

Potential Role for P3 Investors in the Utilization and Expansion of Infrastructure Loan Programs

December 2, 2019

1. The biggest challenge for American public infrastructure is addressing deferred maintenance and delayed investment on basic assets.

- Basic American public-sector infrastructure (transportation, water and social assets) is fully developed and largely commensurate with economic and demographic growth. But it suffers from significant deterioration and obsolescence.
- The benefit-cost ratio of addressing these issues is generally straightforward and strongly positive. Why has it become a major challenge?

2. The core of the challenge for public sector infrastructure authorities and agencies is long-term liability management, not long-term funding capacity or risk transfer.

- The vast majority of state & local governments and infrastructure agencies have access to funding bases (through taxes or user fees) that can easily support the cost of renewing basic infrastructure. In addition, these governments and agencies have access to long-term debt markets (primarily the municipal bond market) that can cost-effectively finance current projects with future long-term funding.
- But these governments and agencies are also subject to short-term fiscal constraints (e.g. annual balanced-budget rule, statutory limits on bond issuance, limited scope to raise water rates, etc.) that make it difficult to incur and manage the debt liabilities necessary to renew infrastructure. Regardless of the actual benefit-cost ratio of doing so, it is simply easier to ‘kick the can’ – which compounds the problem.
- For basic infrastructure assets, the public understands that in the long term their taxes or user fees will be required to fund renewal – but near-term increases are strongly resisted. In addition, most basic infrastructure assets have an intrinsically low risk and efficiency-variability profile (in terms of construction, operations and revenue) and the public sector has wide experience with them. There are very few ‘magic bullets’ in either funding sources or risk transfer that can lower the cost of renewal sufficiently to overcome fiscal constraints.
- In contrast, actively and creatively managing infrastructure debt liabilities can directly address fiscal constraints with more scope to overcome them. On a present value basis, the overall cost of renewal may not differ significantly, but innovative debt structures may avoid arbitrary fiscal constraints, permit longer term renewal program planning and minimize near-term funding requirements. Such liability management can allow renewal projects to proceed sooner and more efficiently.

3. What can P3 investors currently offer in the context of liability management?

- The original excitement about P3s as a broad solution to America's basic infrastructure challenge was largely due to a misperception of their ability to dramatically improve public-sector liability management.
- The enthusiasm waned when P3s were more fully understood. DB and OM contracts can improve project delivery and operations, but public sector agencies can access these services directly for most basic infrastructure projects. The project finance or leasing framework of an AP concession agreement will address many arbitrary fiscal constraints, but public resistance to 'privatization' (real or imagined) imposed other constraints. Most importantly however, the cost of P3 equity in the structure, in comparison to possible funding source or risk transfer benefits, was seen as prohibitive and unnecessary for most basic infrastructure projects.
- True P3s (i.e. transactions with a significant P3 equity investment) are now seen as a specialized approach for infrastructure projects with fundamental technology risk (e.g. desalination plants), potential new and highly variable funding sources (e.g. express toll lanes) or wide scope for managerial expertise (e.g. airport retail malls and highway fast-food franchises). However, these situations form only a small part of the overall public infrastructure challenge. As a result, P3 infrastructure investment capacity is hugely underutilized.

4. What can federal infrastructure loan programs currently offer in the context of liability management?

- In contrast to P3s, federal infrastructure loan programs have until recently generated very little excitement. Although the programs directly address infrastructure long-term liability management, the original perception was that the benefit was limited to a lower (Treasury-flat) interest rate. For highly rated public agency borrowers with access to the tax-exempt bond market, interest rate benefits are minimal and need to be balanced with increased transaction and compliance costs. Also, the first major program, TIFIA, suffers from a high level of bureaucratic friction and is characterized by long and unpredictable approval timelines.
- However, TIFIA's successor for the water sector, WIFIA has had a much more successful start and is emerging as a transformative program for infrastructure lending. Although the basic interest rate benefit is the same as TIFIA, and federal crosscutter compliance is likewise required, WIFIA has been implemented with much less bureaucratic friction and far faster approval and execution times. The program is increasingly seen as a practical tool for liability management.
- More importantly, the efficiency and practicality of the WIFIA program encourages potential public sector borrowers to consider utilizing the more subtle but powerful benefits of a WIFIA loan structure for liability management. These include:

- ✓ A long-term interest rate lock during construction – in effect, a costless option for the borrower. Since WIFIA has to date approved water infrastructure construction programs as long as nine years (even longer approvals may be possible) this is a significant benefit.
 - ✓ Debt service deferrals for up to five years after construction. The value of this feature for highly-rated water agencies is actually not in cash preservation but in the continuation of rate lock for future optional interest draws – on large loans, this can be significant.
 - ✓ Combined with approved long construction periods, the 35-year post-construction term of a WIFIA loan may now extend well beyond 40 years. Within this long tenor, WIFIA specifically allows the non-WIFIA part of the financing to be amortized first (e.g. with standard 30-year muni market) resulting in even higher overall interest rate savings. More importantly, a very extended overall amortization schedule means that near-term funding requirements (i.e. water rate rises) can be minimized.
 - ✓ As a very long-term, cost-effective private placement, a WIFIA loan is a practical alternative to avoid many fiscal constraints that apply specifically to public-sector bonds.
- These benefits, which are more related to the structural features of a WIFIA than to the simple interest rate savings, are at an early stage of development. There is considerable scope for expansion and refinement as potential borrowers consider their usefulness for liability management and the WIFIA program itself gains experience and obtains approvals.
 - It should be noted that, in contrast to the transfer-payment nature of simple interest rate savings, supporting WIFIA loan structural features actually utilizes the intrinsic strengths of the federal government (e.g. as a patient, non-market investor) and are therefore highly consistent with a broad range of federal infrastructure policy objectives. This is a solid basis for future continuation and expansion of the WIFIA program.

5. How could P3 investors improve the utilization and expansion of federal infrastructure loan programs for deferred maintenance and delayed investment liability management?

- The WIFIA program demonstrates the potential usefulness of federal loan programs for basic infrastructure liability management. However, this capacity is by no means fully developed in terms of the scale of potential application. Many of the structural features require expertise to access their full value, especially when customized modifications are required. The application and approval process itself, along with continuing compliance requirements, are an infrequent or one-time action for potential borrowers. The WIFIA program is still at a nascent stage; awareness of its emerging success is not widespread even in the water sector, not to mention the possible development of similar programs for other infrastructure sectors.
- As noted above, there is a significant underutilization of P3 capacity for investment in US infrastructure. This interested and specifically skilled investor base could be instrumental in realizing the potential power of federal loan programs for basic infrastructure liability management. Developing this, both on the borrower and federal lender side, would require many of the same infrastructure capacities as investors had hoped to deploy in more traditional

P3 structures: managerial expertise, at-risk investment and overall market development. Specific elements could include:

- ✓ **Process and Compliance Expertise:** Significant economies of scale can be realized when a complex process (e.g. federal loan application, execution and compliance) is done repeatedly on behalf of many borrowers. This would start at the ‘development’ phase when financing options for a necessary project were being considered by the public sector agency: a full proposal with optimal utilization of loan programs would be submitted by the P3 investor. In addition, many federal compliance requirements (e.g. Davis-Bacon) that must be continuous through a long construction phase may benefit from outsourced expert management and risk transfer.
- ✓ **Monetization of Structural Benefits:** The monetizable value of structural features of a federal loan may be greater than a potential borrower can realize in a specific situation. For example, the interest rate options embedded in the construction rate-lock and debt service deferral features might be more valuable in the long-term to another entity (e.g. a pension fund) than to a borrower with shorter-term objectives related to fiscal constraints (e.g. keeping near-term rates low). A P3 investor could monetize the potential value through a low-rate subordinated debt co-investment with the federal loan. Such P3 debt or equity investments could also take risk positions associated with the structural features that borrowers wished to avoid.
- ✓ **Advocacy for Refinement and Expansion:** Analogous to the role the P3 industry played in expanding state and local statutory frameworks to permit P3 transactions, the P3 industry could advocate for the refinement and expansion of federal loan programs. Certainly, public infrastructure sector organizations already lobby for increased transfer benefits (e.g. sub-Treasury rates) but the more subtle and potentially powerful structural benefits (which also have neutral or even positive federal budget impact) require specialized advocacy. In this context, minor technical changes may lead to significant improvement – and have a much better chance of success (see example below).

Specific Example of WIFIA Technical Amendments for Possible WRDA 2020

Specific objective: Lengthen potential term of various WIFIA structural loan features.

Policy goals:

- Encourage American water systems to address major deferred maintenance and delayed investment as quickly and efficiently as possible.
- Extending long-term WIFIA loan features that permit moderate, steady and affordable water rate increases while ensuring prudent lending practice.
- Encourage commitment to a long-term plan that achieves sustainable full cost recovery.

Proposed technical amendments to USC Title 33 Section 3908(c)(2) and Section 3908(c)(3):

(3) Deferred Payments [and Extended Construction and Repayment Periods]

(A) Authorization

(i) [*current language*]

(ii) In connection with a long-term plan to achieve full-cost recovery for necessary projects while implementing sustainable and affordable rate increases, the Secretary or the Administrator, as applicable, subject to subparagraph (C), may allow obligor to:

(a) implement a programmatic construction plan with a period of up to [10] years in which the schedule of Eligible Project Costs may be amended and resubmitted in accordance with achieving obligor's long-term plan objectives;

(b) for the purpose of implementing sustainable and affordable rate increases in accordance with obligor's long-term plan, allow obligor to add principal and interest to the outstanding balance for a period of up to [10] years after substantial completion of the construction program

(c) for the purpose of implementing sustainable and affordable rate increases in accordance with obligor's long-term plan, allow obligor to extend final maturity date of the secured loan for up to [50] years after the date of substantial completion of the construction program, subject to expected useful life of construction program assets.