THE BOND BUYER

Travails of three Southwest P3s underscore potential pitfalls

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When public-private partnerships unravel, the consequences can be costly.

Three P3 projects in the Southwest valued at more than $4 billion devolved into legal disputes in the past two years as the formerly enthusiastic partners met unanticipated obstacles to completion or disagreed over contract terms.

Rendering of the Great Hall renovation project at Denver International Airport, which was to have been done as a P3 that the airport ultimately canceled.

Denver International Airport's $1.8 billion deal with Great Hall Partners to redevelop its main terminal was canceled in August, just months after construction began. The project ran aground after builders discovered deficient concrete in the original, 24-year-old terminal. The private and public partners couldn't agree on a solution.

The Denver debacle came as major airports across the nation, including Kansas City, Los Angeles, and New York's LaGuardia redevelop under similar P3 programs.

The most recent P3 clash came in Norman, Oklahoma, when the University of Oklahoma canceled its parking and commercial leases on the $250 million Cross Village student housing complex one year after the luxury apartments opened. That led to an eight-notch downgrade of the bonds and threats of lawsuits between OU and the trustee for bondholders UMB Bank.

Such unforeseen scenarios could chill other projects as colleges replace traditional dormitories with high-end, privately financed luxury housing amid an uncertain enrollment and demographic outlook. Cross Village was OU's first P3 housing project.

“When P3’s are not successful, it makes other governmental entities more wary of accepting a P3 opportunity,” said attorney Keith Poliakoff, a public finance specialist at Saul Ewing Arnstein & Lehr in Florida. “Entering into a contract with someone new to the area or marketplace could be disastrous unless major safeguards are placed into the contract.”

The OU Cross Village project ran into problems similar to those of a $361 million luxury housing complex at Texas A&M University called Park West, the largest student housing complex in the nation. When occupancy fell far below expectations, bondholders agreed to accept new terms to forestall a default.

To boost occupancy to 96%, Park West’s operator had to reduce rents by 30%, bringing a negative outlook to a Moody’s Investors Service B3 junk-bond rating.

“Rapid erosion in liquidity could trigger some sort of event of default in the near term,” Moody’s warned in July 2018.

Also in Colorado, the nation’s first P3 commuter rail line, the $2.1 billion Eagle P3, ended up in litigation last fall after the Denver-area Regional Transit District issued a termination notice over delays tied to federal regulatory issues. That dispute was partially resolved in April when RTD lifted its termination notice for Denver Transit Partners, a private consortium that built a 23-mile rail line from downtown to Denver International Airport.

Grade crossings on the 23-mile A Line between downtown and Denver International Airport were protected by flaggers for more than two years after the line opened to the public because of concerns about the reliability of the signals and crossing arms that prevent car and truck drivers from crossing the tracks when a train is passing. DTP's lawsuit demanded $80 million from RTD to pay for flaggers at intersections where automated barriers failed to pass federal inspection.

To get the project's G Line operating this year, RTD obtained regulatory waivers from the Federal Railroad Administration and the Colorado Public Utilities Commission.

Crossing-guard glitches kept safety flaggers on duty for years after the Denver RTD's A Line opened to the public, causing rancor between the agency and its private partner.

"DTP will not bear the cost of the crossing attendants in the event there are delays in achieving the remaining waivers, similar to past costs that are currently subject to relief claims by DTP and are in litigation," Moody's analyst Earl Heffintrayer noted in affirming the bonds rating of Baa3 with a negative outlook.

From the outset of a P3, the public and private partners must appeal to different constituencies and stakeholders. The government entity must assure taxpayers and voters that all laws and process were obeyed, that bids and qualifications were well vetted, that most, if not all, risks were anticipated and that the winning bidder can be trusted to deliver and manage a high-quality project more efficiently than government could.

Misunderstandings, such as whether the government is “selling” a public asset, often arise, particularly on highway toll lanes.

The private partners are putting their professional reputations on the line along with millions of dollars, all in public view. Deals that might have been arranged behind closed doors can be aired out in disclosure notices or lawsuits. Bondholders and other investors are betting on the companies, the value of the project and the commitment of the public partner over 30 years or more. They count on the law firms, the consultants and the bankers to trouble-shoot every potential risk that the deal will not pay off.

“The governmental entity must do considerable amount of homework before it even agrees to proceed,” Poliakoff said. “A good contract can put in necessary safeguards to protect a governmental entity against a default. Thereafter, it's exceptionally important for the governmental entity to closely monitor the contract and to not fear pulling the plug, as DIA did, if the contract goes awry.”

Poliakoff said that the airport made the right move in terminating its partnership with Great Hall, led by infrastructure giant Ferrovial Aeropuerto.

“Kudos to DIA,” he said.

Ending the P3 deal will cost Denver between $140 million to $180 million, according to Moody's estimates. The airport is on the hook for $189 million of bonds issued on behalf of the private partners, but the bond fund still has about $120 million, per Moody's. That means the city will have to provide $70 million to decease the debt.

"Though the forward looking credit impacts are manageable, the fact that the airport now faces these challenges highlights the risks inherent in some PPP contracts that have unclear or weaker risk transfer and cost certainty provisions, such as taking over a brownfield/retained asset while designing for and building in a dynamic operating environment," Moody's Heffintrayer said.

"The airport will remain exposed to cost overruns on the project as it no longer has a fixed-price contract with GHP," Heffintrayer added. "However, the airport would have been responsible for the costs of the change orders it requested and if it lost the dispute with GHP about the relief claim for the quality of the existing concrete."

OU's decision to cancel nearly $7 million of annual leases in Cross Village left developer Provident Oklahoma Educational Resources Inc. with about a third of its annual debt service missing after it already experienced difficulty filling the apartments. The complex opened with 28% occupancy and was about a third full with OU pulled its leases. POER had already announced reduced rents when that decision was made, and the bonds had already fallen below investment grade.

According to UMB Bank's attorney David Dubrow, OU's previous administration led by President David Boren was fully on board with Cross Village, setting specifications for the design and participating in an investor presentation. When Boren stepped down, he was replaced by James Gallogly, a former oil executive who pronounced OU's finances "a mess" and began drastic cost-cutting, including firing several officials involved in the deal.

The original leases were not approved by the board of regents in 2017, according to the minutes of an October 2018 board of regents meeting. At that meeting, months after the leases were signed by OU administrators, the board approved one-year leases. By then, Gallogly was openly critical of the arrangement, and the university did not renew the leases.

The change of administrators is one of the risks that attorneys Howard Zweig and Karl Camillucci of Taft Stettinus & Hollister cite in a paper on university P3s.

“After the departure of those officials, lost institutional knowledge could lead to critical misunderstandings between the university and its P3 partners or failures by the university to abide by the terms of the P3,” Zweig and Camillucci wrote. “The complexity and distinct terms of each P3 project exacerbate this risk. Transferring the knowledge and understanding of retiring officials to their successors is a daunting but critical challenge. Universities should develop detailed succession plans to assure that future university officials will understand the terms and provisions of, and the university’s rights and obligations with respect to, each P3 partnership and project.”

For investors, the foundation of any P3 deal is the stability of the government entity that is soliciting the project, Poliakoff said.

“Although a minority of projects may fail, the strength to investors is not the developer, but the underlying governmental entity itself,” he said. “As such, provided that the governmental entity is financially strong, savvy investors will remain open to these types of relationships.”