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P3s, Bond Ratings, and Debt Calculation

BY DAN HUGE AND WILLIAM JONES
As public-private partnerships (P3s) have become an increasingly popular method of funding large capital projects, much discussion has focused on the choice between financing a project the traditional way (using tax-exempt bonds) and using a P3. Two factors should influence that decision: How rating agencies analyze P3s, and the subsequent impact those analyses have on bond ratings.

The difficulty that comes with analyzing P3s is that financing is often supplied by the concessionaire; therefore, associated costs cannot be determined so easily, as they would be in a typical governmental entity’s bond structure under conventional debt financing. How are ratings for the bonds themselves determined, and how do rating agencies decide what, if anything, to add to an entity’s debt burden?

**BOND RATINGS**

Jurisdictions will need to make important financing decisions in determining whether or not to pursue a P3, as well as the type of P3 to be executed. When the financial component of any deal under consideration becomes part of the concessionaire’s responsibility, the effect on an entity’s bond ratings must be considered.

P3 participants may earn a rating that is substantially below what they would expect if they were to pursue traditional funding via tax-exempt bonds. The current bond rating of any governmental entity considering a P3 becomes part of the rating process for any related debt issuance, and such a benchmark rating typically serves as the ceiling for any rating related to P3 borrowing. A jurisdiction’s rating will often remain significantly higher than any final rating assigned to a P3, rendering any such perceived ceiling a moot point. (This is because many risks—such as completion risk, cost risk, debt structure, and securitization—are borne by the concessionaire.) When combined, these additional risks usually put the ranking into the Baa/BBB to Ba/BB category.

These ratings gaps may create a sizeable difference in financing costs, but that doesn’t necessarily mean that a government entity should finance a project using traditional means. Financial losses might be offset by increased efficiency, reduced risk, and other benefits that the right P3 project can provide. Jurisdictions, including all relevant stakeholders, need to conduct cost-benefit analysis to evaluate the risks and rewards of a proposed P3 project, and they should do so early in the decision-making process. For further guidance, the Government Finance Officers Association adopted an advisory addressing a wide range of factors that governments should consider.1

**HOW THE RATING AGENCIES VIEW DEBT**

Due to the idiosyncratic nature of P3s, each rating agency will likely evaluate each financing arrangement on its specific merits. The three major rating agencies—Fitch, Moody’s, and Standard & Poor’s—have general principles that they consider when evaluating the creditworthiness of proposed P3 projects.

**Fitch Ratings.** Fitch’s stated goal when assigning a rating to a P3 project is to match any related debt to the amount that a governmental entity would have issued if it had chosen to build the project by traditional means. As a result, Fitch adds the amount of outstanding project debt to existing debt levels the jurisdiction has already assumed.

Outstanding debt can take many forms, including federal loans, private activity bonds, bank debt, or any other form of financing a private concessionaire may have obtained. This calculation does not account for any scheduled milestone payments unless debt was issued to meet such obligations. Additionally, operations, maintenance, and/or lifecycle costs are not calculated as debt, since these expenses would have been incurred regardless of the procurement method.

Fitch does not consider whether a revenue source can be used to offset any debt-financed liability, until the issuer can demonstrate three full years of revenues that cover the cost of any availability payments. Until this point in the cycle, the amount of debt incurred is fully recognized as net tax sup-
ported (NTSD). Fitch then conducts an analysis to determine if this scenario will hold true over the life of the obligation. After obligations are met during the three-year measurement period, Fitch may opt to classify the amount of any remaining debt as a contingent liability.

**Moody’s Investors Service.** Moody’s takes a similar approach to rating P3s, but there are minor differences. Notably, Moody’s calculates the amount of debt to be added to a government entity’s books as the higher of the liabilities reported on the public entity’s financial statement or the termination payment the government entity would need to make if the developer were to default. As an example, in the Ohio River Bridges P3 executed by the State of Indiana, the amount owed under a default by the developer equated to 80 percent of the outstanding amount owed on the bonds.

To be labeled self-supporting and thus removed from the calculation, a jurisdiction must demonstrate that project revenues will offset any availability payments, including operations/maintenance and lifecycle costs, for the entire life of the project. Ultimately, this requirement can be satisfied by documenting several years of continuous coverage and demonstrating that such coverage will continue into the future. Second, and equally important, the entity must commit available project revenues to meeting all outstanding debt obligations during the life of the project or until retirement, whichever comes first.

**Standard & Poor’s Rating Service.** S&P evaluates a government’s obligation under a P3 to determine if it is debt-like in nature, and to identify whether or not pledged revenues are backed (or partially backed) by taxes. In turn, these considerations guide the firm’s decision to count P3 payment obligations as debt, a contingent liability, or neither when calculating an entity’s NTSD. Generally, if a P3 obligation is determined to be secured solely by non-tax

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### P3s and Payment Types

P3s form a broad category; for the purposes of this discussion, the term refers to instances where a governmental entity makes an availability payment, which is a remittance in exchange for the use of an asset. Milestone payments, or payments made during construction, are also included. Revenue deals (e.g., tolls) where the concessionaire assumes the revenue risk or where an upfront payment is made to the governmental entity in exchange for a source of revenue earned in the future, are not considered here. This is not to say that revenue deals do not represent an important category; rather, this discussion focuses on dissecting P3s where the revenue risk resides with the governmental entity.

The financing of procurements normally comprises two methods of payment from a governmental agency to the concessionaire: milestone payments and availability payments. Milestone payments are issued in installments that are paid throughout the construction period. This type of payment can be made when a private operator actually achieves a desired result (i.e., a milestone), or when a percentage of the project is complete.

Availability payments are made at regular intervals after the project’s completion. These payments can only be made if the project is deemed ready for utilization, and they are not based solely on the receipt of a specific revenue source, such as tolls. In addition, they may increase based on an inflationary factor/measure, and they can be reduced if performance targets are not met.
backed revenue, payments will not be included as part of the jurisdiction’s debt. This is typically the case in volume-based projects such as the Indiana Toll Road, where there is no recourse if pledged revenues are insufficient to cover project debt. However, if revenues pledged for payment to the concessionaire include a tax-backed component, S&P will conduct additional analysis to determine the amount to include in its analysis of a government’s debt statement.

For tax-backed revenue (general obligation, appropriations, or special tax), S&P evaluates milestone and availability payment obligations separately. If milestones are contractually contained within a P3 procurement, they are likely to be added to a sponsoring government’s debt statement. This is the case even if milestones are to be met using appropriations as opposed to a debt instrument because the commitment and revenue used to satisfy such an obligation is identical to paying outstanding debt. Put simply, S&P views these milestones as contractual payment commitments made by the participating government entity.

Another consideration is the manner in which S&P treats the additional debt amount that reflects the capital component (excluding anticipated operation/maintenance and lifecycle costs) of availability payments. If there are additional non-tax-backed revenues pledged for either milestone or availability payments, S&P reduces the amount of debt added to a government’s debt statement to the extent that those additional non-tax-backed revenues have been demonstrated to provide partial or full self-support of the payment obligation. In most cases, because project revenues are not available until construction is complete and all milestones have been met and paid, other non-tax-backed revenues are typically not available to provide support for milestone payments. For availability payments, there must be a demonstrated record of these revenues providing self-support—i.e., self-support that is not based on revenue projections.

Once the amount of debt that is paid by tax revenues is identified, and prior to incorporating any P3 obligations into its debt analysis, S&P will calculate the net present value (NPV) of future milestones and the capital portion of availability payments made by the government entity to the concessionaire. The discount rate is pegged to what the borrower projects as the cost of funds it would have incurred if it had issued its own debt for the project, and what the agency considers to be additional factors (such as an entity’s bond rating and duration of the subject P3 agreement). In turn, this NPV calculation becomes the source for the amount of P3 debt that is represented by both milestone and availability payments. Thereafter, milestone payments are incorporated into S&P’s debt analysis at financial close. Conversely, availability payments are considered contingent liabilities during construction and, if necessary, added to debt statements once these payments commence. Presumably, this occurs at the

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point where substantial completion of a project is realized.

CONCLUSIONS

P3s are a hot topic among governments as they grapple with the tough task of spending limited tax and revenue dollars in the most efficient and effective way possible. Jurisdictions need to make sure they understand the individualistic nature of P3 agreements as well as the nuanced decision making that accompanies the process by which such projects are evaluated. These considerations — especially credit ratings — must be analyzed when weighing the costs and benefits of any given P3. 1

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Note

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