

# INFRA OPTIONS PROLIFERATE

WHEN THE FIRST WAVES OF THE COVID-19 PANDEMIC BROKE ACROSS THE SHORES OF AMERICAN BUSINESS, THERE WAS A COLLECTIVE FEELING THAT WE HAD SEEN THIS BEFORE – NOT NECESSARILY THE PUBLIC HEALTH CRISIS, THE LIKES OF WHICH HAD NOT BEEN EXPERIENCED FOR A CENTURY, BUT THE COMMERCIAL DISRUPTIONS AND FINANCIAL DISLOCATIONS EXPECTED TO RESULT FROM SUCH A MASSIVE SHUTDOWN OF THE ECONOMY. AS THE PANDEMIC UNFOLDED, HOWEVER, OUR WORST FINANCIAL EXPECTATIONS NEVER CAME TO PASS. BY **CHARLES G RENNER**, KANSAS CITY-BASED PARTNER AND **WILL P NULTON**, KANSAS CITY-BASED ATTORNEY, **HUSCH BLACKWELL LLP**.

Credit markets did not seize up as they did a decade prior. On the contrary, across many categories of lending and credit 2020 was a record year. The municipal bond market absorbed record levels of issuance late in the year, joining select other categories of debt in tallying fresh new highs. This dynamic proved to be highly favourable to getting more infrastructure projects into the pipeline.

Supporting these debt levels were two key factors: first, an ultra-accommodative Federal Reserve policy led to greater money creation; second, and most surprisingly, state and local government coffers did not suffer as badly as many had imagined.

A January 2021 report from Nuveen LLC, the Chicago-based money manager, remarked that “overall municipal credit conditions have held up far better than most forecasts predicted. After 11 consecutive years of robust growth, municipal government tax receipts declined only about 1% on average in 2020.”

Likewise, property tax collections surged, thanks in part to rapidly appreciating residential real estate, and while many prepared for a massive increase in defaults, these, too, failed to materialise.

To be sure, there are Covid after-effects still to be sorted out. Supply chains across many industries are a mess and have led to shortages of basic materials and semi-products that are key inputs to infrastructure projects, not to mention startlingly high rates of inflation among some product classes. But by-and-large, the financial impact of Covid was muted, and comparisons to the global financial crisis of a decade ago were off the mark.

Those fears from the pandemic’s early days, however, did lead many local and state leaders to brace themselves for the worst. As late as September 2020, a US Conference of Mayors survey found that 98% of respondents expected municipal operating budgets to decline over the next 12 to 18 months. The same survey also revealed that approximately two-thirds of US mayors believed infrastructure to be their top

investment priority post-Covid, especially projects that generate economic growth and those that expand the delivery of city services.

The US Conference of Mayors survey essentially confirmed what we had been hearing anecdotally throughout 2020: despite the pandemic, we have to find a way to get shovels in the ground on key infrastructure projects. Aside from needing a post-pandemic economic boost to restart state and local economies, the urgency is also fuelled by a legacy of underfunding infrastructure. The latest American Society of Civil Engineers’ (ASCE) quadrennial report card on the health of US infrastructure scored 11 of the 17 infrastructure categories included with a D+ or lower. While the report finally handed out an overall grade of C-, the first passing grade achieved in 20 years, clearly, there is much work to be done, especially considering the US\$2.5trn funding gap the report identified across all types of infrastructure.

## Traditional versus hybrid P3s

Our law firm’s latest Public-Private Partnership (P3) Trends Report, published in March 2021, provided an opportunity to explore how state and local entities are addressing vital infrastructure needs and how those efforts are being financed. What we found was very encouraging. Rather than waiting for a federal infrastructure bill or the return of a more placid economic environment, many state and local leaders pushed ahead with key projects, and increasingly, they turned to the P3 procurement model to move projects from the drawing board to the real world. Both the P3 project pipeline and the roster of P3 projects reaching a financial close saw record levels in 2020.

Despite Covid-19, there were a record number of P3 projects that entered the pipeline in 2020 in the pre-launch phase, both a testament to the forward-looking mindset of many state and local governments and the appeal of the P3 procurement model. Year-on-year, there was a 26% increase in new projects entering the pre-launch phase in 2020. Overall, there were 84 active P3 projects in the U.S. during 2020, a 320%

jump from 2018. While the number of projects that reached financial close only saw a modest increase, given the difficulties of the public health crisis, this has to be viewed as a positive development. Importantly, despite the vast increase in the total number of P3 projects – both active and in the planning stages – there was only a slight increase in the number of projects cancelled or placed on hold.

The roster of recently closed P3 projects in the trailing 12 months prior to the onset of the pandemic looked very similar to the recent past. Over the past few years, we had seen a diversification of P3 project types and payment mechanisms, as well as a slow but steady shift away from private equity. There were still traditional P3s being closed, like the extension of express lanes to I-95 in Virginia; however, we also saw a significant number of hybrid P3s reach financial close.

The I-95 project in Virginia, which reached financial close in April 2019, is traditional for many reasons. First, the asset was a highway surface transportation project. These horizontal projects dominated the P3 landscape in the US for decades. Second, the P3 agreement put in place a demand-risk model for paying project participants; this meant that the private partners' payments were directly tied to the revenue generated by the asset and were therefore vulnerable to shifts in market behaviour. The funding mix also looked fairly traditional, with a modest senior secured loan facility coupled with US\$262m in tax-exempt bonds issued by the Virginia Small Business Financing Authority.

The pandemic highlighted some of the reasons why P3 projects have shifted from this traditional model to hybrid models. In the weeks that followed the Covid shutdown, there was a reported 65% decrease in traffic in or around I-95 in Virginia; for a project whose revenue stream depended upon highway congestion, this was a potentially devastating development. This was not an isolated event, as the Institute of Transportation reported similar drops in traffic throughout the U.S. during the initial stages of the coronavirus pandemic. Accordingly, rating agencies took notice and downgraded the project's debt to BBB- in April 2020.

Fortunately for project participants, traffic rebounded fairly quickly in most places, reaching 90% of pre-Covid levels by midsummer; however, the lesson was well learned. Our research shows that no P3 project utilising a purely demand-risk model closed last year after the onset of the pandemic. Instead, availability payments dominated P3 agreements. This is where the public partner pays a concessionaire directly according to a predetermined formula and schedule. Many of the new "vertical" project categories – such as courthouses, student housing, and waterworks, among others – do not generate revenue in the traditional manner, if at all; therefore, the rise of availability payments has opened the door to a greater variety of projects being procured using the P3 method.

### The rise of higher ed P3s

Among these newer vertical P3s, institutions of higher education played a prominent role in 2020. Higher ed dominated the pre-launch projects segment, accounting for 17 of the 40 projects, and while student dormitories have been a staple of P3 projects over the past few years, we are now seeing a significant number of campus energy projects utilising the P3 procurement method.

During the last three quarters of 2020 – roughly concomitant with the coronavirus outbreak – eight of the 15 projects reaching a closing involved institutions of higher education. Of these, there were a couple of notable energy projects, such as the University of Iowa's US\$1.5bn project that involves the updating, maintenance and operation of the institution's energy and water systems. The university will receive a US\$1.165bn upfront payment for a 50-year concession.

This in turn was financed by a fairly traditional P3 capital stack that contained a term loan, the private placement of debt, and a substantial contribution of sponsor equity, US\$570m, the largest of any project in our report cohort. The agreement calls for the grantor to pay an annual US\$35m escalating fee, increasing by 1.5% each year beginning on year six for providing utility services, an operating and maintenance fee, and a variable rate fee for new projects.

Of note with the University of Iowa project is the use of availability payment-like fees that are adjustable, a key feature given higher ed's cloudy outlook. It is hardly a secret that the higher ed industry is experiencing something of a paradigm shift, where competition for students is vigorous and public money is dwindling. Covid-19 did not help matters, accelerating trends that were already in motion, such as greater use of distance learning. One of higher ed's defining features – its campuses – are undergoing a vast rethink, just as institutional balance sheets come under greater stress. Having said that, the heated competition for students is placing a high premium on building or rebuilding legacy assets. This is exactly the kind of situation where P3 can thrive, enabling institutions to access capital and expertise that might otherwise be unattainable.

The momentum toward campus energy P3s has not abated in the new year. California State University, Fresno, closed on an energy P3 project to modernise and maintain its energy utility system in February 2021. The project utilised a novel bond issue – Sustainable Development Goals (SDG) Impact Bonds – issued by the project's special purpose vehicle, Bulldog Infrastructure Group. The payout on the SDG bonds is linked to the project's ability to meet the university's renewable energy goals, with potential financial penalties in the event goals are not achieved. The Fresno State project – along with many others on the drawing board – demonstrates that novel financing mechanisms are very much in play with the newer breed of P3 projects. ■