allowed us to use tax-exempt debt to fund road projects, and we funded the Central Texas Turnpike [CTT] that way."

"In 2002 we took a trip to Europe with LSI [Lone Star Infrastructure, a joint venture of fluor, Balfour Beatty and T.J. Lambrecht, which was building the CTT project] to look at other opportunities. Tax-exempt debt is good, but we wanted to look at the possibility of using equity, which many US contractors were not familiar with. European developers have different risk expectations." The observation is a common one, not least in these pages. US contractors have been the driving force behind tacking on design-build contracts to non-profit concessions (the 63-20 corporation). For this reason, many market participants have assumed that US firms would be active largely as EPC contractors rather than owners.

Russell disagrees. "I think that US firms will take substantial positions. The initial Cintra-Zachry proposal was for Cintra to put up 85% of the equity, but by the time the concession agreement for SH130 came out Zachry was putting in a much higher level of equity."

First out the gates

SH130 is the first concession proposal to emerge from the predevelopment agreement, and covers the 5th and 6th sections of State Highway 130 – the first four are covered through the CTT financing. Central Texas used a combination of a $1.36 billion tax exempt bond, a $916 million TIFIA loan, $700.0 in state funds, $511.7 million in local grants and $163.6 million in investment income.

The 5 and 6 sections have a cost of roughly $1.2 billion, and will be run as a for-profit enterprise. Cintra and Zachry are the developers, and have the responsibility for the construction and financing of the section. The concession stands a little to one side of the main TTC programme, since unlike much of the rest of the corridor it has gone through environmental review.

The concession agreement was announced on 29 June, and committed Cintra-Zachry to paying $25 million upfront for the concession, spending $1.3 billion to build the road, and sharing its revenues with the state. The proportion that each side takes home varies according to the revenue that the concession produces, but could be a maximum of 50/50.

The concept also surfaced recently on the acquisition by Transurban of the Pocahontas Parkway. Transurban offered a revenue sharing arrangement as the price of, essentially, taking the road into private hands (although the road is again a concession). The deal was financed through a $410 million loan from Depfa, BBVA and HVB, which closed in May (for more, search "Pocahontas" at projectfinancemagazine.com).

Advisers close to the deal have suggested, largely in jest, that the SH130 revenue sharing proposal copies the Pocahontas proposal. The emergence of the two proposals is likely, though, a coincidence, and Russell is at pains to stress that the proposal came out of long-standing discussions between state and developers.
TIFIA touchstones

TxDOT, in its statement on the SH 130 agreement, also stressed that the road would remain in the state's hands, a promise that most road projects in Europe, real or shadow toll, could make. But the design-build-finance-operate concession does transfer construction and traffic risk to the concessionaire. The other promise from the administration of Governor Perry is that "no tax dollars" will spent on construction of the road. This last statement is rather elastic, and certainly does not include federal TIFIA funding, since Cintra-Zachry submitted a letter of interest for a $320 TIFIA loan in June 2005.

TxDOT's slate of roads is set to be the largest road-related consumer of innovative infrastructure funding from the Federal Highways Administration (FHWA), in part because the state has taken the lead in applying for funding under the SAFETEA-LU (Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users) authorisation.

Even with the broader palette of financing techniques that the updated Transport Bill proffers, Texas has had to apply for experimental authorisation to gain approval for TIFIA funding. One of the chief obstacles to the use of TIFIA funding, which takes the form of a subordinated loan from the FHWA, is the time it takes to gain approval. Texas hopes to get around this by applying for TIFIA loans for projects before they have been awarded.

The problem, according to Mark Sullivan, who runs the TIFIA programme at the FHWA, is that "the legislation did not really envisage a market in which the entity not in control of a project would apply for funding. It was designed for a municipal finance-type market." Working on the assumption that one concession awarder applying for funding is a less fraught process than four of five concession bidders all applying in advance of even winning a concession.

The special experimental authorisation, known as SEP-15, allows Texas to apply for TIFIA funding before identifying a builder and, crucially, without obtaining an investment grade rating in advance. This last is important, since different sponsors will have different risk appetites, and will structure their financings with varying degrees of leverage. What the SEP-15 authorisation says is that any bidder for a pre-approved concession that intends to use TIFIA funding should submit an indicative investment grade rating.

As part of the SEP-15 process, the state DOT and the FHWA have entered into an early development agreement, and the DOT has to report back report back on whether exempting the project from Title 23, which SEP 15 is designed to circumvent, is necessary. The mechanics of implementing the agreement are far from finalised – indeed the former, slightly more cumbersome, arrangement, may return to favour if SEP-15 does not work.

Texas has submitted proposals separately for the TTC-35 agreement, and for a further three concessions, of which SH121 will be the first. At present, of the four projects submitted as SEP-15, three are from Texas, and the fourth, the Oregon Innovative Partnerships Program, is clearly modelled on the Texas process. Russell says that he has been in touch with his counterparts in Oregon to share advice on implementing such agreements.

Private dancer

Private Activity Bonds (PABs) are also likely to make up a part of Texas' funding mix. The bonds, also authorised under SAFTEA-LU, allow for-profit entities to issue tax-exempt debt, up to a total cap of $15 billion. And TxDOT has applied in advance for authorisation to issue $1.62 billion in such instruments. TxDOT's speed in pushing forward its PPP programme, at least relative to several states, may give it a jump in exploiting the new instruments. "PABs are going to be critical," says Russell, "but I don't think that we'll edge out other states. We think that of we're successful then that cap will probably be increased."

The private activity bonds would also make it less likely that developers will put forward 62-30 solutions, which are attractive in part because they allow a developer to access tax-exempt debt. The other main reason for 62-30s' popularity – the lack of available equity for transport projects – is now effectively inoperable. Russell is cautious about the survival of the structure, saying "it's yet to be determined whether 62-30s will be widely used. Some teams have proposed to use them, and some haven't, but then that's the beauty of the system."

Russell rejects the idea that 62-30s, which lack a profit-driven operator, cannot be maintained post-construction the way that for-profit concessions can. "We'd hold them to the same standards as anyone else, and think that any operator would be sufficiently energised to run them as a business."

Still, it is telling that the most recent two projects to come out of the CDA programme – the SH121 and the SH130 5&6 – are both concessions, and their developers are all equity investors.
Environmental redux.

At the heart of the Texas approach to developing road concessions is the process of environmental review that states and developers have to go through to get roads built. TxDOT has extensive powers under the state's transportation code to decide on funding methods, subject to the approval of the Texas Transportation Commission. But much more drawn out is the environmental review process.

The master development agreement structure, developed by TxDOT and its advisers at Nossaman, owes much to the unwillingness of private sector partners to confront the vagaries of the environmental review process unaided. Says Russell, "it's a huge element of risk for them. For both 35 and 69 we could have awarded them in one go, but we need to go through the environmental and engineering process for them, and thought that it would be useful to have them on board."

But the master development agreement, for which Cintra-Zachry is receiving $3.5 million in fees, does not necessarily mean that the state has to go forward with the concession structure on all of the identified routes. Moreover, the final alignment of the two corridors is still far from final, and TxDOT is currently going through a round of public hearings on the project.

The comprehensive development agreement process enjoys relatively broad support among the state's political class, although this consensus depends in part on the details of the project being sketchy at present. While toll roads are not a novelty in Texas, the scale of the Trans-Texas Corridor, particularly its potential width, has alarmed some Texans. More importantly, since the project is explicitly designed to facilitate trade with Mexico, there is potential for opponents of the project to make an appeal based on xenophobia.

Upfront or afterwards?

Some of the criticisms levelled at the contracts would be surprising to a European reader – disclosure of project agreements is to a much greater level than in the UK, for instance, although some commercial information is still redacted. Other criticisms focus on foreign ownership, the same issue that reared its head in Indiana, and the burden of the tolls on local communities.

Indeed, the one issue that escapes mention – for now – is the use of proceeds from a refinancing. The sales of toll roads in Indiana and Chicago did not include any refinancing provisions, since the sellers assumed, with some reason, that this would lower the amount that buyers were willing to pay. The high prices that Macquarie and Cintra were able to afford were possible because of their ability to extract equity from the concessions using subordinated debt and accreting swaps.

For new concessions, where local opinion will be against excessive private sector returns for new infrastructure, the issue is a little more pertinent, even with a revenue sharing regime in place. Still, according to one adviser familiar with the process of drafting CDAs in Texas, "we were definitely surprised by how much attention that the sharing of refinancing gains got from the Europeans." TxDOT will definitely share in any gain from a refinancing of the SH130, as laid down in the concession agreement.

This provision might affect the amount that a concessionaire is willing to pay upfront, but this sum is usually set against revenue sharing later on in the concession's life. The potential for refinancing gains is at the mercy of movements in capital markets, and is much less tangible than the decision that a locality will make as to whether it requires the upfront fee from a CDA for immediate infrastructure work. For SH121, for instance, according to Russell, roughly 75% of government's revenue under the concession is likely to come from the developer as an upfront payment rather than through a sharing agreement.

The Texas slate of projects will ultimately create a strong flow of financing work for banks and developers. Some details have yet to be worked out, for instance how other bidders can compete effectively against Cintra-Zachry on a concession that Cintra-Zachry has created. Such details will emerge slowly, and occasionally painfully, a product in part of US contracting scruples. But there is little doubt that Texas is first out of the traps, a powerful advantage in the US bank market.