IIJA AND INFLATION

Two 'I's pivotal for infrastructure in 2022

BY SCOTT ZUCHORSKI AND SETH LEHMAN

The road to recovery post-COVID has been an arduous one for U.S. transportation infrastructure as a whole. Two years into the pandemic, infrastructure is likely to see a firmer upward trajectory this year. How sharp that trajectory is will hinge largely on two 'I's: IIJA and Inflation.

The Infrastructure Investment & Jobs Act (IIJA)

Signed into law this past November, the Infrastructure Investment and Jobs Act (IIJA) is not a cure-all elixir that will magically solve all of the challenges for infrastructure in the United States, which has lagged far behind other regions of the world for years. That said, the IIJA is intended to provide sorely needed federal funding to address necessary bridge and road repairs.

Perhaps more importantly, though, are the opportunities for private investment in these projects and nontraditional assets that the IIJA creates, namely broadband and carbon capture facilities. Increased federal outlays might make deals more financeable, facilitating greater use of public private partnerships (P3s) and increasing overall investment. The ultimate impact of the bill on infrastructure projects will depend on federal guidance, rulemaking and decisions on awarding grants, as well as how state and local government decide to allocate and leverage the funds.

Capitalizing on private investment is an important consideration in the IIJA, which increases the current aggregate volume cap for qualified highway or surface freight private activity bonds (PABs) to $30 billion from $15 billion. Doubling PAB capacity will allow for more P3 funding resources for surface transportation projects. The IIJA may be a boon for large bridge projects in particular, specifically providing $27.5 billion through a formula allocation to address bridge repairs. Another $12.5 billion will be available through a competitive grant program for bridge projects.

There were 220,308 bridges, or 36 percent, that needed to be replaced or repaired in 2020, according to the American Road and Transportation Builders Association. Of these, 45,023, or 7.3 percent, were structurally deficient bridges in poor condition. The states with the greatest exposure to structurally deficient bridges as a percent of all bridges are West Virginia, Iowa, Rhode Island, South Dakota and Pennsylvania. Based on the formula funding for bridges, Pennsylvania would receive the most significant amount of these states, with $11.3 billion for apportioned programs and $1.6 billion for bridge replacement and repairs.

States may also apply for $16 billion of federal grant funding specifically for major projects that deliver substantial economic benefit to communities. As an example, Kentucky is expected to apply for this pool of funds to help fund the Brent Spence Bridge Project, a second bridge that would connect Cincinnati with Covington, KY, in addition to the allocation that Kentucky will receive under the bridge formula program.

Under the IIJA, broadband projects will receive unprecedented funding. We expect to see greater private investment in the sector, particularly with broader PAB eligibility for qualified broadband projects. Broadband PABs are fully exempt from the volume cap for government-owned projects and 75 percent exempt for privately owned projects. PAB volume may receive further boost under the Build Back Better bill through provisions that reduce the PAB financing threshold for affordable housing. These projects would only need to finance 25 percent of their project with PABs instead of 50 percent to qualify for the 4 percent low-income housing tax credit, freeing up PAB capacity for other projects.

While the IIJA potentially provides a long overdue shot in the arm for infrastructure projects, the second 'I' could present itself as a proverbial fly in the ointment.

Inflation

COVID-19 has affected all major segments of infrastructure to varying degrees with airports, railways and ports still digging out of very formidable trenches. Toll roads, by contrast, proved to be a remarkably resilient asset during the crippling pandemic months and are, as a result, much closer to full pre-pandemic recovery. Toll roads are seeing traffic performance consistent with Fitch Ratings' expectation of traffic recovery to 2019 levels by later this year.

What could be particularly disruptive is the path of inflation. Higher inflation will cause net income to rise as long as revenues grow at the same pace as O&M. This stands to benefit projects that apply automatic annual rate increases indexed to inflation, which is evident in the majority of toll roads throughout the country. Conversely, some projects that do not have the economic, legal or political flexibility to raise revenues in line with inflation may experience some financial impairment.

Inflation appears to be on a higher rate trajectory when compared to past recent periods. This may have implications for debt structuring or constrain the overall leverage commonly linked to investment-grade infrastructure financings, which tend to be more backloaded repayment amortizations.

Additional influences tied to transportation sectors include labor shortages and supply chain disruptions, which has been particularly hard for ports. Fitch Ratings expects supply chain constraints to ease in 2022, but broad federal vaccine mandates have the potential to exacerbate labor shortages.

Conclusion

The IIJA could help increase appetite for new investment as the pandemic wanes, and travel restrictions are more fully repealed. Potentially countering a stronger appetite for expansion is higher and federal monetary policies in 2022, which may stall growth momentum. How high and quickly inflation increases will dictate how much of a potential road block it represents on the path to full recovery. ✪

Scott Zuchorski is a managing director in Fitch Ratings' Global Infrastructure and Project Finance Group, where he heads the North America Infrastructure Team. Scott received his bachelor of science from Cornell University and his masters of public administration from the Maxwell School at Syracuse University. Scott has been with Fitch since 2010.

Seth Lehman is a senior director in Fitch Ratings' Global Infrastructure and Project Finance Group, where he serves as head of the Transportation North America Team. Seth received both his bachelor of science in statistics and economics, and his M.B.A. in finance from New York University. Seth has been with Fitch since 2008.