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Concession arrangements in US transportation PPPs

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In the past year, private participation in the US transportation sector through public private partnerships has increased significantly—the recent successful closings of the \$3.8 billion Indiana Toll Road concession and lease and the acquisition by a private party of the Pocahontas Parkway tolling, operation and maintenance rights in Virginia reflect the increasing momentum in this market, as does the rapidly increasing availability of equity capital for PPP projects. This article discusses risk allocation between the public sector and private sector parties in concession arrangements for these types of transportation projects.

The legal foundation for PPPs in the US transportation sector principally consists of state or municipal authorising legislation and associated contractual arrangements between a public authority and private participants. Whether such legislation authorises “concessions”, “leases”, “development agreements”, “comprehensive development agreements” or “facility concession agreements” with respect to either existing or newly constructed transportation assets, the underlying concept fundamentally is a concession—the right to toll users (or to receive availability payments) in respect of a transportation asset for a period of time in return for performing

construction, operation, maintenance and related obligations.

Each state (and approximately 21 states have passed some kind of authorising legislation) or municipality pursuing PPPs can be expected to develop its own template for PPP “concession” contracts with private participants. These contractual arrangements may be very specific in nature and address rights and obligations of the parties for a particular asset; or they may be more generic, as in the case of a “master” development agreement setting out the framework for the construction of a new transportation corridor, with additional specific agreements to be concluded at a later date. However titled, the concession agreement template will reflect the parameters set out in the authorising legislation and the risk allocation that the public transportation authority proposes as the basis for private participation. In the case of a bidding process for existing transportation assets, as in the Chicago Skyway and the Indiana Toll Road PPPs, it would not be unusual for bidders to have the opportunity to review and comment on the form of concession agreement prior to bid submission. Earlier in 2006, the Texas Department of Transportation also circulated a draft programmatic term

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sheet for comprehensive development agreements in Texas for comment by market participants.

Risk allocation in the concession contract is a key factor in the valuation of concession rights by potential private sector participants. For states and municipalities, therefore, an appropriate risk allocation will help maximise net proceeds from transportation PPPs, while also furthering the public policy goal of transferring risk to the private sector.

In US transportation PPPs, broad categories of risks typically addressed in concession arrangements include (i) risks relating to revenue generation, (ii) risks relating to operations and maintenance and potential for increased costs, (iii) risks relating to governmental action and force majeure, (iv) termination risk and counterparty payment risk, and (v) dispute risk.

Risks Relating To Revenue Generation

The PPPs relating to existing tolled transportation facilities that are leased to private sector participants have typically placed traffic risk (i.e., market risk) on the private participant. Accordingly, analysis of historical traffic patterns and projections prepared by traffic consultants are fundamental tasks for private sector participants. Tollsetting discretion also typically is granted to the private operator, subject to maximum toll parameters and specified indices for toll increases in later years (e.g., GDP, CPI). Revenue-sharing with the governmental counterparty also may feature in the mix. Even with agreed toll schedules and formulae, the long-term nature of these concessions (50 – 99 years) can make valuation of the concession rights a very complex exercise.

An alternative to market risk is an availability-based payment formula whereby the state or municipal counterparty absorbs traffic risk and pays the private sector operator for making the facility available and maintaining specified service levels. This approach is proposed in the pending Miami Port Tunnel project in Florida. In this regard, and similar to termination payment risk discussed below, private sector operators will focus on counterparty credit risk, e.g., whether the public authority acting as the

contract counterparty has the full faith and credit of the applicable state or other source of funding.

Competing transportation facilities pose risk to revenue generation. In the US, following the buy-back of the SR 91 toll lanes in California from the private operator due to a non-compete provision, protection against competing facilities (the definition of which is subject to negotiation) has tended to take the form of monetary compensation for demonstrated adverse revenue effects, rather than an outright prohibition against the construction or improvement of competing facilities. Other risks to be allocated include risks associated with connecting facilities, such as toll levels on an interstate connecting with another state.

With respect to other revenue-generation opportunities, for example, real estate development, advertising, telecommunications and ancillary transportation services such as gas stations and restaurant facilities, concession arrangements are very project specific. Whether to reserve these types of activities to the state or municipality in a particular concession is a case by case analysis.

Risks Relating To Operations And Maintenance And Potential For Increased Costs

Operating and maintenance risk is a key risk that is generally transferred to the private sector operator. Public authorities have focused heavily on including detailed operating and maintenance standards in PPP concession arrangements to provide assurance to users that high quality service will be provided in exchange for payment of the toll or user fee. In addition, if over time levels of service decline due to congestion, the public authority may seek to include an obligation of the private operator to build additional lanes to improve service levels, provided sufficient right of way is available and extraordinary construction, such as overpasses or flyways, is not required.

If the private operator is taking over an existing transportation facility, it would not be unusual for the public authority to provide transitional

personnel or other operational services during an agreed period following the transfer of operational responsibility. Public authorities generally reserve the right to access the facility for inspections, to address emergency situations and to perform remediation or other works for which it has retained responsibility. This may include responsibility for adverse environmental effects due to conditions existing prior to the handover of operational responsibility to the private participant.

In line with more traditional procurement practices, the public authority may seek to include a bonding requirement for the private operator to provide prompt recourse for service deficiencies.

Police and enforcement powers are generally reserved to the public sector; however, operating costs of the facility may include reimbursement to the public sector of the costs of providing this service.

Public authorities typically are permitted to change operating standards to conform to applicable law or other generally prevailing operating standards. The risk of increased costs arising from these types of changes is generally borne by the operator; however, the private sector is not expected to bear the risk of “discriminatory” changes that are analogous to adverse governmental action. Public authorities also generally retain the right to require the operator, at the public sector’s cost, to implement further improvements designated by the authority requiring additional construction works. The public authority may seek to recover a portion of the costs of such works from the private sector operator if it can be established that the improvements increased traffic on the facility.

It is not unusual for the relevant authorising legislation to provide that the privately operated transportation facility is exempt from state or municipal property taxes, sales or use taxes, and similar charges. As these types of costs fundamentally affect project economics, private sector participants pay close attention to the risk of these types of taxes and other fees in the evaluation process.

Risks Relating To Governmental Action And Force Majeure

A private sector operator is not expected to bear the risk of arbitrary or discriminatory governmental action. Conversely, the state or public authority may only be willing to bear these risks with respect to entities over which it can exert control. Hence, public authorities are generally willing to accept responsibility for actions of state and local governmental authorities, but may not be willing to accept responsibility for actions of US federal authorities or changes in federal law. Appropriate allocation of this risk depends in part upon whether federal regulation has a significant impact on the transaction.

Adverse governmental actions can include, for example, discriminatory taxes or other charges or revised operating standards imposed in a discriminatory fashion (whether solely to the relevant facility or to private sector operators generally in the jurisdiction). Failure to permit toll increases in accord with the regime set forth in the concession contract would be treated as a breach of contract regulated under the default provisions of the contract. If an adverse governmental action were to occur, the private sector operator generally would be entitled to compensation and may be entitled to terminate the concession and receive a termination payment.

Force majeure risk, insofar as it may result in increased costs or reduced revenues, generally is borne by the private operator. It would not be unusual, however, for the private party to be entitled to accommodations such as the right to extend the term of the concession for the period of the force majeure event or to increase tolls or user charges to compensate for any increased costs arising from the force majeure event (assuming agreed upon insurance is also in place).

Termination Risk And Counterparty Payment Risk

Private sector operators generally bear the risk of termination for default, after appropriate cure periods (including lender cure periods and substitution

rights). Termination in this event may or may not result in a termination payment to the private sector party. If not, providers of debt financing will expect to have the right to replace the operator (subject to certain approval rights of the public authority) and, if the concession has been terminated, to enter into a new concession arrangement for the remaining term of the previously existing concession to provide some certainty that cash flows will continue to be available to service debt. In the case of default by the public authority, a termination payment equal to the fair market value of the concession is not unusual (and lenders may require express acknowledgment that such payment will not in any case be less than outstanding debt and associated financing obligations, such as hedge termination costs).

Termination for convenience by the public sector is typically strongly resisted by private sector participants. Notwithstanding that a termination payment is payable by the public authority for any such termination, the degree of work and effort required to participate in the development of these projects, and the long-term business planning associated therewith renders termination for convenience an unsatisfactory outcome. Conversely, public authorities may determine that the public policy parameters within which they operate require a flexible exit and hence require such a provision as a condition to private sector participation.

A corollary to the inclusion of a termination payment is the creditworthiness of the party obligated to make payment. Hence, the credit standing of the relevant public authorities in the states, and whether they are entitled to the full faith and credit of the state, is typically assessed. Even if a claim is available against the public sector, the risk of the legislative appropriation process is an added consideration (which has been analysed in the municipal bond markets in the US for many years). In addition, whether or not immunities from suit are applicable or can be waived is a threshold inquiry.

Dispute Risk

PPPs in the US bring together private and public parties with differing perceptions and experiences of dispute resolution. Both parties may be willing to include informal procedures for some period of time and to resolution of technical disputes by experts. With respect to basic contract disputes, however, public sector parties may be accustomed to administrative proceedings within their respective departments for formal determination of claims or other disputes. In essence, this is a follow-on from their experience as public agencies dealing with private construction or service contractors. Private parties investing sizable sums of equity in PPPs and arranging for accompanying debt financing, on the other hand, will want to ensure that an independent tribunal ultimately has the authority to resolve disputes. Hence, a significant amount of time can be spent accommodating these diverse perspectives. Arbitration is one common forum for dispute resolution, as is adherence to a public agency's dispute resolution process subject to appropriate access to state courts to challenge an administrative determination.

It is clear to date, however, that private sector participants in PPPs will not accept a process that ultimately provides discretion to a public official to determine the outcome of fundamental claims (e.g., whether or not a concession should be terminated).

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