STATE OF NORTH CAROLINA
21ST CENTURY TRANSPORTATION COMMITTEE

The Role of Public-Private Partnerships in Delivering Transportation Projects

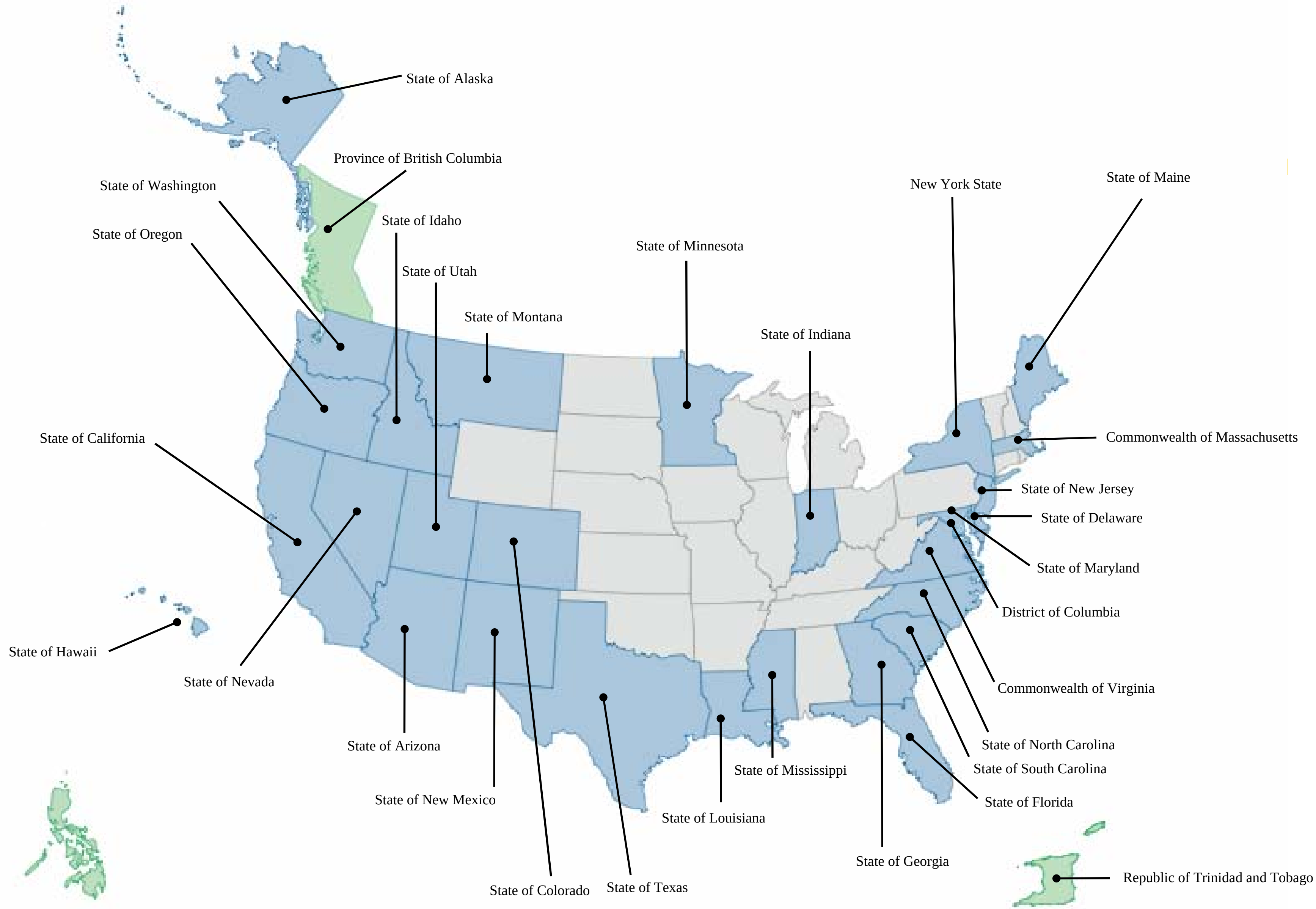
February 21, 2008
Wilmington, North Carolina

KAREN J. HEDLUND
NOSSAMAN GUTHNER KNOX & ELLIOTT LLP

Nossaman Infrastructure

- Law and consulting firm specializing in innovative procurement, contracting, and financing of large infrastructure projects
- Honored to work for more than 30 State DOTs and regional transportation authorities around the country
- Projects include most of the large signature projects other agencies seek to emulate
- Special counsel to North Carolina Turnpike Authority

Nossaman Infrastructure Clients



Where do PPPs work best?

- Form of relationship with private sector should be dictated by the projects needs and characteristics
- PPPs embrace a wide variety of contractual relationships
- Concessions: “Greenfields” vs “Brownfields”
- Key variables:
  - Project Definition
  - Work Responsibility
  - Risk Allocation
  - *FUNDING*

Forms of Public-Private Contracting

Design-build-operate-maintain
with tax- exempt financing
– <u>no</u> private equity

Long-term concessions for *new* projects
- private funding or
private + public funding

Concessioning of existing
assets (Skyway, Indiana)

Parties at the Table

- Equity Participants
  - Integrated Transportation Companies (Transurban)
  - International Construction Companies (Dragados, Cintra)
  - Funds (Macquarie, Carlyle**)**
- Lenders
- Design and Construction Companies
- Operating Companies

1. Traditional Procurement Tradeoffs

<u>Advantages</u>:

- Government maintains total control over design
- Competitive initial construction cost
- High transparency and low political risk

<u>Disadvantages</u>:

- No guarantee of lowest ultimate price
    - Limited cost control over design process
    - “Overdesign”
    - Exposure to change orders
    - Life cycle cost no taken into account
- 100% public funding

2. Design-Build Contracting + *Private* Operation (DBOM)

Advantages:

- Long-term performance risk shifts to the contractor
- Fixed fee for operations
- Incentives to minimize life-cycle costs

Disadvantages:

- Agency retains revenue risk
- Need adequate remedies if contract terminated early
- IRS bond rules limit financial incentives to contractor

3. Delivery of New Projects through Long-Term Franchises/Concessions

Advantages:

- Large, new sources of capital
- Minimizes dependence on public revenues
- Developer assumes more environmental and development period risk
- Developer asssumes traffic and revenue risk

Disadvantages:

- For-profit entities require taxable financing – PABs now available
- Less public control over operations
- Limits on rates and charges must be set by contract

4. Delivery of New Projects through Long-Term Franchises/Concessions (cont.)

Other Considerations:

- Political risk if “bad deal”
- Limit on return on investment?
- Confidentiality needs vs transparency
- Length of term - 35, 50, 65, 99?
- How adjust for unanticipated changes
- Need for “gap” funding

5. Monetization of Existing Assets through Long-Term Concessions

Advantages:

- Large, new sources of capital to fund other projects
- Private sector assumes long-term revenue risk and O&M burden

Disadvantages:

- Future rates and charges may be higher than if asset retained in public ownership
- Public share in future net revenue gains is limited
- Difficult contractual issues

Concessions: Key Public Sector Objectives

- Effective Competitive Procurement Methods
- Maximize Private Sector Investment and Risk Sharing
- Limited Public Financial Exposure
- Reasonable Tolling Structure and Profits
- Opportunity for Revenue Sharing
- Quality Design, Construction, Operation and Maintenance
- Effective Assurances of Performance
- Effective Remedies

Effective Competitive Procurement Methods

- **When and How to "Marry Up"**
  - "Hard Money" PPP – Characteristics:
    - Public partner defines project
    - Clears it environmentally
    - Achieves public consensus on project and PPP
    - Validates financial feasibility
    - Sets toll rate schedule
    - Develops complete business and contract terms, technical specifications

Effective Competitive Procurement Methods

- **"Hard Money" PPP - Nature of Competition**
  - Competing hard money bids
  - Selection primarily a price competition
  - Qualifications submittal and short listing
  - Proposer assembles design, construction, O&M pricing and forces
  - Proposer delivers firm equity/debt commitments

Effective Competitive Procurement Methods

- **“Predevelopment” PPP – Characteristics:**
  - PPP formed at beginning or during environmental process
  - Complex, large development project
  - Project configuration fluid
  - Finance plan rudimentary or non-existent
  - Preliminary T&R analysis done and suggests financial feasibility

Effective Competitive Procurement Methods

- **“Predevelopment” PPP – Nature of Competition:**
  - Selection is qualifications and “concept” based
  - Successful work earns exclusive right to negotiate concession agreement

Limited Financial Exposure

Objective: reduced capital expenditure, reduced exposure to claims from unanticipated events

- 100% private financing – financial model indicates toll revenues fully pay debt and return on equity
  - No public capital needed
  - Up-front cash payment or share in revenues
  - *but most projects have a gap*
- Mixed private/public financing –public sector financial contributions needed to fill gap

Limited Financial Exposure

No single formula for risk sharing – project specific

- **Revenue risk**
  - Real toll concession – no public sector revenue risk
  - Availability payment concession – public sector takes revenue risk
    - Public sector controls tolls and throughput
  - Shadow tolls – no tolls, but contract payments based on traffic
- **Other risk transfers**
  - Cost escalation
  - Differing site conditions
  - Hazardous materials management/remediation
- **Shared risks**
  - Change in law
  - Force majeure

Reasonable Tolling Structure and Profits

- **Public sector needs:**
  - Maximize its upfront income or long-term revenue share?
  - Minimize toll rates?
  - Prevent excessive profit?
  - Manage traffic demand and congestion?
  - Depoliticize setting toll rates?
  - Toll exemptions for critical public purposes?

Reasonable Tolling Structure and Profits - Tools

- Indexed toll rate schedule – caps future toll rates,
- Use of stated caps or inflation indices (CPI)
- Banded revenue sharing – generates public partner revenues, prevents excessive profit
- Examples:
    - Pocahontas: 40% of real net cash flow after IRR on total investment = 6.5%; 80% after IRR=8.0%
    - Segments 5 & 6: 4.65% of gross revenue until IRR on equity = 11%; 9.3% of next band of gross until IRR = 15%, 50% of all further gross

Quality Design, Construction, Operation and Maintenance

- **Issues**
  - How can public partner assure quality?
  - Operation and maintenance standards?
  - Major rehab and restoration?
  - Capacity enhancements, tech'y upgrades?
  - Operation within regional network?
  - Congestion pricing?
  - Interoperability?

Quality Design, Construction, Operation and Maintenance

- **Tools**
  - Performance-based measures and standards – specify outcomes, and inspections to measure outcome achievement
  - Regular reports by private partner to determine and maintain asset condition
  - Financial audits, monitoring, spot testing and inspection
  - Renewal and replacement scheduling and reserves
  - Handback requirements

Effective Assurances of Performance

- Lender skin in the game
- Bonds from design-build contractor
- Guarantees from parents of design-build contractor, O&M contractor
- Letters of credit for specific obligations – routine O&M; renewal and replacement work; handback work
- Reserves

Effective Remedies

- Scale remedies to the type and severity of breach
- Liquidated damages – for delayed completion, noncompliance with routine covenants
- Step-in rights, including receivership
- Anticipatory breach and assurances of future performance for persistent default
- Termination for major uncured default
  - Lender rights to notice and cure

Manage for Success

- Bring in experts that have “been there, done that”
- Obtain knowledge of the market
- Develop internal expertise
- Obtain public buy-in
- Start with one, suitable project to learn the process

Contact

Karen J. Hedlund, Esq.

Nossaman Guthner Knox & Elliott LLP

2111 Wilson Blvd.

Suite 600

Arlington, VA 22201

Phone: (703) 351-5010 Fax: (703) 351-9506

khedlund@nossaman.com

www.nossaman.com

Nossaman
Guthner Knox Elliott LLP