DCPCS BRIDGE THE BELTWAY GAP

ON APRIL 9 2020, A PRIVATE CONTRACTOR WAS ABLE TO RAISE US$281M OF PROCEEDS IN THE US MUNICIPAL BOND MARKET TO FINANCE THE CONSTRUCTION OF THE LINCOLN SOUTH BELTWAY, A NEW 11-MILE EAST-WEST HIGHWAY SOUTH OF LINCOLN, NEBRASKA. BY BARNEY ALLISON, PARTNER AND BRANDON NGUYEN, ASSOCIATE, NOSSAMAN LLP.

The bonds were sold during an unprecedented meltdown in the US tax-exempt market brought on by the national response to the Covid-19 pandemic and the temporary liquidity crisis it spawned.

This issuance of bonds represented the culmination of a months-long process spearheaded by the Nebraska Department of Transportation (NDOT) to finance a project that is expected to improve east-west connectivity for regional and interstate highway travel through Nebraska.

This is the story of how strong counterparty credit and a well-structured financing transaction was able to overcome the crisis and deliver the financing required to build the project.

Introduction

Lincoln, Nebraska, is the capital of the state and the home of the University of Nebraska Cornhuskers college football team. Located adjacent to Interstate 80, for years the city has suffered from a heavy volume of regional and interstate truck traffic, congesting city streets; upon its opening, the Lincoln South Beltway project is expected to reduce large truck-related crashes by as much as 30%.

Under NDOT's typical approach, construction of the Lincoln South Beltway would have been broken into smaller parts, with each individual part built depending on the availability of tax revenue to make payments to the contractors. With this approach, the project would usually be completed in seven to 10 years as cashflow trickled in overtime via normal tax revenue and appropriations by the Nebraska Legislature.

As a result, the public would not realise the benefits of the new highway until sometime between 2028 and 2030. Since the contractor indicated that it could complete the project as early as 2023 following a construction period of just three years, it was clear that the NDOT's normal financing model would lead to inefficiencies due to the inherent disconnect between the construction schedule and the availability of payments.

NDOT does not have the statutory authority to incur debt; in addition, the Nebraska constitution includes an express limitation on the incurrence of debt by the state or its agencies.

Under the Nebraska constitution, the state – and by extension, state agencies such as the NDOT – may only contract debts "never to exceed in the aggregate one hundred thousand dollars, and no greater indebtedness shall be incurred except for the purpose of repelling invasion, suppressing insurrection, or defending the state in war…"[1]

If the project was ever to proceed under these unique legal constraints, NDOT and the contractor would need to devise a novel method of securing construction financing never before utilised in the state.

The DCPCs

To address these inefficiencies, while also remaining in compliance with the Nebraska constitution's prohibition on incurrence of debt, the parties agreed on a financing framework specifically tailored to the Lincoln South Beltway's timing and regulatory complexities.

On January 24 2020, the NDOT and the contractor entered into a construction contract that generally requires the contractor to complete the project in three years, while allowing NDOT to make a fixed stream of payments over the original seven to ten year pay go schedule.

Pursuant to the terms of the construction contract, the contractor will perform work that entitles the contractor to certain progress payments paid by the NDOT based on the amount earned for quantities of work completed and accepted by the NDOT.

To the extent a monthly progress payment owed to the contractor is in excess of the applicable maximum cumulative amount specified under the construction contract – US$7.5m per calendar quarter – the excess amount of the progress payment owed to the contractor will be made by the NDOT in the form of Deferred Contract Payment Certificates or DCPCs issued to the contractor.

As the direct payment obligor for the DCPCs, the NDOT will make payments with respect to the DCPCs on dates specified in the DCPCs. The DCPCs were structured with certain features that provided flexibility and security for their holders. For example, the DCPCs:

- Are freely transferable and are not subject to the completion or operation of the project;
- Grant their holders unconditional and irrevocable rights to payment from the NDOT, subject only to appropriation from the Nebraska Legislature as described below; and

- Have priority above all other payment obligations in relation to NDOT capital improvement project contracts provided that the NDOT may make payments under deferred contract payment certificates issued in connection with future capital improvement projects at the same level of priority as payments under the project's DCPCs.

In addition, given Nebraska state law restrictions on debt incurrence, the DCPCs could not function like promissory notes or other security instruments typically found in the commercial lending space. Instead, the funding of DCPCs would need to be tied to annual appropriations from the Nebraska Legislature in order to comply with state law limitations.[2]

The NDOT plans to pay for the project in part with funds generated under the Build Nebraska Act, which was passed with the intention of building capital improvement projects such as the Lincoln South Beltway.[3] Additional funding would come from gas tax revenue, which is statutorily dedicated to funding highway construction projects.[4]

Together, funds from the Build Nebraska Act and gas tax revenue would supply the funding necessary for the NDOT to fulfil its payment obligations to the contractor under the DCPCs.

During each State of Nebraska budgetary cycle, the NDOT will seek an annual appropriation from the Nebraska Legislature in an amount sufficient to cover all payments related to the project. The NDOT would then apply such amounts to satisfy the NDOT's payment obligations under the DCPCs.

However, the construction contract provides that the NDOT is not required to make payments under the DCPCs if there is no appropriation from which payment can lawfully be made. Accordingly, payments will not be made on the DCPCs in any year if there is no appropriation, or an insufficient appropriation, with respect to the project.

Figure 1 below is a pro forma example of the expenditure of funds to pay for the project during its construction phase, as well as the use of the fixed payments from NDOT to pay the DCPC's over the term of the bonds.

Sale of the DCPCs

Following the contractor's receipt of a DCPC, the contractor will sell all of its right, title and interest in the DCPC and the payments owed thereunder to Lincoln South Beltway SPV LLC, a bankruptcy-remote special purpose limited liability company and an affiliate of the contractor, the SPV.

Once the SPV has purchased a DCPC, the SPV will sell all of its right, title and interest in the DCPC and the payments owed thereunder to US Bank, National Association, as trustee agent, for the benefit of the bondholders.

The sale of DCPCs thus facilitates a flow of funds from Nebraska Legislature appropriations, through to the contractor and its affiliated SPV, finally to the municipal market investors whose initial bond purchases contributed to the upfront proceeds funding the project at financial close.

Figure 2 below illustrates the project's financing structure, the role of the various participants and the discounted purchase of DCPCs using the proceeds of the bonds to pay the contractor.

Securing financing amid Covid-19

The NDOT solicited contractor bids for the Lincoln South Beltway from October 4 2019 through to December 12 2019. Pursuant to the terms of the NDOT's bid solicitation, the winning bidder was required to obtain all financing for the project by a date certain and put up financial close security.

The NDOT awarded the contract to the contractor on December 20 2019 and the contractor then set out to secure financing for the project as required under the terms of the construction agreement. Following the award, the contractor and its financing team ultimately elected to access the municipal bond market to obtain all the financing for the project.

On March 27 2020, the underwriter, RBC Capital Markets, launched the bond offering by posting a preliminary official statement and investor presentation describing the project, the project participants, the financing structure using the DCPC's as collateral and relevant transaction documents.

Unfortunately, the late March launch of the bonds coincided with the onset of the ongoing Covid-19 pandemic, which ushered in a period of heightened market volatility and disrupted the global, national, and local economies.

The spread of Covid-19 forced investors to grapple with a considerable degree of uncertainty, resulting in widespread risk-averse sentiment and accordingly, a dramatic decrease in liquidity across the capital markets.

FIGURE 1 - CONTRACT PAYMENTS

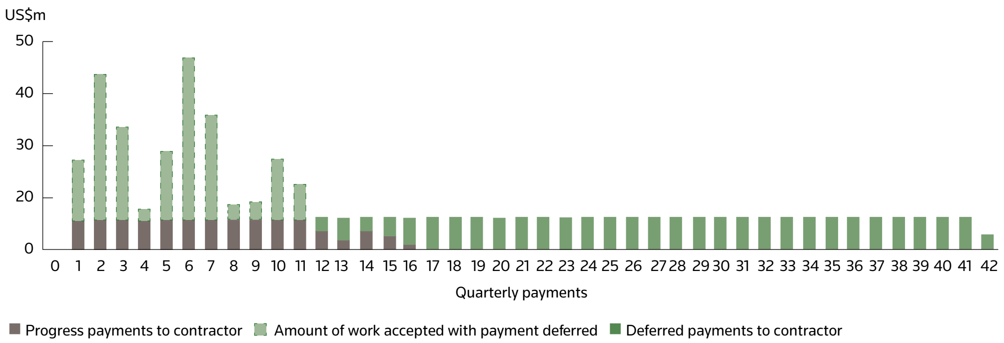
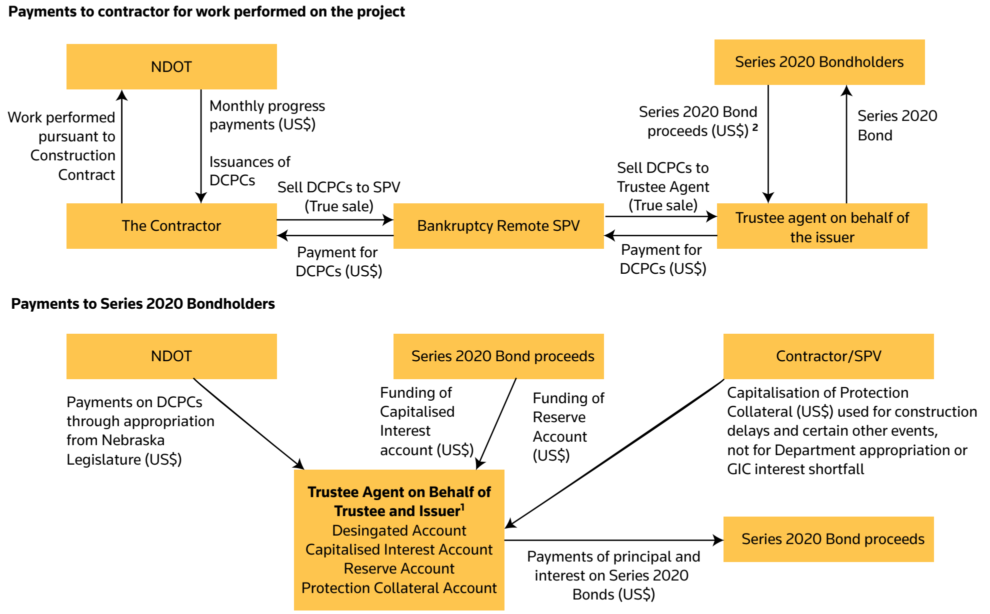


FIGURE 2 - CONTRACT STRUCTURE



1 Prior to the payment of debt service on the Series 2020 Bonds, funds will be withdrawn from the Designated account and transferred from the Trustee Agent to the Trustee for deposit to the Bond fund and applied to the payment of debt service on the Series 2020 bonds pursuant to the Indenture

2 In addition, on the closing date, the contractor will transfer the sum US$1,184,000 with the Trustee for deposit in the project account.

Largely due to the economic impact of Covid-19, it appeared for some time that the bond market was on the verge of collapse, with its normally robust investor pool unavailable to finance the project. However, thanks to early intervention by the US Federal Reserve in mid-March, the bond market stabilised enough to provide the project with an adequate investor base.[5]

These measures – coupled with the NDOT's strong credit backing the transaction and the relatively short term of the bonds – bolstered the offering in the view of investors.[6]

The contractor was ultimately able to price the bonds at rates that largely matched those included in the financial model provided with its December 2019 bid (final yields range from 1.99% to 2.49%). Considering the uncertainty permeating the market just days prior, the Lincoln South Beltway bond pricing was a welcome success in an otherwise difficult financial market.

Conclusion

With the NDOT's strong underlying credit supporting the transaction and an innovative financing structure that placed a premium on payment flexibility and insulated the debt holders from project risk, the Lincoln South Beltway achieved a successful financial close.

NDOT will be able to deliver a much-needed highway project to the region, but from a broader perspective, the transaction serves as an example of a creative financing structure that could become more prevalent in the market.

Even before the virus outbreak, state DOTs were experiencing funding challenges due in part to declining federal funding. Covid-19 has already exacted a heavy toll on the fiscal health of some public authorities, and the pandemic is forcing many others to prepare for economic hardship.

In light of the uncertainty associated with the duration of the Covid-19 pandemic and the impact on highway authority revenues, the Lincoln South Beltway could provide a useful template for other public authorities that are expecting revenue shortfalls in the near term, but wish to continue forward with financing of critical capital improvement projects with a tool that provides budget certainty and a low cost of funds. ■

Footnotes

1 – Neb. Const. art. XIII, §1.

2 – In Ruge v. State, 201 Neb. 391, 267 N.W.2d 748 (1978), the Nebraska Supreme Court held that future payments made contractually dependent upon appropriations were not subject to the constitutional debt limitation.

3 – The Build Nebraska Act dedicated one quarter of one percent of sales tax receipts for expansion of the expressway system, federal designated high priority corridors and preservation of the existing transportation system. See Neb. Rev. Stat. §§ 39-2701 to 39-2705 (2016 and Cum. Supp. 2018)).

4 – See Neb. Rev. Stat. §66-4, 147 (2018).

5 – On March 15 2020, the Federal Reserve slashed its federal funds rate to nearly zero and expanded asset purchases to approximately US$1.5 trillion. Most notably, the Federal Reserve extended its asset purchase program to include purchases of short-term municipal bonds.

6 V The State of Nebraska has investment-grade credit ratings of AAA and Aa2 from S&P Global Ratings and Moody's, respectively. The bonds will mature between 2023 and 2031.