U.S. Department
of Transportation
**Federal Highway
Administration**

Memorandum

Subject: **ACTION:** Clarification of Eligible Project Costs for Public-Private Partnerships

Date: January 4, 2011

From: Regina McElroy
Director, Office of Innovative Program Delivery

In Reply Refer To:
HIN-1

To: Victor M. Mendez
Administrator (HOA-1)

This memorandum seeks your concurrence in considering as Federal-aid eligible, costs related to highway projects delivered by public-private partnerships ("P3") using the Availability Payment ("AP") Concession Model.

The FHWA Team is proposing a new innovation in the P3 arena that will significantly advance projects in the 21st century. The Office of lnnovative Program Delivery (OIPD) established a working group comprised of key individuals drawn from FHWA's Leadership ranks as well as staff experts representing the Office of the Chief Financial Officer, the Office of lnfrastructure, and the Office of the Chief Counsel. OIPD, as per your guidance, directed this group to be innovative, creative, expansive and flexible as they worked to develop a method to establish Federal-aid eligibility for cost components in a P3 AP Concession. The approach we used to address this issue was extraordinarily successful and will provide a template for future efforts aimed at developing creative and flexible solutions to effectively respond to a rapidly evolving project delivery environment.

P3s are contractual agreements between a public agency and a private entity that allow for greater private participation in the delivery of transportation projects. Typically, this participation involves the private sector taking on additional project risks, such as design, construction, finance, long-term operation, and traffic revenue. There are two models in the U.S. used to compensate investors through a P3 concession. The first is a toll concession model where the private concessionaire is compensated through toll collections. The second model is the AP Concession Model. For P3 projects using the AP Concession Model, payments are provided to a project concessionaire according to a pre-determined schedule over a specified period of time while a facility is "made available" at a negotiated performance level.

More and more States are exploring P3s as a way of responding to the shortfall in public funds, the aging condition of our assets, and the ongoing financial crisis in the domestic and global marketplace. P3s can spur new financing sources (such as private capital) and encourage and facilitate procurement processes that can produce significant cost savings. In general, P3s offer a mutually beneficial way for private entities to work with State and local governments to deliver critical high-performance transportation services with fewer public resources. Not surprisingly, USDOT considers P3s to be an important tool in the project delivery tool box.

To date, FHWA has not directly participated in Federal-aid reimbursement of APs. In fact, despite extensive implementation of this model internationally, only three projects have been advanced under the P3 AP Concession Model in the US. Recently, we received a request from the California Department of Transportation and the San Francisco County Transportation Authority, sponsors of the Presidio Parkway project, to determine Federal-aid eligibility for the APs included in that project.

Over the course of an extensive review process addressing the Presidio Parkway request, we determined that the AP Concession Model needed to be defined in the context of existing statutes and regulations. The challenge was to correlate this new approach - having different labels, processes, and definitions - with a body of statutes and regulations that were enacted in contemplation of a narrower range of project delivery methods. This required re-defining the P3 model in terms that would be recognized by the existing statutory framework. The details of the proposed approach are presented below. The proposal has immediate applicability to the Presidio Parkway project, as well as broad applicability to all P3 projects.

Your concurrence in this matter will result in the Administration advancing a policy to significantly facilitate the implementation of future P3 procurements. This action is in keeping with the Agency's Every Day Counts initiative in that it allows the industry to move beyond standard approaches that rely on past practices and support increased opportunities for lifecycle efficiencies, performance innovations, and expedited project delivery. And, in addition to supporting improvements in "how" projects are delivered, it will also support the ultimate delivery of projects. P3s can help avoid the indefinite deferral of actually delivering a project, with the attendant delays in mobility and losses in National economic productivity.

Background: Determining a mechanism for Federal-aid participation presents several threshold issues for FHW A and the Federal-aid reimbursement process: (1) Identifying eligible costs; (2) reimbursing eligible costs included in the AP, but not discreetly delineated; and (3) reimbursing costs incurred up-front, but paid out over time.

While traditional construction projects have component parts that can easily be segregated by phase, cost, contractor, subcontractor, etc., and typically one can look to the construction contract to find the universe of specific, enumerated eligible construction costs, P3 Agreements treat projects as comprehensive, single units. In the AP Concession Model, the project is delivered by the Concessionaire over an extended period of time, starting with up-front construction, which is followed by operations and routine and capital maintenance during a concession period that is often thirty or more years, during which the facility is open to traffic. Final handover to the State of a fully functional, payments take into consideration component parts of an overall project, but do not necessarily correspond with line-item costs of the P3[1]. Rather, an AP is unitary;

[1] In the AP Concession Model, there is sometimes a separate "milestone payment" made at the time the facility opens to traffic. Unlike, APs, milestone payments may be made based on line-item costs of construction.

that is, it is designed to cover all aspects of project delivery. There is no direct correlation between the timing of the AP and performance of work by the Concessionaire. Whether APs are made in lump sums or at regular intervals, or a combination of both, they are not allocated to cover specific pieces of the project (e.g. direct up-front construction costs). APs amalgamate up-front hard construction costs as well as deferred payments for construction and other costs.

For projects advanced under the standard (i.e., non-innovative) paradigm, certain costs to the State, such as profit, financing and overhead are implicit in the contractor's bid and generally pertain to quantifiable, eligible work identified in the construction contract. In contrast, the innovative AP Concession Model recognizes these cost components, and allocates representative amounts of each cost category among the (1) construction of the facility, (2) availability of a quality transportation facility for public travel, and (3) the ultimate delivery of the constructed project at the end of the concession period, all of which are all covered within the global P3 project.

The aggregation of project costs into a unitary payment provides cost certainty for the State by establishing all costs up front and promoting substantial savings through innovation and cost efficiencies by procuring the project via a "one-stop shop". P3 Agreements typically shift the risk of over-runs on construction and operations and maintenance through the life of the concession to the Concessionaire. P3s also provide the efficiency of allowing the State to deal with one party for all project-related issues. Finally, the Concessionaire is incentivized, via shifting of risk inherent to this procurement model, to be as innovative and efficient as possible as such innovations and efficiencies have the potential to translate into cost savings.

Discussion: It is appropriate to consider APs as costs for Federal-aid reimbursement. APs cover construction-related costs throughout the concession period, and as such may be deemed eligible for Federal-aid reimbursement. States are responsible to cover any ineligible cost items included in the AP, such as routine operations and maintenance ("O&M") costs and portions of indirect costs allocable to O&M costs.

APs must comply with the allowability requirements in Federal cost regulations, which require all costs to be reasonable and allocable. Under Government-wide OMB cost principles, Federal-aid funds may be applied to eligible project costs that are reasonable (49 C.F.R. § 18.22). Under the AP Concession Model, determination of reasonableness occurs up front and requires a significant amount of due diligence by state and local officials in the cost estimation and contract negotiations phases of the project. The AP model helps facilitate the evaluation of reasonableness by providing an up-front picture of all the costs over the entire concession period prior to handover to the State. APs may be considered reasonable Federal-aid costs because reasonableness is vetted through: (1) a highly visible public procurement process, and (2) a competitive bidding process that results in selection of a project that offers the best overall value.

APs may also be considered reasonable because they provide an up-front picture of all the costs over the entire concession period prior to handover to the State. Further, there is a significantly increased level of cost and schedule certainty provided by the P3 Agreement and the allocation to the Concessionaire of project delivery risk.

Considering the issue of reasonableness in the innovative AP Concession Model context requires a more expansive view of the "project". Standard projects involve hard capital construction costs being incurred in a relatively short period during which actual road building occurs, and Federal-aid funds being disbursed in large sums to pay for the State's itemized list of discrete activities directly connected to initial construction of the facility as such costs are incurred.

In the innovative AP Concession Model, the project scope includes the entire life of the P3 concession period. APs, paid over time in sums that are each much smaller than the relatively large up-front payments seen in the traditional way of implementing projects, take into account the costs of opening the road to traffic, but they also cover routine and capital maintenance costs, necessary rebuilding, and delivery of a high-quality facility at the end of thirty-plus years. In short, with the innovative AP Concession approach, project delivery can be viewed as a two-for-one: the public has access to a new facility upon substantial completion, and the State acquires a road that is in a pre-negotiated, like-new condition when the concessionaire hands it over. This "return on investment" for Federal-aid participation in the APs should be recognized in assessing reasonableness.

With respect to allocability, a cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received (2 C.F.R. §225, Appendix A, Section C(3)(a)). AP-related indirect costs attributable to initial construction costs, capital maintenance (life-cycle) costs, as well as routine O&M costs, must be appropriately allocated consistent with Government-wide cost principles.

Pursuant to 23 U.S.C. §116, costs for routine O&M must be excluded from any Federal-aid reimbursement for an AP. Although the AP is a unitary payment compensating the Concessionaire for performing all of its obligations under the P3 Agreement, FHWA would require O&M costs (and indirect costs allocable to O&M) to be clearly ascertained in the process of doing the advanced determination of eligibility described above.

In terms of process, all costs would be established in advance and there would be an up-front determination of eligibility. APs would be made according to a pre-defined schedule and each payment would be tied to the pre-determined eligible costs as set forth in the project's official financial model concurrent with the execution of all necessary equity and debt agreements. Initial construction costs, capital maintenance (life-cycle) costs, and related indirect costs consistent with Government-wide cost principles would all be eligible. Projects seeking reimbursement for APs should seek Advance Construction authorization from FHWA pursuant to 23 C.F.R. §630.106(a)(2) and (c)(l) and utilize the Advance Construction process. Under 23 U.S.C.§115 and 23 C.F.R. §630.106(a) and (c)(l), States may elect to undertake highway construction in advance of Federal-aid apportionment. Such "Advance Construction" gives states the flexibility to accelerate highway projects using non-Federal funds while maintaining eligibility to be reimbursed with Federal-aid funds at a later date.

The State advances the construction of a project without requiring that Federal funds be obligated at the time FHW A approves a project under an Advance Construction authorization. A Project Agreement is used to authorize an Advance Construction project; however, the execution of the project agreement does not constitute a federal obligation, commitment or guarantee. At any time the State may request that the project be "converted", or obligated, in whole or in part to a Federal-aid project provided that sufficient Federal-aid funds and obligation authority are available.

Advance Construction authorization would allow FHWA to approve the P3 project and the APs up front without obligating the entire amount of the APs years in advance. The AP amounts would be set forth in a Project Agreement and FHWA would obligate funds as the State makes the APs and seeks reimbursement from FHW A. The Project Agreement would set forth the eligible and ineligible cost categories, based on project-specific characteristics and cost estimates, and establish the reimbursable amount for each AP. The Federal-aid reimbursement amount for each AP would exclude ineligible costs such as O&M and related indirect costs. Pursuant to the project agreement, FHW A would work with the State DOT to ensure compliance with FHW A eligibility requirements.

Project costs in the project agreement should be consistent with the costs outlined in FHWA's Major Projects documentation for the Project.

Application: Each project seeking Federal-aid reimbursement for projects using the AP Concession Model would utilize the Advance Construction process. As to cost eligibility, the process of allocating costs within the total AP would be as follows:

1. FHWA will identify cost components that are eligible under title 23 as direct costs of the P3 project. This will include construction costs, life-cycle costs and finance costs attributable to eligible activities. To the extent the project receives a TIFIA loan, TIFIA loan repayment amounts will be included in the calculation because they pertain to title 23-eligible activities, albeit for cost allocation purposes only, as TIFIA loan repayment amounts are not reimbursable with Federal funds, per title 23.
2. Cost components deemed ineligible direct costs under title 23 would then be identified. In most P2s, this category will consist primarily of O&M costs.
3. Other costs that are more administrative and indirect in nature, will be properly attributable to both title 23-eligible cost components as well as ineligible cost components and must be allocated to each in accordance with Federal cost regulations.
4. Finally, indirect costs will be allocated appropriately between the eligible and ineligible components of direct costs in a proportional manner. Once allocations have been complete, the resulting figures will provide the basis for participation in the APs to be made to the Concessionaire over the duration of the project. [Note: The final level of Federal-aid participation cannot be determined until the time of the closing of the Concessionaire's financing for the project.]

Recommendation: FHWA should consider APs for highway projects as the basis for project cost reimbursement, so long as inherently ineligible costs, such as routine O&M costs, are excluded. As soon as practical, the Office of lnnovative Program Delivery will issue more comprehensive guidance to the Agency as to FHWA’s treatment of Aps as outlined herein.