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How Standard & Poor's Treats Public-Private Partnerships in U.S. State and Local Government Debt Analysis.

Although infrastructure needs in the U.S. — and worldwide -- are very high, in our view, the governments in many developed nations have cut back on infrastructure spending, in large part, we believe, because of budgetary concerns. In the U.S., government spending on projects, as a percentage of GDP, has dropped to a two-decade low of about 1.7%, according to the Federal Reserve Bank of St. Louis. (See "U.S. Infrastructure Investment: A Chance To Reap More Than We Sow," published May 5, 2014, on RatingsDirect.) This limited infrastructure funding comes when the country's infrastructure has repeatedly received a near-failing grade from the American Society of Civil Engineers (ASCE) in the comprehensive assessment it issues every four years. The low grade reflects the enormous amount of capital needs, from bridges to levees. For example, according to ASCE, one in nine bridges in the U.S. is structurally deficient, and to eliminate the backlog of repairs or build replacements by 2028, local, state, and federal spending would have to increase by $8 billion per year.

As U.S. state and local governments look for alternative ways of delivering large infrastructure projects, interest has grown in using public-private partnerships (P3s), a risk-sharing method that governments have used globally for many types of infrastructure.

Standard & Poor's Ratings Services believes it will be useful to provide additional context about its views on P3s and to address how it incorporates P3 payment obligations into its debt statement analysis for U.S. state and local governments.

Frequently Asked Questions

What are public-private partnerships?

A P3 is a risk-sharing partnership–consisting of a government and a private business–that builds, finances, and operates an infrastructure project. In a P3, the roles and responsibilities of both the private-sector and government participants are typically specified in a contract, frequently referred to as a concession agreement. Under the concession agreement, the private entity is contractually obligated to deliver a service, typically to design, build, finance, operate, and maintain an asset for a specified fixed period, defined as the length of the concession. Concession periods of 30 to 40 years are common, but some are longer. These projects are arranged as either availability- or volume-based projects. For volume-based projects, the government typically receives an upfront payment in exchange for allowing the private entity to operate and collect the project revenues over the contract term. For availability-based projects, the government makes construction milestone payments and availability payments to support the new asset. In many, but not all cases, toll revenues, gas taxes, or appropriations back the government's availability payment commitment. Because of the issuance structure, the P3 debt issuances are often free from the constraints of a government's debt affordability models. We evaluate the nature of a government's obligation under the P3 agreements in determining whether we consider the obligation to be part of a government's tax-supported debt.

How prevalent is the use of P3s in the U.S.?

Although other countries have used P3s more widely, in the U.S. their use has been more recent and somewhat limited. However, interest in the P3 approach is growing in the U.S., and several states are developing programs. California, Florida, Indiana, Texas, and Virginia have participated in P3s. Currently, 33 states have authorized P3s, and others such as New York, North Carolina, and Pennsylvania are developing new P3 programs. The U.S. projects have primarily focused on transportation, such as roads, toll lanes, and transit projects. However, the Long Beach Courthouse in California is an example of a social infrastructure P3 project, and other states currently active in transportation P3 projects are also considering approving legislation allowing social infrastructure P3s. We expect that the states with established P3 programs will continue to use P3 financing. In our view, the large size and complexity of the projects and the concession agreements, as well as the lack of uniformity in the terms of these agreements–no two P3s are alike–have all created high start-up costs and acted as a barrier to greater adoption of this model. This is particularly true when start-up process span different administrations, whose interest in P3s may vary. In addition, in the U.S. the municipal bond market has provided a readily available low-cost financing mechanism with long amortizations that are beneficial to many infrastructure financings, which has also limited the use of P3 financings in the U.S. In our opinion, recent problems regarding the Virginia Route 460 project, the Indiana Toll Road bankruptcy, and the federal judge's ruling on the Illiana Corridor project, regardless of these projects' ultimate outcome, might have created some headwinds for P3s in states that are unfamiliar or inexperienced with the P3 model. In our view, a more intrinsic barrier could be that despite a free market orientation in the U.S., governments don't have an evolved culture of public-sector agencies handing over these functions to the private sector. Whether this is because of political accountability, engrained views of the role of government, or other reasons is uncertain; however, we believe that at least in the near term, support for these projects will be mixed. (See "U.S. Public-Private Partnerships Encounter New Road Bumps As Political Appetite For The Projects Waxes And Wanes," published Sept. 9, 2015.)

How do the risks transferred differ from volume-based to availability-based P3s?

A P3 structure's benefits are that it includes some level of private investment and that there is, typically, a transfer of construction and/or operating risk to the private party. The private investment typically ranges from about 10% of total project cost for availability-based projects to about 30% in volume-based projects. In volume-based transactions, usage or volume risk, hence the name, is transferred to the private entity. For these, the government typically receives an up-front payment and/or payments over time in exchange for allowing the private entity to operate and collect the project revenues over the contract term. Funding usually comes largely directly from user fees or tolls and the private sector assumes most of the operating and volume risks, with very limited recourse to the government in case of lower-than-expected usage. Although in most cases toll road P3s are structured as volume-based projects, there are instances where concerns over the sufficiency of toll revenues to cover payment obligations could lead a government to use an availability-based model. For availability-based projects, the government typically transfers the construction and operating risks, but retains the risk of usage. In other words, the government's annual payments are for making the facility available for use, regardless of the actual usage (volume) or the amount of revenues derived from the project, if any.

How Does Standard & Poor's treat U.S. state and local governments' P3 payment obligations?

We might treat the government's P3 obligation as debt, as a contingent liability, or neither. The key determinants are the source of revenue to pay the P3 obligation and whether we consider the obligation self-supporting. Once we've determined to include all or a portion of the obligation as

debt, we size the debt statement impact based on the type of payments (such as milestone, availability) and the net present value of the payments.

If we consider the revenue stream used to repay the obligation to be tax-backed revenue, then we'll include the P3 obligation as tax-supported debt, subject to adjustments mentioned below. Tax-backed revenues include tax revenues, appropriations, and special taxes. If the security for repayment is from a true enterprise operation or from a nontax-supported source, such as toll revenues or grant anticipation revenue bonds paid solely from dedicated federal funding, then we won't include it as tax-supported debt or contingent liability.

Does Standard & Poor's consider P3 availability payments to be debt-like?

While a unique structure, P3 availability payments have many features that make them debt-like. Under an availability payment model, the government enters into a long-term contract or obligation to pay. In most cases, in addition to being long term, these payment obligations are fixed commitments with penalties, or termination payments, if the agreement ends. Often, the government pays these obligations from the same revenue sources as more traditional tax-exempt municipal debt. Furthermore, similar to debt, these payments fund capital improvements or meet other government purposes. Finally, generally, the sponsoring government owns the asset.

Does Standard & Poor's factor in self-support for P3 obligations?

In some cases, in addition to tax-backed revenues, pledges of nontax revenues, such as toll revenues, will support the P3 payment obligation. In these cases, we'll determine if these nontax revenues provide partial or self-support of the payment obligation and adjust the size of the obligation to include in our debt calculations. Our self-support analysis is based on historical coverage (see "Debt Statement Analysis"published Aug. 22, 2006), but we could adjust our view of self-support if we expect future coverage to be lower than historical.

Does Standard & Poor's make any adjustment to the availability payment obligations when including them as debt?

In deciding how much debt to include in debt statements, we evaluate milestone and availability payment obligations separately. Milestone payments are made in recognition of reaching a construction milestone and, in most cases, occur before the asset is available for use. Absent some form of self-support in the P3, we treat milestone payments as debt and add them at the P3's financial close. Availability payments include a fixed portion that represents both the capital portion of project-related debt issued by the partnership and equity partner's contribution and a variable portion that represents lifecycle operations and maintenance (O&M) expenses. In our view, adding the string of total future annual payments represents a more comprehensive estimate of a government's true obligation over the life of a project. However, because we view O&M costs for these projects as operating costs and to ensure equal treatment with other tax-backed debt, where a breakdown is available, we separate the O&M cost from the other components of the availability payment. We add availability payments as a debt-like obligation on delivery of the asset.

Because milestone and availability payments include either an interest component (for debt issued) or a return on investment (on the equity contribution), before adding the obligations to our debt statements, we discount the future payments to arrive at a net present value of the principal component of the P3 payment. Given that P3 projects are typically done in lieu of a traditional debt financing for a public entity, we estimate a discount rate that is representative of a public entity's cost of capital based on its rating category and length of the P3 contract. We would generally use Municipal Market Data or a similar data source to estimate the discount rate.

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