pfi market intelligence

MEXICAN TOLL ROADS – BACK TO THE FUTURE

By Allan T. Marks, Partner
Milbank, Tweed, Hadley & McCloy, Los Angeles

An extract from the key industry report:

INFRASTRUCTURE FINANCE: THE ROAD AHEAD

EDITOR: ROD MORRISON

THOMSON

www.pfimarketintelligence.com

SECTION 03 CHAPTER 16

MEXICAN TOLL ROADS – BACK TO THE FUTURE

By Allan T. Marks, Partner, Milbank, Tweed, Hadley & McCloy, LLP, Los Angeles[1]

Overview

Recently, I was asked to predict which North American market holds the most promise over the next couple of decades for large private investments in toll roads, bridges, tunnels, transit projects and other transportation infrastructure projects. The interesting and somewhat surprising answer: Mexico. How things change.

What is going on in Mexico? Toll roads that were once huge failures for private investors are being re-privatised in auctions by the Fideicomiso de Apoyo al Rescate de Autopistas Concesionadas (FARAC), the federal government agency that took them over in a government bail-out (of sorts) over a decade ago. State governments are also granting new concessions and exploring innovative arrangements to finance new projects or to shift the economic and operating risks of existing assets to private operators. And sophisticated market players within Mexico – construction companies, operators, banks and institutional investors – are stepping up to the challenge of aggressively pursuing these opportunities, often in partnership with foreign developers, operators, insurers and financing parties.

Background

In many ways this transformation in Mexico is astonishing. Between 1989 and 1994, during the first wave of private highway development in Mexico, over 50 toll road concessions were granted by the Secretary of Communications and Transport (SCT). In the economic collapse of 1994, many of these road concessions failed. Other factors contributed, to be sure, such as high capital costs, construction delays, overly optimistic traffic forecasts and the effect of free competing roads. Further, the fact that many of these underperforming roads were financed using US dollar-denominated debt proved catastrophic when the Mexican peso dramatically lost value against the dollar in 1994.

FARAC assumed control of 23 of 52 federal road concessions by 1997. Now that market conditions have improved and many (though not all) of these road concessions are performing well, FARAC is in a position to re-privatise many of the roads. The government is taking advantage of this newly-opened investment window. Potential bidders from Mexico and from overseas, often in partnership with each other, have shown a keen interest in acquiring these assets and in committing to increased investments for future expansions and new roads in Mexico.

According to a US government report, “Mexico's roads are the country's primary transportation network, transporting 98% of the country's people and 70% of its merchandise. . . Mexico has one of the largest systems of toll roads worldwide with 74 toll highways covering 3,684 miles and 48 bridges. CAPUFE[2] (including FARAC's roads) and BANOBRAS[3] control 2,930 miles of toll roads, and the remaining 20% are concessions operated by private Mexican companies and state governments, with 488 and 269 miles respectively. SCT's Department of Toll Highways reports 71 concessioned highways in operation in Mexico in 2001, 42 by financial institutions, 13 by private interests, 14 state owned and two by CAPUFE. The majority of toll road users during the year 2001 were cars (198,252,126), followed by trucks (50,443,681) and finally buses (18,507,930).”[4]

---

[1]Allan T. Marks is a partner in the international law firm of Milbank, Tweed, Hadley & McCloy LLP and a member of the firm's Global Project Finance Group, based in Los Angeles. He has extensive experience working on the acquisition, development and financing of toll roads, rail systems, airports and other infrastructure projects throughout the Americas.

[2]CAPUFE (Caminos y Puentes Federales) is the federal governmental agency in charge of constructing toll roads and bridges in Mexico. FARAC is an arm of CAPUFE.

[3]BANOBRAS is the federal government's national bank for development and public works.

[4]International Market Insight Report No. 116879 (June 12, 2003) by Gerardo Victorica for the U.S. Department of State, U.S. Foreign & Commercial Service (published 2004) (available at http://strategis.ic.gc.ca/epic/site/imr-ri.nsf/en/gr116879e.html).

The competition – Mexico in the context of Canada and the US

The attractiveness of Mexico as a source for serious, long-term private investment in infrastructure results from two dramatic shifts. First, Mexico has become a considerably more stable country in which to invest in the post-NAFTA years. Democratisation and a commitment to market discipline, especially in the financial sector (through privatisation of banks, pension reforms, new insolvency laws, growing capital markets and other measures), has strengthened the nation's economy, banking system, government institutions, the rule of law and monetary policy. The result? Steady growth in GDP and GDP per capita, deeper capital markets and electoral stability – all despite serious internal political challenges and increasing foreign economic competition stemming mainly from Asia.

Second, in comparison to Mexico, Canada and the US each pose significant – and significantly different – challenges to investors in transportation infrastructure as an asset class. These challenges may heighten the relative attractiveness of Mexican infrastructure investments for many of the largest global sponsors of transportation projects looking to expand in North America. Many significant investors and operators from Spain, France, Germany and Australia may find Mexico to be a surprisingly strong alternative to investing in Canada or the US. The most savvy of these companies are already exploring opportunities in all three markets as part of a global strategy of deploying capital to build a diverse international portfolio of projects.

Investment prospects in Canada

Canada has long been a leader in setting forth a comprehensive and coherent scheme for PPPs in highways, tunnels and bridges and in encouraging the private sector to exploit these opportunities. At the provincial level (especially in Ontario and British Columbia) and at the national level, Canada has taken the steps necessary to foster PPP investments and has, to some extent, set a model for other countries to follow. But in analysing future prospects, much of the low-hanging fruit in Canada will have been picked in the next few years as the market matures. There may be less room for future growth there than in either the US or Mexico.

Investment prospects in the US

The US, in contrast, is moving forward only in fits and starts. Clearly, if the US were strongly committed to mobilising private capital through PPPs to meet the critical need for investment in overburdened transportation infrastructure, the market would look very different. That, however, is not the case. Some states, such as California, briefly flirted with private toll road concessions but have had difficultly reviving those statutory programmes. Other states – notably Virginia – have had more success and remain in the vanguard of states that are applying these innovative financing techniques for the construction of new highways, high-occupancy vehicle lanes and other road links to relieve traffic congestion.

One state that was seen as the leader and largest potential PPP market in the US – Texas – has recently become enmeshed in an embarrassing political U-turn that has had at least two concrete effects. First, it has led to a qualified moratorium on new privately built and operated toll roads in the state, subject to certain exceptions for some currently pending projects. Second, Texas has tilted the playing field away from transparency and fairness by changing bidding rules for some projects in mid-stream to favour competing public agencies. Private toll road developers are the first to say that they must prove their competitiveness against public agencies every day in terms of capital and operating costs, price to end-users, system quality, efficiency and safety. But to do so, they require clear, transparent and fair rules. The lack of consistency and perceived unfairness in Texas has certainly put a damper on investors' enthusiasm for that market and threatens at present to chill the development of the PPP market in the US as a whole for at least the near term.

The gap remains very wide in the US between transportation agencies and government executives (who often favour PPPs as a fiscally responsible way to increase mobility without increasing taxes or public debt) and the public at large (who often distrust private toll road operators and have a general distaste for tolls and user fees, along with taxes). Until the political leaders who favour PPPs and their industry partners do a better job of educating the public about the pros and cons of these types of investments, the US is likely to remain a limited market for these types of investments.

In short, some investors view Mexico as offering less political risk for private transportation investments than the US, to the extent that the political will to embrace PPPs is more entrenched south of the border. Although one can certainly debate that proposition, in markets and in the competition for long-term investment capital, perception is everything. That sentiment could bode well for Mexico as it competes for international capital for these types of investments.

Recent Mexican market developments

Concession models

As the credit quality of Mexican toll roads has improved in the last few years, new opportunities have opened in the market for private investment there. The SCT has three basic models to attract private investors to help close the gap between available public funds and the estimated US$5bn per year that Mexico needs to invest to maintain and expand in its interstate network of highways, bridges and tunnels:

- New concessions for a term of up to 30 years, under which the private operator bears the risks of construction, operations, and traffic;

- Private service contracts (also known as Proyectos para Prestación de Servicios, or PPS projects), under which the private concessionaire builds and operates a road in exchange for regular government payments tied to availability and traffic levels (shadow tolls), with the government bearing toll collection risk (if the road is tolled, which it often is not for PPS projects) and some traffic risks;

- Sales of existing roads under new concessions, particularly the sales contemplated by FARAC.

The government supports some concessions to varying degrees by providing, where appropriate, design work, rights of way (of critical importance, especially in Mexico where land acquisition for a road or rail project can be a lengthy and risky process), limited initial funding, and minimum revenue guarantees. For stronger projects, the government weighs bids based on technical, legal and financial considerations and expects the investors to make a sizable investment rather than receiving a subsidy.

Recent transactions

Several significant toll road deals have closed in the past year. The SCT awarded a 30-year concession to Spanish development firm Isolux-Corsán for the construction and operation of a US$335m, 95km toll road from Saltillo to Monterrey in Northern Mexico. This project was recently financed using a combination of senior debt from foreign banks, subordinated debt and a creative mix of quasi-public and private funding sources. Another Spanish constructor, Azvi, was awarded the concession for the 45km road from Tapachula to Talismán (with a branch off to Cuidad Hidalgo). The US$150m concession will last for 20 years.

The US$105m Querétaro to Irapuato highway concession, was granted to the Mexican construction company Empresas ICA in mid-2006 on a re-tender from the SCT after the original bidding procedure was declared void. The multi-state route covering over 90km of roadway, including road-widening to four lanes for approximately half of that stretch, is expected to be completed in late 2008. The country's initial PPS project also involved Irapuato, improving the 75km federal highway running through the state of Guanajuato from Irapuato to La Piedad, and was awarded to ICA in August 2005.

Various other concessions are in the works. Earlier this year the SCT began pressing forward with two projects: the Rio Verde to Ciudad Valles road in the eastern portion of the state of San Luis Potosí and the Nuevo Necaxa to Avila Camacho roadway in northern Puebla. Although both concessions were initially delayed in January and February of this year, the SCT elected to further delay the Rio Verde road in favour of pursuing the Nuevo Necaxa project. The delays resulted in large part from the need for more thorough geotechnical studies to properly assess risks associated with proposed tunnels on these routes.

The SCT has announced the winning bid for the Nuevo Necaxa venture, a US$1.05bn road that will complete the Mexico City to Tuxpan highway. Although two consortia were expected to place project bids by the 25 May deadline, one failed to do so, all but assuring that the remaining consortium of FCC and ICA was awarded the project as its submission conformed with specified requirements. (The interest of the non-bidding party, comprised of Bouygues and IDEAL (Impulsora del Desarrollo y el Empleo en América Latina), in this sector is of note because the infrastructure fund IDEAL is spearheaded by Mexican billionaire Carlos Slim.)

The 112km Rio Verde highway deadline for proposals was extended to 12 June 2007. The US$350m project drew interest from Mexican, Spanish and Italian bidding groups. ICA won the competition.

Several other projects are currently in tender status, including:

- Nueva Italia to Apatzingán – A 32km road through the state of Michoacán;
- Irapuato Bypass – A 28km road that will connect the Irapuato-Léon and Irapuato-Guanajuato highways;
- Reynosa-McAllen Bridge – A US$60m, 2.6 km PPP toll bridge in Tamaulipas;
- FARAC Package 3 – A 30-year lease package of four sections of existing roadways totaling over 550km.

FARAC Package 3, the first of as many as 13 expected FARAC asset packages, has certainly drawn the most interest of the SCT concession projects released thus far. At least a half a dozen significant bids came from all over the globe. Mexico's major repeat players teamed with foreign groups in their bidding – ICA joined with Goldman Sachs while IDEAL teams with Sydney-based Macquarie Infrastructure Group. Almost US$1.5bn of the bid amount will be used by the Mexican government to retire existing debt. In the end the ICA/Goldman team won the deal with a US$4.1bn bid backed by a US$4bn financing being led by Santander. The SCT expects to reach financial close on the concession sales by the end of September 2007. Like all anticipated FARAC packages, Package 3 bundles highly-desirable roadway assets with less attractive sections in order to free the Mexican government of the nearly 50 roads and three bridges that were renationalised over a decade ago.

In addition, as many as 12 other projects are in their initial planning stages, awaiting approval of the SCT before being officially tendered to the open market. The SCT plans on proceeding with the Mitla to Entonque Tehuantepec and Zacatecas to Saltillo concessions in the near future. All of these projects show both governmental ambitions to expand private road concessions and significant private sector interest (both Mexican and foreign) in capturing these opportunities.

Increasing the role of the private sector

Government of Mexico – current goals

The new administration of President Felipe de Jesús Calderón Hinojosa, who was elected in 2006 to a six-year term, has ambitious plans to expand the role of the private sector in meeting Mexico's transportation needs. Relying particularly on the FARAC concessions, President Calderón hopes to raise as much as US$25bn from sales of highway concessions over the next six years. About half the money raised will be used to increase the capacity of the road network by building new highways and adding lanes, extensions or other improvements to existing facilities. The balance of the money that the government realises from these asset sales will be used to retire debt that the government incurred in connection with previous highway investments. The initial FARAC auction could raise at least MX$25bn (or about US$2.3bn) according to government estimates.

There are a variety of ways in which the Calderón privatisation plan increases private sector involvement. First, the government would convert up to 16 existing public highways to toll roads to be managed by private operators. Second, existing government-owned and operated toll roads are being auctioned to the private sector, chiefly by FARAC. Lastly, private companies are being solicited to build new, privately-managed and operated toll roads in both urban and rural areas.

State governments – current goals

Mexico has a strong federal system, and state governments are also rushing to take advantage of concession structures to attract private capital to meet growing demand for mobility. Many states have long had concession laws and are updating them along many of the same lines as recent federal legislation. Of course, there is a range of political attitudes among state governors and legislators for or against private toll roads. But the significant point for potential investors is to realise that opportunities for state road and bridge concessions offer an important alternative path into the Mexican market.

Some states have already explored the prospect of granting concessions to private companies to build and operate toll roads and bridges. Others, such as the State of Nuevo León, have successfully raised funds from institutional investors in the capital markets without the need for a private concessions. In 2004, in the first transaction of its kind, the State of Nuevo León transferred toll collection rights for the Monterrey-Cadereyta toll road to a private trust that issued long-term bonds in the Mexican capital markets.[5] The bonds were backed by future toll revenues and supported by a financial guaranty insurance policy issued by a US based monoline insurer. Since there was no private concession, the state government (through its Red Estatal de Autopistas) retained day-to-day responsibility for maintenance of the road and toll collections, but the state was able both to transfer to investors and the private bond insurer the risks associated with traffic and toll revenues and to fully refinance the public debt that the state had owed to BANOBRAS for the original construction and an earlier refinancing of the road.

Other state governments have previously enacted comprehensive laws that provide the statutory authority for the states to grant concessions for the private development and operation of road and rail projects. As more transactions have been carried out at the state level, these laws have been modified where necessary to meet the concerns of institutional investors and ratings agencies about some of the sovereign risks that are embedded in a concession arrangement, mainly to protect the sanctity of the contract and the toll collection rights through to the end of the concession term.

Today, many Mexican state governments are also enacting laws to allow for shadow tolls and availability payments to private concessionaires along the lines of the federal PPS model. Michoacán recently approved legislation allowing for new projects to be procured under a DBFOM (design/build/finance/operate/maintain) structure for three to 15 years. The State of Mexico (not to be confused with the federal government) enacted a PPS law last year, though it contains various limitations. Similar PPS legislation is also pending or about to be proposed in Tamaulipas, Durango, Aguasclientes, Puebla, Tabasco and Sonora. The State of Guanajuato is conducting feasibility studies for a new PPS-based toll road from León to Irapuato and is also pursuing plans to build an intercity rail network under a PPP concession that was awarded several years ago and is now nearing the financing and construction stage.

Future prospects

The first round of FARAC bids were due on 26 June 2007 . The Inter-American Development Bank (IDB) has approved a partial credit guarantee of up to US$400m which may be available to the winning bidder. The bid deadline has been extended in the past, but a number of companies are still expected to bid.

Overall, market trends are split. The new Mexican market has yet to see widespread use of PPPs to finance new, greenfield road projects. To a large extent, this pattern reflects continued wariness on the part of investors both domestic and foreign with respect to three main risks of new projects there:

- Capital cost overruns;
- Lack of confidence in traffic and revenue forecasts;
- Issues relating to rights of way (e.g. land acquisition, geotechnical risks).

Acquisitions or refinancings of existing assets remain the easiest deals to close. Of course, these transactions are largely free from the biggest risks (mentioned above) associated with greenfield projects. Indeed, largely on the back of monoline-wrapped bond offerings, several toll roads with long operating histories have been successfully refinanced with longer-term debt. With sufficiently long tenors, coverages have increased to the point where toll rates can be significantly lowered, increasing traffic and earning the support of both the local populace and the state and federal governments. The FARAC auctions, to the extent they are designed in part to maximise revenue to the federal government, are unlikely to result in significant toll rate reductions.

---

[5]The author represented the State in that transaction.