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Midtown Financial Close Ignites Virginia Politics

By William G. Reinhardt, PWF editor

Virginia Gov. Bob McDonnell announced on Monday morning, April 16, that the toll revenue financing had closed on a DBFOM concession worth $2.1 billion for expanding the capacity of the Elizabeth River tunnels between Portsmouth and Norfolk, one of the Hampton Roads region's top transportation priorities.

Then all hell broke loose, largely over the $1.84 peak-period toll that the concession company, Elizabeth River Crossings (ERC), plans to start collecting electronically in September. The agreement with Virginia DOT envisions that about 17.5% of the $1.45-billion construction cost will be funded by tolling the existing free tunnels during the five-year construction period. The large savings on capitalized interest and favorable borrowing costs helped to reduce the starting toll from $2.89 in an earlier plan.

Responding to toll protests, McDonnell, who has vice presidential aspirations, agreed to increase the state's share of the funding in order to delay the start of tolling until January 2014, when he leaves office. A contract amendment was signed that allows VDOT to postpone the start of tolling after a 45-day notice provided that the amount of any damages due to the investors has been authorized or appropriated by the General Assembly and allocated to the Commonwealth Transportation Board.

McDonnell appeared to waffle, and local politicians, anti-tax litigators, and former Gov. Tim Kaine (D), quickly massed to oppose VDOT's heavy reliance on tolls. PWF sources say even the TIFIA Joint Program Office at the U.S. Dept. of Transportation tried to undo its $422-million loan to the Midtown concession company soon after it closed.

"If it had been 12 hours later, this deal wouldn't have closed," says one of the bond underwriters.

Earlier, when McDonnell indicated additional public funding could be found for Midtown, Democratic state legislators from northern Virginia quickly jumped in with their own demand that state funds be appropriated to reduce the reliance on tolls to finance the proposed Metrorail extension to Dulles airport, in northern Virginia.

(The state's entire contribution to build the $3.4-billion Metrorail project now is set to come from aggressive toll increases on users of the state-owned Dulles Toll Road, which connects the 495 Beltway and Dulles airport. Without state funds, the current $2.25 one-way toll for using the 14-mile road would double by 2014 and triple in six years to finance half of the rail project's cost.)

McDonnell refused to commit budget funds to the Dulles rail financing plan. That prompted the Democratic legislators to vote down the entire state budget, which must be approved in July.

Neither McDonnell nor the legislature favors a gas tax increase, and a plan for a sales tax surcharge to fund transportation projects in the Hampton Roads region was defeated by the legislature a few years ago. Local polls taken after the Midtown signing showed only 14% of Hampton Roads respondents support tolling.

VDOT stands behind the ERC concession, which Skanska and Macquarie have been pursuing since 2005. "The Midtown Tunnel project is ranked as the number one transportation priority by the region's leaders and is the largest project to get under way in the region in almost 30 years," said Transportation Secretary Sean T. Connaughton. "Procurement as a public-private partnership is the only feasible way to fund a project of this magnitude, and that depends on tolls."

Having stirred the pot, however, Connaughton now may face stiffer opposition to his plans for toll financing of I-95 managed lanes, U.S. Route 460, the Hampton Roads Bridge Tunnel, the James River Bridge, I-66, I-64 and the Monitor-Merrimac Memorial Bridge-Tunnel.

Anti-toll politics in Virginia won't go away soon. "This is a political issue with significant legs," says a close observer of the Midtown agreement. He believes the politics will force McDonnell to further buy down of the Midtown tunnels during construction of the improvements.

ERC's risk would be reduced if McDonnell finds the money to replace some of the toll financing with public equity. "As long as their construction estimates are good, ERC's standing improves every time the public sector steps in" with more money, he says.

(Forecasts done for ERC by Arup predict tolling the Midtown and Downtown tunnels during construction would net $362 million, or 17.5% of the total project funding. Shortfalls are possible. Arup's base case estimate for diversion in the first year of toll collections is 28%. Standard & Poors estimates traffic will drop by 44%.)

Reducing the demand risk should be reflected in ERC's concession price, the observer says. So far, there doesn't appear to be a mechanism for calculating that benefit in the concession agreement, however.

VDOT spokesman Ryan Pedrazza, says "VDOT has not engaged ERC as yet" on the compensation question.

Legal Threat

ERC, VDOT and lenders, including TIFIA, also face an undefined but potentially serious threat from a legal challenge being mounted against the Midtown tolling scheme. The democratic state delegate from Norfolk, Ken Alexander, is aligned with former GOP state chairman Pat McSweeney, a Richmond lawyer, to undo the ERC deal.

According to press reports, McSweeney believes the use of Midtown tolls to fund related network improvements is a tax, not a user fee, and, therefore, can't be levied by the Commonwealth Transportation Board, which signed the concession. No lawsuit had been filed as of PWF's press time.

Representing Portsmouth, Alexander is expected to run for Lt. Governor in two years. McSweeney, a civil litigator, has 40 years of experience in Virginia government. He successfully challenged the state's 2007 transportation funding law as unconstitutional, and has deep knowledge of state government and tax law.

ERC and its lenders, especially TIFIA, "have got to be concerned about this lawsuit," says the observer.

Skanska/Kiewit/Weeks

The $1.45-billion design-build Downtown Tunnel/Midtown Tunnel/MLK Extension project is fully permitted and involves:

- adding a new two-lane car and truck tube next to the existing two-lane Midtown Tunnel under the Elizabeth River between Portsmouth and Norfolk, Va.;
- extending and improving the Martin Luther King Freeway approach road in Portsmouth, including a new I-264 interchange, that will allow travelers to choose either tunnel, depending on congestion levels;
- performing maintenance and safety improvements on the existing Midtown and Downtown Tunnels.

The work will be done at a fixed-price of $1.47 billion by an integrated joint venture of Skanska Civil (45%); Kiewit (40%) and Weeks Marine (15%). Parsons Brinckerhoff is leading the design work for ERC.

Twenty-four sunken-tube tunnel segments, each about 300 ft long, will be fabricated at Weeks's yard in Baltimore, assembled, and floated into position in the Elizabeth River. Sections will be filled with water, sunk into a dredged trench, and connected together. Key risks are poor foundation conditions, requiring extensive piling in the riverbed, and uncertain labor productivity in the Hampton Roads region.

When completed, average trip times will be reduced by 30%, according to ERC's traffic consultant, Arup.

TIFIA and PABs

The Midtown financing in mid-April is comprised of:

- $272 million in sponsor equity, including contingent equity

- $663 million in senior-lien private activity bonds (PAB) secured by toll revenues
- a $422-million TIFIA subordinate loan, also secured by toll revenues, which defers interest for the first 10 years of the 44-year loan
- a $308-million contribution from VDOT.

Construction costs are not fully funded in the financing, which triggered concern from both S&P and Fitch, which rated the project debt and BBB-. The plan of finance includes $368 million from tolling both of the highly congested Midtown and Downtown tunnels starting in September.

ERC's equal partners, Macquarie Financial Holding Limited and Skanska Infrastructure Development Inc., agreed to provide a $50.6-million line of credit to backstop any shortfall in their base-case revenue estimate. The two partners also put in $207 million in cash equity (9.8% of the project funding), which also is backed by a letter of credit.

The Virginia Small Business Financing Authority was the conduit issuer of the PABS which were sold by Barclays Capital, Bank of America Merrill Lynch, and BMO Capital Markets. The average life of the tax-exempt PABs was 24 years with coupons ranging from 5.32% to 5.5%.

Halcrow advised VDOT on O&M, Steer Davies Gleave on traffic, and O.R. Colan Associates on right of way. KPMG was VDOT's financial advisor and Nossaman provided legal and PPP procurement advice. Marsh consulted on insurance.

Arup was traffic and conditions assessment advisor to ERC. Hunton & Williams was its local counsel. Orrick also advised ERC. Traffic consultant Atkins and attorney Dewey & LeBoeuf advised the lenders.

Getting To $1.84 Toll Took Every Trick

The original Midtown and Downtown tunnels were financed with toll revenue bonds over 50 years ago. Tolls were removed in 1988 and daily traffic, mostly commutes, is now about 90,000 vehicles on the four-lane Downtown Tunnel and 35,000 on the two-lane Midtown Tunnel. Peak-period demand results in backups of two miles or more on weekdays.

Getting political approval of toll rates in the middle- and low-income area served by the Elizabeth River crossings has always been the key hurdle for the financing of the Midtown tunnel. The idea of funding a portion of the Midtown construction costs by tolling the existing tunnels was included in a proposal made to former Gov. Tim Kaine's transportation department in 2008 by Elizabeth River Crossings (ERC). In addition to reducing capitalized interest, early tolling allows fine tuning of revenue forecasts for debt financing.

Made up of Macquarie Group and Skanska Infrastructure Development, ERC was the only PPP team to respond to the state's call for a private partner to help solve the two-mile backups at the tunnels between Norfolk and Portsmouth.

After years of work with Virginia's Dept. of Transportation, the starting toll was set at $2.86 in an interim agreement signed in January 2010 during the final year of the Kaine administration. Negotiations since then under Gov. Bob McDonnell's watch reduced the starting toll to $1.84 for peak users and $1.54 off peak, collected electronically.

To reach that low toll, however, Virginia DOT agreed to:

- allow electronic tolling on two existing tunnels during the six-year construction period for the improvements, as proposed by Skanska in its unsolicited proposal in 2008;
- allow truck tolls that are four times the peak-period car toll;
- allow an aggressive toll escalation schedule of the greater of CPI or 3.5% a year, starting at the completion of the Midtown Tunnel expansion in 2016 and extending for 58 years;
- put in $308 million of its federal highway funds as public equity to buy down the starting toll.

Most recently, Gov. Bob McDonnell indicated the state would contribute up to $125 million more in order to delay the start of tolling until January 2014. No funding source has been identified to increase the state's equity contribution, however.

One further option for buying down the Midtown car toll would be for VDOT to make partial or full payment to the private operators for the operation and maintenance component, estimated at $1.3 billion over the 58-year term of the concession.

While praising VDOT's efforts to reduce the tunnel toll, a transportation leader in the state faults the agency for falling down on public outreach. VDOT met several times with the affected localities and the toll rates were made public last summer. But local issues raised in writing were never responded to in writing, he says, and there were no public presentations on tolls by VDOT, which relied instead on the media.

How Washington State DOT Tolled SR 520

Like the Midtown Tunnel, the SR 520 floating bridge in Seattle was built almost 50 years ago as a tolled commuter crossing. Toll booths were removed in 1979 once bonds were retired. Now, substantial improvements are needed to meet safety and capacity needs in the highly congested corridor, at an estimated cost of $4.65 billion.

Available funding is well short of that. So Washington State DOT decided in 2008 to toll the existing free bridge while a wider, safer bridge is being built next to it with public financing. The move is part of a larger change in philosophy in Washington State on the role of toll financing, says Craig Stone, toll manager at WashDOT.

Fourteen toll bridges were built in the state a generation ago. Tolls were removed when bonds were repaid. Now those and other transportation assets will be rebuilt with a reasonable contribution from tolls. "Tolls are part of the highway user's contribution to the regional transportation system," says Stone.

WashDOT intends to issue $1 billion in GO debt backed by bridge tolls to help fund four ongoing design-build contracts for completing the SR 520 bridge and approaches late in 2014.

Variable-rate electronic tolling started last December at a peak-hour charge of $3.50. After a slow start, February traffic was 19% higher than forecast and revenues were 7% higher.

Diversion rates to the larger I-90 bridge five miles away quickly hit the 48% predicted by Wilbur Smith Associates. Average daily trips have dropped to 60,000-70,000 from peaks of 115,000, and traffic is in free flow most of the time. Transit ridership is up by 10% and vanpooling by 17% since December, according to Stone.

The first civil penalty notices to violators went out in April seeking the initial toll amount, a $5 reprocessing fee for each reminder bill, and an added $40 civil penalty for each unpaid toll transaction.

The first of four 2.5% annual rate increases will take place in July, followed by a 15% hike in 2016, as allowed by the Washington State Transportation Commission. Real rates will remain at about $4.50 for the remaining term of the bond financing by Citi and J.P. Morgan.

According to Stone, here's how it was done:

> Tolling of the free SR 520 bridge during construction of its replacement was sold to commuters in a wealthy corridor between Seattle and Bellevue/Redmond in a series of public meetings conducted by over two years by the Secretary of Transportation, chairman of the Transportation Commission, which regulates tolls, and the executive director of the metropolitan planning organization. "It was very listening oriented," says Stone.

> The typically well-educated drivers using the bridge understood the tradeoffs on financing costs, largely the savings on capitalized interest. Over $172 million in capitalized interest was repaid as part of the $768-million Tacoma Narrows Bridge financing in 2002, which started tolls after completion.

(Another, less apparent, benefit of the SR 520 approach is that toll operations during construction are proving out revenue forecasts, which will reduce WashDOT's credit subsidy in its application for a TIFIA loan.)

> Substantial amounts of work are underway in the corridor with public funds on the $2.4-billion first phase of the project so commuters can see that their dollars are being spent as promised.

> Time-of-day electronic tolling has reduced congestion in the corridor during peak hours, providing an improved level of service to the bridge users during the initial months of operation.

> The improved corridor will have a transit component—a new transit/HOV lane for buses and carpools in each direction, which pleases Seattle transit advocates.

> Importantly, WashDOT's Secretary Paula Hammond has gained the trust of the legislature, which has given WashDOT the authority to toll the Columbia River Crossing during construction in order to contribute a third of the project funding. It also recently provided funds for a study of construction-period tolling the I-90 floating bridge, the free alternative to SR 520.)

Bottom line, says Stone: "It really hasn't been controversial with the public."