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Midtown Tunnel, Virginia, US

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The financial close of the Midtown Tunnel last month brought to an end an eight-year procurement process and, as the first P3 to close in the US this year, cemented Virginia's reputation as the leading state in P3 procurement.

Project Background and Procurement

It was in May 2008, four years after a request for information and after various studies, that Virginia Department of Transportation announced it was seeking conceptual proposals' for a project to rehabilitate the Midtown and Downtown Tunnels, build a new tunnel next to Midtown, and extend the Martin Luther King expressway. Only one response arrived in September – the Elizabeth River Crossings consortium of Skanska and Macquarie. At the time, VDOT had no grant funding on offer and expected the whole project costs to be repaid by toll revenue.

The project was halted in February 2009 while a panel of commonwealth officials considered the bidders' capacity to deliver it, but at the end of June the panel announced their approval. It was in January 2010 that ERC signed an interim agreement VDOT under which they would prepare a feasibility study, structure the project, set toll rates, carry out preliminary engineering work and generate cost estimates to feed into the comprehensive development agreement to be signed with VDOT. The sponsors were effectively starting from scratch in developing the project.

Christopher Voyce, senior managing director at Macquarie, notes: "The interest thing to us was seeing how VDOT was able to manage the "competitive negotiation process" quite well. We felt under price pressure as we would in a bid situation."

Among VDOT's concerns was keeping toll rates down on the crossings. This, along with the pure demand risk structure, saw the authority agree to request a TIFIA loan from the US Department of Transportation and to provide about one-sixth of the project costs in subsidy. With long tenors and low pricing, roughly equivalent to US Treasury bonds, the loans are hotly contested among states seeking to fund new transport infrastructure. The loans are subordinated except in the event of default, when a springing lien gives them senior debt status.

In July 2011, IJ News revealed that the project was one of four actual or potential P3s that had been pre-approved to bid for a TIFIA loan, helping to resolve negotiations over how low toll rates could be kept. Andrew Ancone, managing director at Macquarie, says: "Could we have closed the deal without TIFIA? I think the answer's yes, though it would have to have been a different deal in terms of toll rates and public subsidy. The benefit of TIFIA was to provide a more affordable project for both users and VDOT."

Financing and Risk

Around the same time, the sponsors were tapping the bank debt and bond markets in search of a financing solution for the project. The US DOT would want long-dated debt to approximately match the tenor of the TIFIA loan. Even with an expected US$422 million of TIFIA debt, the envisaged capital structure required over US$600 million of senior facilities.

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The preferred solution was not long in doubt. Banks were offering less than one-third the tenor of the capital markets.

Christopher Voyce recalls: “It was at that point that it was clear to us that there wasn’t sufficient available bank capacity at the tenor we were seeking for us to pursue a bank financing.” He adds: “With the bond transaction we achieved a tenor of 30 years, with an option any time after 10 years to refinance. Having that certainty of tenor was very important to the TIFIA office and was not something the bank market was able to offer. Given that the tenors offered in the bank market were significantly shorter, banks were concerned about the need to refinance, shortly after opening the new Midtown Tunnel, rather than on the strength of the long-term cash flows.”

In December 2011, ERC signed a comprehensive development agreement with VDOT encompassing the capital structure and risk allocation with which financing would be arranged. The deal envisaged the following funding arrangement:

- US$362 million subsidy from VDOT
- US$422 million TIFIA loan
- US$1.7 billion private debt, equity and future revenue from operations

As part of the deal, the two parties agreed to split the financing risk between the signing of the agreement and financial close. Any increases in TIFIA or bond all-in rates would result in an increase in the public subsidy according to an agreed formula. Similarly, any decreases in TIFIA or bond rates would result in a decrease in the subsidy. In the event, the private activity bonds would come in at a lower than expected margin, reducing the public sector contribution from US$362 million at commercial close to US$309 million at financial close.

A revenue sharing arrangement was also agreed, under which VDOT shares toll revenues with the sponsor on a sliding scale if traffic and revenue exceed a forecast case.

The project would take a further four months to close, partly due to waiting for the TIFIA loan to become available. Finally in April the sponsors were ready to launch a US$675 million private activity bond issue. It was rated BBB- by Fitch and Standard & Poor’s, reflecting the demand risk structure and a prediction by the latter that the ramp-up period would be longer than their base case. The TIFIA loan, which had come in at US$422 million as expected, had the same rating.

The deal priced rapidly and investor appetite was strong; the bonds were oversubscribed by between 3.5 and four times. With pricing thus tighter than expected, the final shape of the deal required a smaller amount of PABs and grant funding: US$663.75 million and US$309 million respectively. A breakdown appears below.

ERC provided about US$221 million of equity, plus a contingent equity contribution of a US$50.6 million letter of credit during the construction period. This protects construction and reserve funds in the event of traffic underperformance on the existing tunnels.

The design and build contractors are a consortium of Skanska (40 per cent). Kiewit (45 per cent) and Weeks Marine (15 per cent). Skanska and Kiewit will provide construction guarantees on a joint and several basis up to 45 per cent of the contract amount, approximately US$640 million.

According to a report by Standard & Poor’s, the minimum DSCR is 1.32x and the average is 1.78x across all facilities, or 1.65x average during the senior debt's term. A base case analysis by Fitch shows average DSCR on the senior bonds of 2.24x; average total coverage during the life of the senior bonds is 1.81x.

VDOT announced recently that they would postpone tolling on the tunnels until January 2014. Instead the state will pay US$100 million to the sponsors to cover the anticipated revenue. A Macquarie spokeswoman said they do not expect this to impact debt service coverage.

Project legacy

As the inaugural US P3 of the year, the Midtown Tunnel bodes well for the capital markets’ ability to finance projects efficiently, and reflects badly on the state of bank debt for the same projects. The spreads on the bonds compare

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favourably to the Denver FasTracks Eagle P3, which Macquarie closed in August 2010, while bank tenors of less than ten years present an unacceptable refinancing risk to most sponsors, so it seems that the bank market will be eclipsed in the US as it has been in Canada, at least for the foreseeable future.

With VDOT currently consulting on future mooted projects, such as the Hampton Roads Bridge Tunnel and the widening of Interstate 64, as well as pushing on with the Route 460 P3, the state looks set to remain the centre of attention for P3 developers.

Project at a glance

Project Name: Midtown Tunnel
Location: Virginia, USA
Description: Rehabilitation and electronic tolling of the Midtown and Downtown tunnels under the Elizabeth River and construction of a new two-lane tunnel next to the Midtown Tunnel, as well as construction of the Martin Luther King extension expressway, over a six-year period, and operation and maintenance over 52 years
Sponsor: Macquarie (50 per cent), Skanska (50 per cent)
Bookrunners and bond underwriters: Barclays, Bank of America Merrill Lynch and BMO Capital Markets
Concession period: 58 years
Total project value: US$2.1 billion
Total equity: US$271.6 million including contingent equity of US$50.6 million
Total senior debt: US$663.75 million
Debt breakdown: US$320 million term bond, maturing in 2042, yield 5.5 per cent (equivalent to 215bps over municipal bonds); US$210 million term bond, maturing in 2037, yield 5.32 per cent; US$92 million term bond, maturing in 2032, yield 5.25 per cent; about US$53 million serial bonds maturing between 2022 and 2027, yield rising from 4.45 per cent in 2022 to 5 per cent in 2027
Debt:equity ratio: 80:20 (excluding contingent equity)
Financial adviser to sponsor: Macquarie Capital Advisers
Legal adviser to arrangers:
Legal adviser to sponsor: Orrick Hetherington & Sutcliffe, bond counsel Hunton & Williams
Traffic and revenue adviser to sponsor: Steer Davies Gleave
Legal adviser to arrangers: Dewey & LeBoeuf
Date of financial close: 9 April 2012

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