Joining the DOTs

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The noises from Wall Street are by now almost uniformly positive. Public private partnerships, even when narrowly defined as European-style concession-type structures, have a much wider fan base than they did even two years ago. For several years, even fans of PPPs said that they were best suited to very narrow classes of assets. Sceptics preferred to use municipal finance to fund nearly all infrastructure, and emphasise the essential separateness of the US system of procurement.

An easier sell

There is no doubt, however, that the $1.8 billion Chicago Skyway sale has been an attention-grabber, not just at the states' departments of transportation, but in both local press and local legislatures: that a previously failing road could raise 180% of its estimated sale price was always likely to do so. The figure is eye-catching, even at a time when urban rail improvements can cost ten times as much.

But the road attracted $1.18 billion in support from the bank market – at 125bp over Libor initially – a package that compares favourably with municipal debt. The assumption at departments of transport is that when planning road projects federal money will be a vital and substantial part of the sources of funding. Given the nominal sums on offer from the Federal Highway Administration, they will not dispense with it, whatever the strings attached.

The debate is now proceeding along two tracks – the privatisation argument, which is most appealing to municipal governments, and has received a substantial fillip from the Chicago experience, and the newbuild or brownfield concession argument, which has proceeded for the last ten years, with a number of modifications. Among the authorities tentatively examining the privatisation of transport assets are New York, New Jersey and Indiana.

The most plausible initial candidate for a straight sale is the Indiana Toll Road, which runs across the northern part of the state of Indiana between the end of the Chicago Skyway and the border with Ohio, close to the southern border of Michigan. It runs through some of the more depressed parts of the US rustbelt, but takes in healthy revenues from trucks, and could, at $3.5 billion, be worth twice what the Skyway raised.

But the sale is only one option in front of Indiana governor Mitch Daniels, a Republican with a record of fiscal conservatism confronting an acute budget crisis. The same likely goes for reports that New York State is considering a sale or lease of various assets, including the Tappan Zee Bridge, to facilitate repairs. And New Jersey's Acting Governor Richard Codey, who was examining leasing the New Jersey Turnpike, has now ruled the option out for the time being. Such budget-time proposals take time to come into action and are often complicated by existing debt or local legislation: real estate tax was an issue for Chicago for example and the law had to be changed.

The new BOT landscape

But the state-level authorities tasked with delivering new infrastructure also have a headline-grabbing template – the Trans-Texas Corridor (TTC-35). The scheme, which has a total value of between $29 billion and $36.7 billion, would dwarf anything previously developed even if only partially fulfilled. The winning developer was a consortium made up of Cintra, with 85%, and local construction firm Zachry, with a 15% interest. It beat off competition from a Fluor/Parsons

Brinckerhoff consortium and a Hensel Phelps/Skanska joint venture.

TTC-35 is 360m wide and 1,300km long, linking the Mexican border in the Lower Rio Grande area with the Oklahoma border north of Dallas. The corridor will include toll roads with separate lanes for light and heavy vehicles, plus freight and high-speed train lines, service roads and utility lines. Cintra and its partner, advised by JP Morgan, Earth Tech and PwC, has identified seven projects, of which it is likely to pursue five.

This initial raft of seven projects will have a capital cost of $7 billion, while Cintra's potential share is up to $6 billion. However, as TxDOT makes clear, the agreement, which signed 11 March is simply a development agreement, something akin to preferred promoter status. TxDOT says the deal does not "set the alignment for TTC-35, authorize construction, set toll rates, determine who gets the tolls, or eliminate competition for future services."

The contract represents a substantial step forward, and looks like being a substantial source of new business, although Cintra's development fee – $3.5 million per year, is unlikely to cover costs. But it indicates, in the same way as the Skyway sale, the extent of the financial resources available to European infrastructure operators.

Still, federal funding exerts a strong pull over the fortunes of new concessions, not just in terms of its application to PPP capital structures, but also to the process of procurement. The Federal Highway Administration (FHWA) already offers TIFIA money (search 'TIFIA' for details), although this comes with a slew of conditions.

The DOT's report on PPP, which uses a deliberately broad definition, has called for an increase in the amount of tax-exempt funding available as private activity bonds to support highway construction – up to $15 billion. Such funding would provide an attractive source of municipal finance, although the bill has yet to clear both houses of Congress, since it is still in front of the Senate.

Virgin territory

The states have been working hard to comply with the FHWA's stipulations, one of which was the Special Experimental Project-14 requirement, a process that was used to promote innovative practices in contracting. This process was one that the TxDOT went through, although the pathfinder in this respect was Virginia, which began its PPP process in 1995.

The ten years since the state's Public-Private Transportation Act (PPTA) have provided small encouragement to developers in the state. According to Barbara Reese, CFO at the Virginia DOT, "we've had 40 proposals from the private sector in the ten years since the Act, but only one that included equity finance."

The one proposal that has emerged that resembled a European PPP was from Fluor Daniel, which proposed an element of private equity for the I-495 Capital Beltway HOT Lanes project in a submission from September 2003. "It has proposed to put in 15% of the cost in the form of equity, although we don't yet know whether the final agreement will resemble a concession," says Reese.

Reese says that she doesn't know whether the relative scarcity of proposals before now was a function of the legislation or the appetite of investors, but says that "one huge factor in the current interest of non-US developers has been the value of the dollar." While the current relative values of the dollar and its peers cannot be assumed for the length of a road concession, they make development activity a great deal cheaper.

The Capital Beltway HOT lanes project would involve the addition of extra lanes to a 14-mile segment of the Capital Beltway, from north of the Springfield Interchange to north of the Dulles Toll Road. These high-occupancy toll (HOT) lanes would be free to carpoolers (commuters and other commuters that share a journey by car), buses and emergency vehicles, while cars carrying only one or two people would pay a variable toll to use the lanes.

The financing proposal (which is available at the following web address: http://www.virginiadot.org/projects/resources/I495_20020229021_Tab3.pdf) is fairly detailed, and sets out a schedule of sources of funds for the $764 million project, of which $120 million would be TIFIA subordinated debt, $363 million would be senior tax-exempt bonds, $177 million would come from local government investment, and $92 million from equity.

However, the proposal would involve the transfer of the road to the state upon completion, in part because the structure would allow any debt issuer to pledge toll revenues to bondholders, a key factor in raising debt without enhancement. Bear Stearns is advising Fluor on the plan, which has been approved by VDOT, although Reese stresses that the state and developer are still working out a detailed proposal.

The timing of the approval, which went through as the Skyway debt went into syndication, is largely coincidental. "We didn't see too many surprises in what happened in Chicago, apart from the price, obviously, although as far as I can tell from their briefings that even surprised Goldman Sachs [Chicago's adviser]."

Moreover, the strength of the bank market's response has not been a large factor in the process. "To be honest, from where I'm sitting, the costs are so large that you're going to see a combination of sources," says Reese. She does say, however, that "there isn't more than a 100bp gap between the cost of municipal and bank debt."

The Capital Beltway proposal is not the first to incorporate some kind of HOT land element, since the $130 million SR91 in California included an express land element. That section however, while initially privately financed, cost the state $207.5 million to buy back in 2002. Such lanes are notoriously difficult to forecast, since striking the right balance in toll levels is key, as is predicting the base levels of high-occupancy traffic. Exempt vehicles would contribute to the degradation of the road without contributing to its upkeep, Fluor's proposal that the Capital beltway project be subject be subject to a separate maintenance contract is understandable.

That said, Virginia's experience with private transportation finance has been broadly favourable – the Route 895 Pocahontas Parkway came in $10 million under budget and was financed through a not for profit 6320 corporation set up by Fluor and Morrison Knudsen, which issued $324 million in bonds and was complete in 2002. The Dulles Greenway, and entirely private facility, has had a more mixed history, but is now on a firmer footing.

The Western front

States further west are also experimenting with PPP structures, in particular Colorado and Oregon. Colorado is experiencing some difficulties in passing legislation that would make private tolling arrangements easier. House Bill 1080 was largely designed to make it easier for the developers of the Front Ridge Toll Road, a freeway around Denver that has been 19 years in development, to negotiate rates. But opposition to the eminent domain (or compulsory purchase) powers that the developer would likely have to use to secure rights of way was a large factor in the controversy.

Oregon, on the other hand, is just embarking on a wide-ranging PPP programme, and is keeping its options wide open. Its DOT has established an innovative finance unit to promote PPP in the state, as part of the Oregon Innovative Partnerships Program, which was approved in 2003 by the state's legislature.

The department has a wide degree of latitude in pursuing new projects, since it remembers the fate that befell the Tacoma Narrows project in Washington State, which began life as a PPP, and ended as a design-build contract. Tacoma (for more details search www.projectfinancemagazine.com), was proposed by Bechtel as a concession, but repeatedly modified by the state's legislature.

Oregon does, however, need to gain federal approval, under the latest version of the Special Experimental Project, SEP-15. According to Jim Whitty, who is manager of the office of Innovative Partnerships and Alternative Funding, "we're planning to do solicited procurement for three projects, and we're seeking approval to go beyond the federal procurement guidelines. We could dispense with it, but that would mean dispensing with the possibility of raising federal funding."

The Oregon process is likely to follow that for Texas, albeit on a smaller scale, in that the DOT is pursuing a development project that could emerge as a fully-fledged concession at a later date. It will send out requests for proposals on three concessions on 29 April 29, or as soon as it receives SEP-15 approval.

The three projects for which ODOT is looking for PPP solutions are Sunrise, South I-205 and Newberg-Dundee, of which the first two are located within metropolitan Portland, and the last to the southeast of the city. All have, according to ODOT, strong justifications and solid traffic potential.

"We're at an early stage here," stresses Whitty, "and want to try and draw on the entrepreneurial skills of the private sector as much as possible. Several states have said that they don't want anything more to do with PPP, but we're still examining the options." Among them might be a 6320 corporation along the lines of that pioneered by VDOT.

Whitty says that he has been in touch with most of the major US construction players and municipal finance underwriters, but he has also seen presentations from Cintra, Skanska, Macquarie and Depfa. In this regard, the proximity of Oregon to British Columbia province in Canada, a current hotbed of PPP, has been a bonus, although BC market leader ABN Amro has apparently not yet ventured south.

The projects are likely to have capital costs on the hundreds of millions – the 11-mile New Dundee project could cost up $350 million, while the other stretches have not received their environmental permits and could end up costing more or less, depending on their final scope. The office will hold a conference on 3 May, and keep the RFP open for 120 days, after which it would start negotiating a development agreement.

Oregon is keeping an open mind about funding options, and has even examined the use of shadow tolling options, although Whitty stresses that the revenue stream would likely be a third party with a commercial interest in the road, for instance a casino in a more remote part of the state that would like a route to run to its property. Such an arrangement would have the additional advantage that casinos are usually in a strong position to know how much revenue they can extract from their visitors, and so negotiate shadow toll levels accordingly.

But the impression that emerges from the above rough survey indicates a thawing of sentiment towards, and certainly a rapid increase in awareness of, PPP at the state departments of transport. It does not yet indicate that there will be large-scale opportunities for equity, although the valuations that European players will attach to assets make them more likely. Moreover, those opportunities where private sector participation has been most marked, in HOT lanes, is that area where life-cycle costs are hardest to calculate.

But the attitude of federal and state authorities to procurement processes that would favour the emergence of European PPP concessions is warmer. In fact, if state DOTs follow through on their promises to act more creatively, then Cintra's second PPP gambit, TTC-35, will be more influential than the Skyway. Given the sums that Texas alone is mentioning for highway improvements, the trend in US PPP is clearer than ever before.

BOX

Dulles Greenway: That was then...

The easiest way to upset a US municipal finance banker is to suggest that PPP is an entirely new way of financing roads. Many of them protest that private toll roads, some of them fairly large, have been around since the 1800s, many of them with minimal state involvement. But most of them have since been taken into state hands, and the remainder have experienced bumpy operational histories.

One good example is the Dulles Greenway project, which was recently financed, and was promoted in Virginia under an entirely different legislative framework. State involvement in the Greenway is limited to control, via the Virginia State Corporation Commission, over the toll rates charged to drivers – land procurement and permitting was the private sector's problem.

The problems, however, started after the 14km toll road opened in 1995, and experienced problems stemming from slow traffic growth and high toll levels. It was the subject of a 1993 financing that consisted of $258 million in fixed-rate notes placed with institutions and with three banks (Barclays, NationsBank, and Deutsche Bank) providing construction debt and a $40 million revolver.

This was restructured in 1999, the lenders accepted 90% of their principal, and since then traffic and toll levels have both edged upwards. The refinancing consisted of $35 million in outstanding series 1999A senior lien current interest bonds,

$282 million in outstanding series 1999B senior lien zero-coupon bonds, and $127.5 million in subordinated lien zero-coupon bonds, all led by Bear Stearns.

The new refinancing retires this last tranche, and funds construction of a third lane on the Greenway; the design for adding a fourth lane; interchanges at exits 2 and 3; an access ramp at Dulles International Airport; improvements at interchange 8; and improvement of the existing mainline toll plaza. It will also fund a $69.6 million cash distribution to the equity partners, credit enhancement fees and other costs of issuance.

The new financing consists of two series of callable senior zero-coupon bonds, a $162.5 million 2005A series and a $53.7 million 2005B series, and a $174.4 million in senior zero-coupon 2005C series. The bonds, underwritten by Bear Stearns, feature a monoline wrap from MBIA, and closed on 17 February. The project sponsors are Kellogg, Brown & Root (part of Halliburton), AIE LLC, and the Bryant and Crane families.

The key factor in the success of the refinancing, which gained a BBB underlying rating from Fitch, was the recognition at the state authorities that the Greenway's project company – Toll Road Investors Partnership II – would be allowed to extend its toll-raising authority by 20 years to meet its financial obligations. The move suggests that state authorities have become much more willing to ensure that private sector partners earn a solid return on investment.