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Client Alert

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CALIFORNIA PUBLIC PRIVATE PARTNERSHIP DEVELOPMENTS

New laws in California may significantly accelerate the use of public private partnerships (“PPP” or “P3s”) to meet the state’s infrastructure needs. In February 2009, as part of the lengthy legislative process of adopting a new state budget, the California State Legislature finally passed legislation pushed by Governor Arnold Schwarzenegger to reinstate broad legal authority for P3 transactions. The State Department of Transportation (“Caltrans”) and regional transportation agencies are now authorized to enter into concession arrangements with private sponsors of transportation projects without the need for further legislative action. Existing state legislation authorizing municipal and local governments to use P3 techniques to build, finance and operate infrastructure remains in place. And plans and significant funding for the California High Speed Rail Authority are moving forward with an express mandate to rely in part on private sector investment and risk transfer.

Public Private Partnerships for Transportation Projects in California

California was among the very first states to authorize public private

partnerships in the late 1980s. California Assembly Bill 680, enacted in 1989, permitted the competitive selection of four privately financed toll-road demonstration projects.¹ Under this initial grant of authority, the state developed two projects: ten miles of express lanes in the median of SR-91 (the “91 Express Lanes”) in Orange County and the ten-mile South Bay Expressway toll road in southern San Diego County.

California’s enabling legislation for P3 concessions for new transportation projects lapsed in 2003. Limited new enabling legislation was enacted in May 2006.² Like the initial law, the 2006 legislation permitted the development of four projects: two in southern California and two in northern California.³ The 2006 law, however, contained a number of restrictions that limited its effectiveness.

¹ On July 10, 1989, Governor Wilson approved AB 680, 1989 Cal. Stat. ch. 107, which authorized the department to enter into agreements with private entities for the construction by, and lease to, private entities of four transportation demonstration projects, including at least one in northern California and one in southern California.

² Assembly Bill 1467, 2006 Cal. Stat. ch. 32, amended Section 143 of, and added Section 149.7 to, the Cal. Sts. & High. Code.

³ *Id.*

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First, under the 2006 law, tolls and users fees were not allowed on noncommercial vehicles with three or fewer axles. Second, the law required that concession agreements be submitted to the State legislature for approval, after at least one public hearing. Third, the law required that toll rates be fixed in the concession agreement and that any increases be approved by Caltrans after a public hearing. Fourth, the 2006 law prohibited non-compete provisions, although it permitted compensation for lost revenue in limited circumstances.⁴ Perhaps not surprisingly given these restrictions, no concession agreements for new transportation projects were entered into under the 2006 PPP law.

California lawmakers recently expanded the limited grant of authority afforded by the 2006 legislation. On February 20, 2009, Governor Schwarzenegger approved Senate Bill 4, Second Extraordinary Session, which allows regional transportation agencies and Caltrans to enter into an unlimited number of PPP projects until January 1, 2017, and deleted many of the restrictions on the number and type of projects that may be undertaken.⁵

In addition, Senate Bill 4 provides legislative authority for up to 15 design-build demonstration projects (local street or road, bridge, tunnel, or public transit projects) for local transportation agencies and up to ten projects (state highway, bridge, or tunnel projects) for Caltrans. On a statewide basis, the law also authorizes Design-Build Contracting in respect of corrections facilities, court facilities, and redevelopment agencies.

The new California P3 law:

- allows regional transportation agencies and Caltrans (the State Department of Transportation) to enter into an unlimited number of PPP projects.⁶
- provides broad authority for PPP arrangements with respect to a range of transportation projects.⁷
- establishes the Public Infrastructure Advisory Commission to advise the Department of Transportation and regional transportation agencies in developing transportation projects through performance-based infrastructure partnerships.⁸

- authorizes the contracting entity or lessee (i.e., the private concessionaire) to impose tolls and user fees for use of a facility constructed by it.⁹

The initial selection process for transportation P3s is run by Caltrans and/or regional transportation agencies. It begins when Caltrans and/or the relevant regional transportation agency solicits proposals, accepts unsolicited proposals, and then negotiates and enters into comprehensive development lease agreements with public or private entities.¹⁰ Unsolicited proposals may be accepted for consideration and negotiation but are subject to competitive public bidding before finalization.

After the initial selection process, the California Transportation Commission is directed to select and evaluate candidate projects based upon how proposed projects will (1) improve mobility by improving travel times or reducing the number of vehicle hours of delay in the affected corridor; (2) improve the operation or safety of the affected corridor; and (3) provide quantifiable air quality benefits for the region.¹¹ In addition, projects must address a “known forecast demand.”¹²

⁴ Under the 2006 law, a concessionaire may be entitled to compensation for lost revenue because of the development of a competing facility unless the competing facility is part of a regional transportation plan, is a safety project, is an improvement providing only incidental increases in capacity, is a HOV lane project, or is a project located outside the boundaries of the PPP project, as defined in the concession agreement. 2006 Cal. Stat. ch. 32.

⁵ 2009 Cal. Stat. ch. 2, as codified at Cal. Sts. Code § 143, 149.7.

⁶ Unlike its predecessor the law does not contain a restriction on the number of projects. § 143.

⁷ The law defines a transportation project as the “planning, design, development finance, construction, reconstruction, rehabilitation, improvement, acquisition, lease, operation, or maintenance of a highway, public street, rail, or related facilities supplemental to existing facilities currently owned and operated by the department or regional transportation agencies...” § 143(a)(6).

⁸ § 143(b).

⁹ The new law does not allow the conversion of any existing non-toll or nonuser-fee lanes into tolled or user fee lanes, with the express exception of a high occupancy vehicle (HOV) lane that may be operated as a high occupancy toll (HOT) lane. *See* § 143(q).

¹⁰ § 143(c).

¹¹ § 143(c)(3).

¹² § 143(c)(4).

Projects approved by the California Transportation Commission are then to be submitted to review by the Legislature and the newly established Public Infrastructure Advisory Committee. In addition, Caltrans or the regional transportation agency must hold a public hearing at or near the proposed facility. Prior to executing a final agreement, Caltrans or the regional transportation agency “shall consider” the Legislative and Commission comments. Ultimately, however, discretion remains with the first actor: Caltrans and/or the regional transportation agency that first negotiated the lease arrangement. The law explicitly provides that Caltrans or the regional transportation “shall retain discretion for executing the final lease agreement.”

Like the 2006 law, the new legislation prohibits non-compete clauses. Under the law, no agreement “shall infringe on the authority of the department or a regional transportation agency to develop, maintain, repair, rehabilitate, operate or lease any transportation project.”¹³ However, lease agreements may provide for reasonable compensation to the contracting entity or lessee for the adverse effects on toll revenue or user fee revenue due to the development, operation, or lease of supplemental transportation

projects with the *exception* of (1) projects identified in regional transportation plans; (2) safety projects; (3) projects that will result in incidental capacity increases; (4) additional HOV lanes or the conversion of existing lanes to HOV lanes; and (5) projects outside the boundaries of a public-private partnership.¹⁴

The law provides for additional transparency with respect to tolls. Proposed increases in rates *not otherwise established or identified in the lease agreement* shall be first approved by the department or regional transportation agency, after at least one public hearing.

Public Private Partnerships for Local Government Infrastructure Projects

In 1996, California enacted Assembly Bill 2660,¹⁵ which affords local governmental agencies authority and flexibility to utilize private investment capital. This law continues to govern infrastructure finance for P3s with local government agencies. The new California P3 law enacted in February 2009 for statewide transportation projects does not affect the existing law governing local government infrastructure projects.

The California Government Code provides broad authority for local government agencies to

utilize private sector investment capital to design, construct, develop, finance, maintain, improve, repair and operate fee-producing infrastructure.¹⁶ The Code is designed to provide significant local flexibility and authority.¹⁷ Furthermore, local government agencies are afforded broad discretion to use the authority conferred by the statute “when they deem it appropriate in the exercise of their discretion.”¹⁸ Explicitly excluded from this broad grant of authority, however, is local government power to design, construct, finance, or operate a state project, including toll roads on state highways.¹⁹

The California Government Code provides specific authorization for private infrastructure financing of certain “fee producing infrastructure projects.”²⁰ The Code defines a “fee-producing infrastructure project” or “fee-producing infrastructure facility” as any project or facility where the operation of the facility “will be paid for by the persons or entities benefited by or utilizing the project or facility.”²¹ The Code lists, and permits specifically, projects related to irrigation; drainage; energy or power production; water supply, treatment and distribution;

¹³ § 143(i)

¹⁴ *Id.*

¹⁵ 1996 Ca. Stat. ch. 1040.

¹⁶ See Cal. Gov. Code §§ 5956–5956.10.

¹⁷ See § 5956.1 (“it is the intent of the Legislature that local government agencies have . . . authority and flexibility”).

¹⁸ § 5956.2.

¹⁹ § 5956.10.

²⁰ § 5956.4.

²¹ § 5956.3.

flood control; inland waterways; harbors; municipal improvements; commuter and light rail; highways or bridges; tunnels; airports and runways; purification of water; sewage treatment, disposal, and water recycling; refuse disposal; and certain structures or buildings.

Private Investment Opportunities in California High Speed Rail

The California High Speed Rail Act of 1996 (the “Rail Act”) established the California High Speed Rail Authority (the “HSRA” or the “Authority”) for the purpose of overseeing and implementing the planning, financing, construction, and operation of a statewide intercity high-speed passenger rail system.²² California voters approved the Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century (the “Bond Act”) in November 2008, authorizing \$9.95 billion in general obligation bonds to finance construction of a high-speed train system.²³

The Authority may enter into a broad range of PPP contracting arrangements. The Rail Act added Section 185036 to the Public Utilities Code, authorizing

the Authority, among other things, to “enter into contracts with private or public entities for the design, construction, and operation of high speed trains... including a design-build or design-build-operate contracts” and to “enter into cooperative or joint development agreements with local governments or private entities.” However, the powers included in Section 185036 were conditioned upon the “approval by the Legislature, by the enactment of a statute, or approval by the voters of a financial plan providing for the necessary funding for the construction of a high-speed rail network.”²⁴ This condition has now been met by legislative appropriation of funds²⁵ and the plenary approval by California voters of the Bond Act in November 2008.

California’s Attorney General Edmund “Jerry” Brown has recently rendered a formal Attorney General’s Opinion that the Bond Act authorizes the HSRA to exercise all the powers set forth in Section 185036.²⁶ On February 27, 2009, Attorney General Brown advised the Authority that the Bond Act not only vests the Authority with the powers provided in Section 185036, but the authorizes the Authority to utilize the “entire statutory framework established to bring the high-speed rail network into reality.”²⁷

Thus, Attorney General Brown’s opinion clears the way for the Authority to enter into a wide spectrum of P3 transactions for various parts of the high speed rail project.

The HSRA has already held discussions with at least twelve private firms that have experience in the finance, operations, equipment/systems supply, and construction of large rail projects. The HSRA finance team believes that PPP concessions will provide from \$4.5 billion to \$7 billion in vendor and project funds (equity and debt), together with expertise and risk transfer for systems operation and, possibly, private ownership.²⁸ The Authority believes that the proposed system will net a \$1.1 billion annual operating profit once constructed and reports that private sector interest in participating in the rail network has been, and remains, high.²⁹

The successful implementation of the project will require substantial private investment. The Bond Act specifically directs the authority to pursue and obtain private funds.³⁰ And the prescribed (and proscribed) uses of bonds funds “are intended to encourage the federal government

²² 1996 Cal. Stat. ch. 796 (SB 1420).

²³ One billion dollars is dedicated to improvements to local and regional passenger trains that complement and connect with the high-speed train system. The Bond Act was enacted by the Legislature in 2002, and was originally scheduled to be submitted for voter approval in November 2004, but was postponed twice. See 2006 Cal. Stat. ch. 44 (AB 713), 2004 Cal. Stat. ch. 77 (AB 1169).

²⁴ Cal. Pub. Util. Code § 185036.

²⁵ 2006 Cal. Stat. ch. 47.

²⁶ 7 Op. Att’y Gen. 1002 (2009).

²⁷ *Id.*

²⁸ See California High Speed Rail Authority, Update on Public Private Partnerships, available at <http://www.cahighspeedrail.ca.gov/news/UpdateonPublicPrivatePartnerships.pdf>

²⁹ See California High Speed Rail Authority, Business Plan 2008 Summary, available at http://www.cahighspeedrail.ca.gov/images/chsr/20081107144941_BPSummary.pdf.

³⁰ Cal. Sts. & High. Code § 2704.07.

and private sector to make a significant contribution.”³¹

Restrictions on the use of proceeds from the Bond Act underscore the project’s expected dependence on private capital to leverage the significant investment of state and federal funds. Proceeds from the \$9.95 billion state bond issuance authorized by the voters in November 2008 may not be used for more than one-half of the total cost to construct of each segment of the train system³² nor to pay the system’s operating and maintenance costs.³³ Bond funds are available only for “planning and construction.”³⁴ Additional restrictions and guidance on the use of bond proceeds are under consideration by the California legislature.³⁵

The finance plan being developed by the California HSRA includes federal funding for 25 to 33 percent of the overall construction cost. The entire 700+ mile train system is projected to cost approximately \$40 billion, bringing the expected federal commitment required to well over \$10 billion. Fortunately for California, recent developments in Washington evidence a renewed commitment to public transport and high-speed rail in particular. New Federal Transportation Secretary Ray

LaHood has indicated that high-speed rail “is the transformational issue for this administration when it comes to transportation.” Congress has funded this priority: the Recovery Act includes \$8 billion in capital assistance for high speed rail (HSR) corridors and intercity passenger rail service, including projects that reduce congestion or facilitate ridership growth. The Secretary of Transportation is directed to give priority to projects that develop intercity high speed rail services.

In addition, the Federal Department of Transportation has already designated ten eligible HSR corridors, including the “California Corridor” connecting the San Francisco Bay Area, Sacramento, Los Angeles, the Central Valley and San Diego. Thus, California is perhaps the state farthest along in developing and building a true high-speed train project. Representatives from the HSRA are actively courting federal officials for a significant portion of stimulus’s HSR funds.

Finally, President Obama’s proposed 2010 budget proposes \$5 billion for a five-year high speed rail state grant program. Like the Recovery Act’s HSR grants, it is expected that these funds will be awarded to projects based on assessments of proposed projects’ readiness, environmental clearance, and perceived public benefits.

In sum, in the case of California’s High Speed Rail project, the legal and financial pieces to the puzzle are coming together quickly, after years of delay and false starts. Moreover, the private sector will have an important role to play in this important project. The Authority is actively drawing upon the experience of PPP infrastructure projects, including several high speed rail ventures in Europe. PPP opportunities may include the design, development, construction, operation, and finance of the rail system, or some combination thereof. If successful, the California High Speed Rail model could be adapted for similar projects elsewhere in the United States.

³¹ 1996 Cal. Stat. ch. 697 (SB 1456).

³² § 2704.08.

³³ § 2704.04(d).

³⁴ § 2704.06.

³⁵ On Feb. 26, 2009, California State Senator Lowenthal introduced S.B. 455 which further refines the delegated powers of the HSRA.

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