



TESTIMONY

Comprehensive Development Agreements: SH 130 (Segments 5 & 6)

**Testimony Before the
Legislative Study Committee on Private Participation in Toll Projects**

**Phillip E. Russell, P.E.
Assistant Executive Director for Innovative Project Development
Texas Department of Transportation
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Phil Russell
Assistant Executive Director Innovative Project Development
Texas Department of Transportation

COMPREHENSIVE DEVELOPMENT AGREEMENTS:
SH 130 (Segments 5 & 6)

Traditional transportation funding methods in Texas have left a large gap between what is available and what is necessary to address the transportation challenges our citizens face. Previous legislatures have enacted laws that provide opportunities for the Texas Department of Transportation (TxDOT) to fill that gap, and department staff have been diligent in pursuing these options since their availability to address our goals of reducing congestion, enhancing safety, expanding economic opportunity, improving air quality, and increasing the value of our transportation assets. These alternative project development and financing methods include tools such as Proposition 14 bonds, pass through financing and Comprehensive Development Agreements (CDAs).

One of the most successful examples in Texas of a CDA is the procurement of a contract to develop SH 130, Segments 5 and 6. Absent any other method of financing and without the option of a CDA, this project would not have been built in the foreseeable future. By allowing private investment to partner with the state on this project, Texas is now receiving a \$1.35 billion transportation asset without the use of state funds.

SB 792 from the 80th Legislative Session created a study committee comprised of appointees by the Governor, Lieutenant Governor and Speaker to further look into CDAs and analyze the public policy implications of such agreements. The department continues to look forward to working with this committee to explore the options available to Texans and what CDAs can do for our state in providing near-term, mid-term and long-term transportation solutions.

The History

Central Texans had planned a bypass for many years to accommodate frustrated motorists dealing with the ever-increasing traffic along the portions of Interstate Highway 35 from San Antonio past Austin. Funding for this project was identified, but would take decades to become available through traditional financing methods. Through bonding, local government participation, and traditional Fund 6 dollars, the State Highway 130 (SH 130) toll road from Georgetown to the Austin airport began in 2002. However, TxDOT did not have available funds and could not borrow enough money to complete Segments 5 and 6 from South Austin to Seguin. Therefore these segments were put on hold, again for decades, until traditional funding sources would become available.

Then, the Texas Legislature passed laws in 2003 allowing for a form of public-private partnerships now known as CDAs. Private developers quickly realized the project's potential and TxDOT accepted proposals to make this roadway a reality for motorists. We currently have a successful CDA between the state and the Cintra Zachry consortium to finance and build this 40-mile project with construction beginning in 2009 and expected completion in 2012.

The Alternatives

When Cintra Zachry proposed to fund Segments 5 and 6 under its Trans-Texas Corridor I-35 (TTC-35) Master Development Plan CDA, TxDOT also had several other alternatives, including future construction on TxDOT's traditional pay-as-you-go basis, construction using traditional tax-exempt municipal bond tolls, and a new competitive CDA procurement.

The pay-as-you-go funding mechanism was not financially feasible as TxDOT did not have sufficient gas tax revenues to afford segments 5 and 6. Also, cost inflation would potentially further increase the needed amount of funds. The funding gap would have significantly widened. Right-of-way (ROW) acquisition costs would also have risen substantially with inflation and the project would have faced substantial delays due to lack of funds.

Concurrent with procurement for Segments 5 & 6, TxDOT created a tool to determine whether to undertake a CDA or to pursue a traditional toll revenue bond financing method. The results showed that a traditional tax-exempt municipal bond financing method would require approximately \$700 million from Fund 6 to build, operate, and maintain the project for 50 years, far over the costs of a CDA.

However, a public-private partnership through a CDA could offer multiple benefits. It would mean all private financing, with no public funds subsidy of capital, operations, and maintenance costs. The Cintra Zachry CDA would also include an upfront payment to TxDOT: \$25.75 million – TxDOT has received payment and the funds are being used for various SH 130/5&6 related projects such as land acquisition and the relocation of a weigh station. The percentage of revenue shared with TxDOT will increase as the project financial performance improves over time, until the state's share reaches 50 percent. Also, Cintra Zachry's estimated design and construction costs of \$1.35 billion are similar to TxDOT's estimated capital costs. Finally, the project will be able to begin construction years before it would have been able to using TxDOT's traditional project delivery and financing methods.

One area that has been of concern to the Legislature is that Cintra Zachry's upfront payment of \$25 million will not be enough to cover all-in costs associated with negotiating the CDA and monitoring the contract. The comparative financial analysis of the alternatives available to TxDOT indicates that even if the \$25 million does not cover negotiating and monitoring costs, the costs TxDOT will absorb are negligible compared to those it would have absorbed under the other three options, and the competitive CDA procurement alternative would have cost TxDOT new procurement costs and similar contract monitoring costs.

Risk Allocation

One of the benefits of building projects under a CDA is that substantial elements of risk are transferred from the public to the private developer. However, some risks are better managed by the TxDOT rather than the developer. One of our core principles is to allocate risk in such a way that we maximize the benefits of the CDA to the public.

These risks are identified and allocated on a project-by-project basis. In general, individual risks should be allocated to the party best able to manage and mitigate that risk for the best overall value to the taxpayers.

TxDOT has made many project-by-project adjustments to its risk allocation provisions during the course of procurements. It does so by listening to the proposers; assessing the characteristics of the project, the players, the competition and current market conditions; and carefully applying these principles and practices to the procurement.

Assumption of risk in the CDA with Cintra Zachry

The SH 130/5&6 CDA was negotiated in a competitive environment that gave TxDOT equal bargaining leverage and flowed fairly from the competitive procurement for TTC-35. Cintra Zachry only held a negotiating right under TTC-35 Master Development Plan CDA, and TxDOT had the right to halt negotiations. TxDOT maintained a fallback position that it could revert to previous contractors during negotiations with Cintra Zachry and negotiated a rigorous schedule consistently reflecting a willingness to walk away from the negotiations and submit a new proposal for procurement.

Price reasonableness analysis standards were vigorously applied. TxDOT recognized the importance of verifying the reasonableness of project costs, even though no state funds were used, since the project funding was to be based on toll revenues collected from the traveling public. TxDOT developed a process for verifying price reasonableness prior to awarding the TTC-35 CDA, and incorporated appropriate provisions into the CDA to allow that to happen. The process was developed after consideration of accepted industry practice and standards. Also, the Federal Highway Administration (FHWA) regulations require an analysis of pricing and finding of price reasonableness. The TTC-35 CDA imposed this requirement as a condition to Cintra Zachry's self-performance of any facility. The scope of work, contract terms and necessary pricing assumptions were established. Cintra Zachry provided its proposed price for the work, including estimated quantities, unit prices, and a contingency plan for risks. TxDOT concurrently and independently developed a cost estimate, which included pricing for ROW acquisition and operations and maintenance services. Each party had the opportunity to review and verify the other's detailed price breakdown, assumptions and supporting documentation, and to advise the other party regarding any perceived errors. Finally, FHWA's review and approval of price reasonableness was required and obtained.

The terms of the CDA are such that Cintra Zachry assumes unprecedented levels of risk that are normally borne by the public, including:

- 100 percent of design costs and risk of design defects;
- 100 percent of costs and delay impacts associated with utilities in the ROW;
- 100 percent of ROW acquisition costs, including hazardous materials (HazMat) investigations and condemnation costs;
- 100 percent of risk for non-conforming work or construction defects discovered after acceptance;
- Costs and delay risks associated with obtaining and satisfying all approvals and permits from other public agencies (except National Environmental Policy Act (NEPA) and other federally required permits;

- 100 percent of costs of performing mitigation requirements under NEPA approval (except the costs of acquiring the mitigation site);
- Costs of dealing with unexpected sub-surface conditions during construction;
- Costs and delay impacts resulting from encountering unexpected sub-surface conditions during construction;
- HazMat management costs and potential liability (except pre-existing HazMat issues);
- Costs associated with the discovery of endangered species or historical, cultural, or paleontological resources;
- Costs associated with the normal force majeure conditions of strikes, labor disputes, adverse weather, fires, floods, or earthquakes;
- Costs of coverage for insurance, including builders risk, property coverage, professional liability, commercial and general liability, business interruption, auto liability, and workers compensation;
- Costs, including liquidated damages payable to TxDOT, of delay in completion;
- All financing and financing risk costs, including changing market conditions;
- Traffic and revenue risk, including bankruptcy and insolvency;
- Costs of quality management;
- 50 percent of independent oversight costs;
- 100 percent of Operations and Maintenance costs;
- Costs of meeting handback requirements;
- Indemnification obligations to TxDOT; and
- Risks covered by Performance and Payment bonds.

These are the most advantageous risk allocations TxDOT has ever obtained in its contracts for design, construction, and operation of state highways.

Toll Collection Risk

Under the agreement for SH 130/5&6 with Cintra Zachry, TxDOT has retained responsibility to collect tolls from users and risk that certain users might fail or refuse to pay if they do not have electronic toll transponders on their vehicles. TxDOT has the authority to pursue toll violators and has the Vehicle Title and Registration database for video toll matchup to aid in its pursuit of violators.

TxDOT has additional reasons to retain the toll collection function and risk, such as service cost savings and more efficient risk allocation. TxDOT already has in operation a customer service center to perform the toll collection and enforcement functions, and its incremental costs were much lower than the cost to Cintra Zachry of building and operating its own service center. Also, statute authorizes authorities to charge a toll premium to users without transponders, a practice currently used by the North Texas Tolling Authority. TxDOT may keep the entire premium to cover costs of collection and enforcement and make up for the small percentage of tolls that are not possible to collect. If this risk were imposed on Cintra Zachry, a higher toll premium would be necessary.

This risk allocation is more favorable to TxDOT than tolling risks that local tolling agencies and their customers regularly take with traditional municipal bond toll revenue

financing. Under this risk allocation, TxDOT and its customers are completely protected from toll rate increases to make up for poor traffic projections. Cintra Zachry is bound by a maximum toll rate schedule – it has no right to exceed these rates regardless of the inability to meet debt coverage agreements with its lenders. However, local tolling authorities are bound under bond indentures to raise toll rates if necessary to meet debt coverage agreements. Also, TxDOT's toll collection risk is mitigated by the toll premium. Cintra Zachry assumes collection risk due to faulty operation of video cameras. Likewise, local tolling authorities' risk is mitigated by the toll premium, but they also assume collection risk due to faulty operation of video cameras.

Competing Facilities Provision

Any competing facility clauses in Texas recognize the fact that projects developed now and in the future could have an affect on the revenue brought in by a nearby road, but development and improvements to other roadways will continue to occur regardless. Developers are better able to craft their proposals when they have an idea of what roads may be constructed over the term of the agreement.

The state and the developer can agree to an exempt list of projects that will be allowed to be built without required compensation. The non-compete clause does not prevent any nearby projects from being built regardless if they are listed within the contract. These clauses merely set forth a requirement that if a non-exempt project is built that negatively affects a project then compensation will be made. For instance, if a non-exempt project within the zone has a positive impact on toll revenue, the positive value will be "banked" or credited to the state. If a project has an adverse impact on toll revenue, the impact will be offset by any positive value banked by the state. Over time, if the adverse value exceeds any banked amount, the developer may make a claim for compensation. However, the developer bears the burden of proving its claim.

Transportation Code Chapter 371, Subchapter C provides several protections when entering into a CDA. The law states the agreement shall not prohibit the construction, reconstruction, expansion, rehabilitation, operation or maintenance of a highway or transportation project. For example, any needed safety improvements or projects within the state transportation plans are allowed under CDAs without the need for the state to provide compensation for lost toll revenue.

There are those that would like to avoid the use of competing facility clauses because they feel it will prevent improvements from being made to nearby facilities, thereby increasing the attractiveness of using the toll road. The fact of the matter is that TxDOT is in the business of providing transportation services to this state and is committed to the continued maintenance and rehabilitation of existing infrastructure. Such clauses are standard business agreements used around the world and do not prevent maintenance or new capacity from being built near a toll road.

Further, TxDOT and local tolling authorities have dealt with contractual limitations on competing facilities for a long time. The difference is that these provisions were not found in contracts for construction and operation of the toll road. Instead, they were in bond indentures. Lessons learned from California provided a basis for the Competing

Facilities Clause in the Central Texas Turnpike Project (CTTP) bond indenture. The Competing Facilities Clause in the CTTP bond indenture obligates TxDOT to use its best efforts to refrain from approving facilities adversely affecting its compliance with its requirements in the bond indenture. The competing facilities clause in the CDA for SH 130/5&6 made several improvements over the CTTP bond indenture provisions, including:

- No restriction on TxDOT's right to build and operate competing facilities – the only remedy is compensation for the loss of toll revenues;
- CTTP bond indenture could compel TxDOT to raise tolls on the CTTP – there is no such obligation under the CDA for SH 130/5&6;
- The definition of competing facility in the CTTP bond indenture is broad – in the CDA for SH 130/5&6, it is limited to a specifically-identified zone; and
- In order to be compensated, Cintra Zachry has the burden to prove harm.

Buyback Provision

CDAs used by the department provide measures for very specific buyback formulas as defined in Transportation Code 371, Subchapter C, based either on the documented base case financial model revenue forecasts or the current market value of the project, whichever is the lesser of the two. We believe this protects the interest of the state and the taxpayers by ensuring TxDOT is not overpaying for the asset should it be determined it is within the best interest of the citizens to buyback the project during the lease. The possibility exists that locking into any specific and/or predetermined values could potentially lock the state into undesirable terms.

It should also be noted that all agreements include “handback” requirements to protect public interest. Whether the buyback is prior to completion of the agreement or if the lease has reached full term, the developer must comply with requirements to reconstruct, repair, and replace portions of the facility during the term to ensure it has been properly maintained and meets federal and state standards. This may also include specified capacity improvements to maintain the defined levels of service outlined in the contract.

At the time of the SH 130/5&6 negotiations, Texas law required that TxDOT have a right to terminate for convenience. The SB 792 mandate to set forth a maximum compensation formula did not yet exist. TxDOT's provision for the SH 130/5&6 established a buy-out right at fair market value or the amount of outstanding bona fide debt, whichever is greater. This formulation has international market acceptance. It also enables access to the credit markets by protecting lenders from loss due to government's discretionary termination of the contract rights.

Conclusion

The need has become so great in Texas to provide new infrastructure, we were forced to examine innovative ways of financing it. With the help of the Texas Legislature and the Governor, TxDOT has paved the way for private investment in state infrastructure with Comprehensive Development Agreements. We must continue to find a mechanism that increases our financial resources, imposes a manageable level of risk, and maintains control of future revenue streams for the benefit of the people of Texas.

The remaining segments of State Highway 130 are critical to the enhanced transportation needs of central and south Texas. By pursuing their construction and maintenance through a CDA, when traditional funding sources are not available or not sufficient, we ensure that Texans traveling in this part of the state will have efficient and safe transportation infrastructure.

The members of the Texas Transportation Commission and the Texas Department of Transportation look forward to working with the Legislature to ensure this valuable method of procurement, along with a tremendously forward thinking body of law, is maintained and improved upon in the coming decades.