SR125: the US PPP bridgehead?

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Macquarie Infrastructure Group (MIG) has closed financing on the $639 million SR125 toll road in southern California. The deal marks the first time that a European-style toll deal has been attempted in the United States. If the deal successfully syndicates, and Congress manages to pass a new raft of incentives legislation, the tax-exempt infrastructure market could face its sternest challenge yet.

The SR125 is one of four projects authorized by the Californian State Legislature under Assembly bill 680 (AB 680), which encourages the development of privately funded projects that would be state-owned, but leased back to developers. Four roads gained explicit authorization, SR91, the SR125, and two others, which are now dormant. The SR91 road is now in the hands of the State, and is not considered a useful model for the financing to follow.

The initial sponsors included Parsons Brinckerhoff, EGIS and Fluor. Aside from EGIS, the group was less interested in the project as a long-term earner, but more as a source of construction contracts. As is typical in the US construction industry, there was little interest in a true public-private partnership deal, and little willingness to put up the equity required. Along came MIG, which began evaluating the road two years ago and liked what it saw.

The road runs between State Route 905, close to the Otay Mesa port of entry with Mexico, and State Route 54, in Spring Valley. But the 9.2-mile road, located in San Diego County, is best understood as a commuter route for the city of San Diego. It has four lanes, and as MIG CEO Stephen Allen points out, ?the road has been part of California's planned freeway system since 1959.?

MIG needs to earn a high and consistent rate of return to attract investors, and usually hunts down toll roads in developed countries with few restrictions on the level of toll that the operator can charge. The biggest difficulty it faces is ensuring a regular repayment on newbuild roads during the construction phase. Bank debt, in this regard, tends to be more flexible.

The other significant innovation on the deal is that it is the first use on a wholly private deal of money mandated under the Transportation Infrastructure Finance and Innovation Act (TIFIA) of 1998. TIFIA money comes with strings attached, most notably the requirement that a project's senior debt is investment grade. This is important, since the TIFIA loan is subordinate to the project under most circumstances and does not require repayment of interest for the first five years.

The TIFIA money, therefore, is layered over the $164 million in equity put up by MIG, which bought out all of the sponsors (and owns 10% of EGIS). MIG has now restructured the deal and tied in Fluor, joined by Washington Group, to fixed-price, turnkey contracts. A further $138 million comes from the San Diego Association of Local Governments, which goes towards the construction of connecting roads at the ends of the concession.

But MIG, advised by Macquarie Corporate Finance, also had to cope with the almost complete absence of competent US banks from the project business. Given the lengthy tenors that MIG would require to make its investment economic, US lenders were even less likely to be interested. As a result the financing has become an opportunity for European banks with a public finance backgrounds to demonstrate their credentials.

The two mandated leads are Banco Bilbao Vizcaya Argentaria (BBVA) and DEPFA Bank. The former has a record of financings of European toll road financings, and was a leading light of the first incarnation of the Mexican roads programme, and has gained some recent refinancing mandates. DEPFA has been making a concerted push into the United States, and has announced plans to set up a monoline to compete in the US public finance market. This mandate is a bet that at least parts of the European experience will be applicable to the US. Abbey National, which worked with MIG on the Birmingham Northern Relief Road in the UK, was originally slated to lead along with BBVA, but the sponsor scrambled to find a new arranger after Abbey decided to depart the wholesale lending business.

The commercial bank loan ? $400 million in total ? has a tenor of 18.5 years. This consists of a 3.5-year construction period, a four-year interest-only period, including an 18-month stabilisation period, a partial cash sweep for three years, and then eight years with a full cash sweep. The incentive will then be in place for a bond financing. If current US infrastructure market conditions persist, pricing anomalies will make monolines, particularly DEPFA's putative outfit, prime candidates. Upon completion, MIG will put in the majority of its roughly $170 million in equity ? only $30 million goes in upfront, with a further small portion injected during construction.

The deal will probably need to be priced off European road deals, since no benchmark exists, and will have to find a medium between the wafer-thin spreads on UK deals and the high interest rates common in, say, Eastern Europe. Nevertheless, sources at the mandated leads anticipate a syndication stretching out over the middle of the year. Certainly, the credit story will take a deal of explaining.

The economics of the road are solid, and the project has received safe, though undisclosed, investment grade ratings from Moody's and Fitch, as TIFIA requires. Electronic tolling will be a large component of revenue, existing freeways are congested at peak hours, and tolling has been accepted on several Californian routes. MIG estimates that the internal rate of return on the project will be between 15% and 20%, based on how well the traffic forecasts hold up.

The deal will be hailed by those pushing a PPP route in the US as a great leap forward. Certainly, there are several upcoming TIFIA projects that might benefit from the solution pushed by European banks. But political and fiscal realities will mean that the tax-exempt market still has the upper hand. Municipal transport treasurers that Project Finance has spoken to in the past say that they will consider hybrid solutions, but only if the tax-exempt market has been exhausted. Despite pressure on state budgets and credit ratings, this is still far from the case.

San Diego Expressway
Limited Partnership

Status: Closed 23 May 2003, in syndication

Size: $642 million

Location: California

Description: 9.2-mile toll road linking Chula Vista and San Diego

Sponsor: Macquarie Infrastructure Group

Debt: $140 million TIFIA loan, $400 million commercial bank debt

Arrangers: BBVA, DEPFA

Tenor: 18.5 years

Financial advisor:
Macquarie Corporate Finance

Lawyers to the borrower:
Milbank Tweed Hadley & McCloy, Nossaman Guthner Knox & Eliot

Lawyers to the lender:

Orrick Herrington and Sutcliffe