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The financial crisis and the PPP market

Potential Remedial Actions

(Abridged version, August 2009)

Overview

This paper has been prepared by the European PPP Expertise Centre (EPEC) following a market sounding with banks, financial institutions, investors, developers and public authorities.

It is an abridged version of several more extensive papers prepared for EPEC members.

It provides a framework for analysing some potential responses to the financial crisis, as it affects the Public Private Partnerships (PPP) market across the EU.

The paper does not offer a catalogue of recommendations, as the most appropriate remedies to the current credit crisis will be dependent on the specific situation of each country, in terms of legal and institutional context, public finance and PPP deal flow. In particular, any actions taken will need to consider whether they comply with the EU procurement directives.

The paper does, however, identify a list of issues and considerations for the attention of public sector prior to adopting a course of action.

European PPP Expertise Centre (EPEC)

EPEC is a collaboration between the EIB, European Union Member and Candidate States and the European Commission which is designed to strengthen the organisational capacity of the public sector to engage in Public Private Partnership (PPP) transactions.

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Executive Summary

The nature of the current credit situation is complex, but its impact on the PPP market can be summarised as follows:

- The collapse of the inter-bank lending market has drastically reduced liquidity. Most banks, particularly those with limited deposit bases, are struggling to raise funds even on short maturities
- Project finance and PPP lending is competing for scarce regulatory capital allocations with more attractive corporate opportunities. This is testing the viability of the current PPP model
- The syndicated loan market has stalled and deals are closing as 'club' transactions. This has an impact on the speed with which deals close
- Bank margins have increased substantially
- Senior bank debt tenors have significantly reduced
- Some banks have partially or totally withdrawn from the Project Finance market. There is also evidence that previously active international players have become more orientated to their domestic markets. "Relationship banking" is back in force
- No viable capital market solution has emerged to replace the wrapped bond market which closed with the demise of the monoline business

However, the PPP market has not collapsed. Deals are still being brought to market and closing, albeit more slowly. There is a high degree of selectivity on the part of banks and a general lack of consistency in the terms and conditions required by funders.

This paper identifies three main types of response available to public authorities:

Remedial actions within procurers' control

The existing procurement approaches are adapted to what used to be a highly competitive buyer's market. The current credit crisis implies a revision of these approaches, as

- fully committed bids can only be obtained at a late stage of the procurement process, often not long before financial close
- it becomes increasingly necessary to optimise the access to a currently, scarce banking market by applying a form of funding competition or "competitive book-building".

In addition, procurers have to get familiar with "mini-perm" structures, which may become the new market standard. Sharing the refinancing risk could deliver value for money but raises significant structuring issues.

Structural changes to the PPP model may also need to be considered, with shorter debt maturities and a changed risk-reward balance leading to higher project ratings.

Remedial actions within States' or Public Authorities' control

In addition to expanding already existing forms of public support to PPPs, such as grants or multilateral lending, there are two main new avenues which are being explored by several countries:

- State guarantees, applied to project debt or project bonds (e.g. the French or Portuguese guarantee facilities).
- Co-lending by the State, such as the Infrastructure Finance Unit of the UK Treasury.

There is evidence of strong potential demand for direct comprehensive guarantees applied to capital markets, filling the gap left by the defunct monoline model. The banking market would probably benefit more from indirect or partial guarantees.

There continues to be very limited experience of co-lending by the public sector, but this appears to be an efficient short term fix to "close the syndication gap". Its longer-term effects on the financial markets for PPPs and whether it can remain a "bridging" measure only, as expected by its promoters, has still to be confirmed.

Remedial actions facilitating the entry of new investors

There is a general consensus that the institutional capital markets are the "natural" lenders to PPPs. However, bringing institutions back to this market will require either

- a restructuring of the PPP model to access the unwrapped market, or
- developing an equivalent of the former monoline model to wrap "vanilla" bonds, as suggested above.

Remedial actions within procurers' control

1.1. Adjust procurement programmes

The very high liquidity and “aggressiveness” of the PPP market which prevailed over the last 5-7 years, has encouraged a trend toward very large PPPs, say those with a capital cost of over €1 billion. The difficulties and risks of such an approach tend to be underestimated. Even prior to the crisis, capacity limits on funding projects of this size could act to reduce competition and limit significantly the procurer’s negotiating power. In the current crisis this is amplified. Depending on currency and country, and with a universe of active banks currently limited to an estimated 8-10 potential lead banks and around 15-20 participants (source: market sounding), projects in excess of €500m are likely to be expensive or require substantial public support. This constraint should be considered when designing a global procurement programme.

PROS: There are clear benefits in designing PPP packages in ways which can be absorbed by the current private infrastructure financing market.

CONS: Redesigning a programme already under way can be problematic as public expectations may have been raised and political commitments given. Certain projects within a programme do not lend themselves well to downsizing because of strong construction or operating rationale e.g.: rail projects. Scaling down a larger project

into smaller components also has time and procurement cost implications.

Horizontal” rather than “vertical” downsizing can be achieved, through the reduction in scope of the PPP element of projects, for example, limiting the PPP element to the “train system” in a rail project. Up-front subsidies can also be considered to reduce the private funding needs (see 2.1 below). However, both approaches may have an impact on the balance of risk transfer.



High-speed rail link for passenger and freight traffic between London and Channel Tunnel - UK

1.2. Adjust the procurement process

1.2.1 Competitive dialogue

The competitive dialogue procedure limits adjustments to the final offers submitted to a procuring authority to “confirmation of commitments” and “fine tuning”, enabling financial close shortly after the selection of the preferred bidder. In order to satisfy this requirement, most procurers have taken the pragmatic approach of requesting fully committed final tenders. This is proving increasingly difficult in the current market and the duration of commitments rarely goes beyond a month. In most cases procurers are faced with reduced levels of commitment requested from the lenders at final offer as well as the duration of these commitments.

There is no evidence that this applies to equity which is generally still available on a fully committed basis.

Procurers may opt for different procurement procedures in certain cases (e.g. negotiated procedure). However, in most cases they have to adjust the competitive dialogue process to reduced levels of financial commitments, up to financial close.

PROS: Insisting on fully committed offers is likely to increase the cost of small projects or to severely delay or cause the failure of large projects.

CONS: Selecting a preferred bidder on the basis of a non-committed offer creates a moral hazard and an execution risk. They include “bait and switch” tactics by bidders, increased risk of litigation by rejected bidders and the issue of how to maintain the integrity of the winning bid when the financing still needs to be finalised.



Wastewater Treatment - Belgium

1.2.2 Securing funding post preferred bidder selection

In a context of scarcity of funds, it is becoming increasingly difficult for multiple bidders to assemble enough banks to cover their entire funding requirement. Except for small transactions, there are not enough banks in the market to support several bids at submission stage. For medium to large projects, it is practically indispensable to allow the preferred bidder to access the largest banking market, including its competitors' funders.

This implies that banks should not be committed to any bidder on an exclusive basis before selection of the preferred bidder.

Several approaches can be envisaged:

a) Funding competition:

This concept was used in the UK market around 2004-5. Its original intention was to reduce funding costs by applying added competitive pressure on the finance markets. Competing groups of funders such as banks and capital market investors were asked to bid their best terms based on the selected bid. This is a complex approach, requiring considerable expertise and resources from the procurer. It has been used on a few large UK procurements only (HMT and MoD buildings, Bart's and Royal London Hospitals). In its original form, it does not fit particularly well in the current market, as it relies upon a market with sufficient liquidity to organise competition.

b) Staple financing:

This approach is used mostly in acquisition finance and "brownfield" projects. The procurer designs its own financing package, with its own advisers, which is offered at the tender stage. Bidders can either take the procurer's offer or, if they can deliver more competitive terms, propose their own. The authority benefits from competition between the bidders, with the protection of its "staple" offer as a back-stop. Again, this method is mostly designed for "re-financing" existing projects rather than "greenfields", as it is difficult to design a sensible staple without a good knowledge of the underlying project.

c) "Competitive" book-building:

This is generally the approach used in the current market, often under the "funding competition" name. The preferred bidder is allowed to access the broader funding market, including funders previously associated with unsuccessful bidders, and completes its financing under the procurer's control. The nature and extent of this control is the difficult issue for the authority. Once there is a preferred bidder, competitive tension is significantly reduced and there is a risk that the bidder will not have real incentives to optimise its offer. A form of sharing the benefits from its original tender with the procurer could provide this incentive, but this is likely to imply the authority's acceptance to also share any downside. There is no tested template for such an approach.

d) A combination of the above:

This is where the procurer separates the financing from the rest of the project and puts it out to competition separately. This is akin to tendering two separate contracts (Design Build Maintain/Operate (DBM/O) and Finance (F)). The procurer may merge the two tenders at financial close under the bidder's responsibility or may choose to keep control of the financing during the contract period. This is also untested and raises complex issues, notably, which party bears the final responsibility of the financing and the integrity of the PPP concept.

PROS: These options are the unavoidable consequence of the current market conditions, at least for large projects. Increasing the size of the potential funding group can only be beneficial to the procurer.

CONS: They tend to distance the bidder from the full responsibility of its financing. In addition, the mechanics of these methods are complex, both at tender and financial close stages, and largely untested.

1.3. Reduce contract duration/loan maturities

Most banks now argue that the very long tenors, i.e. over 25 years, observed in the PPP market before the crisis, were probably unsustainable and mostly driven by pressures on public sector affordability, evaluation criteria with high discount rates favouring long dated payments and acute bank-bond competition. There appears to be a consensus that shorter term loans, i.e. in the 15-18 years range, are much more “bankable” and that longer tenors should be the preserve of capital markets.

While nothing prevents banks from bidding shorter maturities, even for long contracts, such offers are likely to be non-competitive. A possible response would be shorter PPP contracts.

However, banks are also keen to ensure that sufficiently long PPP contracts are maintained to allow them the opportunity to refinance in secondary markets.

The main driver of the PPP contract duration should remain technical (life-cycle and obsolescence considerations) rather than financial. Against this criterion, long contracts for major infrastructure investments would be justified. However, it is likely that very long term bank lending will remain a rarity, even after the markets recover.



Maritime College - Ireland

1.4. Make the best of “mini-perms”

Banks used to lend long term on the expectation of a rapid take-out through refinancing, albeit this was subject to project performance. This was a reasonable assumption in the pre-crisis market. A margin step-up after a period of 7 to 15 years to “force” a refinancing was a common feature.

Mini-perms are an extension of this approach. A short period (3-5 years) after construction completion, there is an aggressive margin step-up and cash sweep (“soft mini-perm”), or even a compulsory refinancing with the ability of the banks to call the project into default if it does not occur (“hard mini-perm”). Often, no principal repayment is envisaged during this period.

The rationale is to increase the probability of an early exit for the lenders and avoid locking the project into unfavourable conditions in the long-term. This would mean, in effect, that bidders are taking the risk that the market will recover at or before the mini-perm refinancing horizon.

The issues are about who takes the refinancing risk and associated costs. In principle the bidders (sponsors) should underwrite the risk in full, through a commitment to provide additional equity if needed or, at least, accept a deterioration of their equity return. However, in most cases, the authority bears the costs of increased margins as they are embedded into the base case.

Sponsors seem to have accepted this risk up until now, in the belief that current conditions are likely to improve significantly in the next few years. They may see this situation as an opportunity, with the expectation of windfall refinancing gains.

It is, however, important that the procurers ensure that (for soft mini-perms):

- Refinancing risk is fully underwritten by the sponsors
- The bidders’ refinancing assumptions are transparent and realistic and the financing can sustain a significant downside case. The finance plan should detail the mitigation measures provided to cover such a downside, e.g. additional equity, which should be tested against the sponsor’s or guarantor’s balance sheets
- The benefit of the primary refinancing is factored into the price, or the additional short term costs still provide value for money.
- Refinancing benefits, at least over and above what is assumed in the base case, are shared in an equitable way¹. The first part of these refinancing gains, simply generated by markets returning to “normal”, should principally accrue to the authority.

¹ Bearing in mind that a likely scenario for the next few years is that base interest rates (EURIBOR/LIBOR) should start moving up again while margins should go down, mainly through a reduction of the embedded funding costs. The two movements could, at least, partially offset each other.

Hard mini-perms can bring value by reducing short term financing costs and by putting added pressure on all parties to rapidly improve financial terms. However, when banks are fully compensated in case of company default, they may effectively transfer the refinancing risk to the procurer. The potential cost benefit to the authority is very difficult to ascertain, short of running comparative "short term" and "long term" tenders. Care should be taken not to effectively allow a "free exit option" to the banks, while leaving the procurer with an unquantifiable bet on the future.

PROS: Mini-perms, subject to the provisions above, are advantageous for the procurers when the cost of the refinancing factored into the bid price is acceptable. However, there is little they can do to encourage them, short of sharing the refinancing risks, and benefits, with the bidders (see 2.5.2)

CONS: They are more complex than a long term transaction with a potential higher execution risk. The authority remains the lender of last resort, should things go badly wrong.



1.5. Improve risk-reward balance

There is a definite trend toward re-adjusting the risk-reward balance away from the procurers, in the current environment. Whilst market participants appear generally comfortable with the standard terms of PPP contracts, concerns are often expressed on project specific issues e.g.: completion obligations, long-stop dates or transfer of certain un-controllable risks. Credit committees also tend to be more conservative and revisit certain “accepted” principles such as onerous bonding or termination provisions. Procurers should be aware that, at the very least, they should expect unusual risks to be priced into the offers. In this context, more balanced contract terms may prove better value for money.

This is particularly true in a market where preferred bidders have to be selected on the basis of non-committed financial proposals. It is important to ensure that the funders have at least accepted the terms of the PPP contract before confirming preferred bidder status, as failure to do so may expose the procurer to very significant risks of extensive renegotiations post-preferred bidder. It is likely that banks will do so for what the market regards as “standard terms” but will reserve their positions where contracts contain particularly novel or project specific contentious issues.

PROS: Balanced standard contracts are generally advisable, especially in the current sellers’ market, where procurers are competing against each other. Unfavourable contract terms may put-off potential bidders and cause programmes to fail. Standard and reasonable contract terms will also accelerate the vetting process by banks.

CONS: Experience shows that “pushing the bidders” can be beneficial to procurers, although it is unsure whether

this is a long term benefit. On the other hand, finding the right level of “softening” of contract is not an exact science, and there is a risk of “giving too much away”. “Clawing back” when market conditions return to normal, howsoever desirable, is generally problematic.

When standard contracts are being used, opening a few clauses may invite bidders to re-open others.

1.6. Require (engineer) higher project ratings

Currently, PPPs typically attract BBB- to BBB ratings, i.e. PPPs are structured to be at or marginally above “investment grade”. This has reflected the requirement of monoline insurers that underlying projects must achieve an investment grade rating before benefiting from an AAA wrap

Several market players are advocating that higher ratings would allow many PPPs to access the “unwrapped” bond market. They consider that such higher ratings, up to A-, could be achieved through modest structural improvements, such as:

- better completion undertakings by sponsors or third party insurers and
- lower debt to equity ratios levels.

In practice, this could be achieved by procuring authorities requiring sponsors to bring sufficient credit support to ensure that the required rating is achieved. Procurers should, however, be aware that they may also come under pressure to modify contractual terms to improve the credit rating of projects.



Remedial actions within States' or Public Authorities' control

2.1. Up-front Government payments

Governments have employed up-front payments in PPPs in the form of capital contributions in number of instances in the past. Their most common use is on revenue based projects, to improve the financeability of the private portion. On availability based projects, up-front payments clearly reduce the overall private financing requirements but, at the same time bring forward the public sector payments. At best (depending on the discount rate used), this may have a positive impact on Vfm calculations by reducing the quantum of private financing costs. It may also allow different public entities to adjust their respective contributions (e.g. up-front payment to Government and a reduced unitary charge to a local authority).

There is an important distinction to be drawn between public sector capital contributions which (i) act to reduce the scope of the project to be financed by the private sector, and (ii) the situation when the public sector provides a contribution to the financing required for the PPP project. An example of the former case is where the public sector commits to provide access roads in a motorway project. This is generally the simplest model – although in the specific example given where the private sector is taking motorway traffic risk, it will wish to be assured that access infrastructure is, indeed, in place.

The situation is more complex where the public sector makes a contribution to the funding requirement of an otherwise privately financed project. Firstly, there will be issues of how and when the contribution is paid (presumably, as a minimum, after equity and pro rata to senior debt). Secondly, lenders will need contractual assurance that the funds will, indeed, be paid – otherwise, the project could run out of liquidity and go into default. Lenders will also be concerned about the seniority of public contributions in the case of project failure, and the implications for lenders' compensation on termination².

PROS: It is probably the simplest way for the public sector to bring financial support to a project (assuming funds are readily available). Other practical benefits are mentioned above.

CONS: However, as a response to the credit shortage, up-front payments do not appear to have any significant advantages compared to the other forms of public support described below: obvious drawbacks are their permanent nature and the lack of compensation to the public party for its investment.

When they represent a significant part of the total financing, they also distort the balance of risks, as all projects risks have to be born by a smaller private element. Some of the financial benefit of the "free" public contribution can then be offset by increased private funding costs.

Finally, they raise potentially difficult inter-creditor issues and unwanted risk transfers, notably in case of default, where the public sector requires a repayment of some, or all, of its contribution.

² A useful discussion of these issues is given in Moody's Special Report "Impact of Grant funding on Senior Debt Ratings" of December 2008.

2.2. Increase multilateral lending

In the current situation, multilateral institutions like the EIB, the EBRD or the IFC, or even export credit agencies are expected to step-up their lending. Such lending can take the form of

- funding only, supported by third party bank guarantees, Letters of Credit (LCs) or other credit enhancers, or
- direct project lending, where the public institution takes project risk alongside commercial lenders.

PROS: Both products are in strong demand.

The funding facilities provide considerable added benefit in the current market conditions because (also see 2.3 below):

- banks' funding costs have sky-rocketed and many are struggling to find any liquidity at all. Banks in this situation may, however, welcome the opportunity to provide guarantees to third parties
- the price differential between commercial bank lending and funding provided by public or multilateral bodies has considerably widened, even when adding the cost of the commercial guarantees. This is because the increase in banks' funding costs is a lot higher (around 150 to 200 bps even for short maturities), than that of the publicly owned institutions (estimated at 30 to 50 bps for AAA rated institutions).

The direct lending facilities are also filling an acute market need, particularly for large projects. In practice, few eligible PPP projects of significant scale are closing today without direct participation from at least one of the major multilaterals. The funds provided by these institutions allow a considerable reduction in the amounts which need to be found on the commercial markets. The presence of public players in the financing is often a catalyst for commercial banks, as they feel "comforted" by the public commitment and additional diligence multilaterals bring to the project. It is not unusual to see banks' participation being dependent upon the presence of a major multilateral.

CONS: Multilaterals often have specific and onerous due diligence requirements. Care must also be applied in the procurement process in preserving neutrality vis à vis all bidders. This is particularly the case when the institutions' final terms and conditions are disclosed at a late stage of the tendering process



2.3. Provide additional liquidity under private sector guarantees

Under this approach, the private sector guarantees funding provided by the public sector to projects. This is arguably the most directly relevant response to the current crisis, as:

- the credit crisis is largely caused by a liquidity shortage, and
- it remains fully consistent with the PPP model, as it attempts to facilitate the involvement of the private lenders, who are still expected to bear the project risks.

The UK Treasury tested a similar concept a few years ago through the Credit Guarantee Facility (CGF), but did not develop it further.

A number of public or semi-public institutions such as KfW in Germany, CdC in France or CDP in Italy are now considering similar approaches.

PROS: By providing such funding, the public sector will respond to an immediate shortage and will do it at a significantly lower cost than a private lender could do (see 2.2 above).

CONS: Funding facilities solve only part of the problem as the appetite of commercial banks for project risk is currently not sufficient to meet the overall demand for senior debt.

Banks also have diverging views on this structure. Some, mostly banks with acute liquidity shortages, welcome it. Others consider that providing a guarantee to long term funders is actually more onerous than a straight loan. This is because long term guarantees are almost impossible to “refinance” and raise documentation and inter-creditor issues between the guarantors and the lender.

2.4. Co-lending facilities

When projects are exposed to a financing shortfall at financial close, the State can fill the gap with public funds. The logic is for the public sector to provide a “top-up” facility, designed to fill the “syndication gap” on exactly the same terms as the commercial banks and, if possible, on a temporary basis. This will best support an existing pipeline of deals in a relatively advanced procurement stage.

In the UK, HM Treasury has set up a Treasury Infrastructure Funding Unit (TIFU) to act as a lender of last resort. TIFU issued its first loan to the Manchester Waste deal in April 2009.

PROS: This is one of the most practical and expedient ways to respond to the credit crisis, particularly if the crisis is assumed to be of a temporary nature. By “stepping into the private lenders’ shoes”, the public sector provides immediate but temporary relief to the financial markets. The expectation is that this approach will allow deals to close in the short-term, and that the market will take over in the longer term, when the State sells down its stakes on commercial terms.

CONS: There are a number of practical issues which need to be dealt with, not the least being the logistics of organising a fully fledged lending unit. Structural issues identified so far are the co-existence of public and private lenders and the timing of the public intervention:

- How and when to decide on the size of the shortfall
- Inter-creditor issues, e.g. voting rights and possible conflict of interest for the public side, which is both procurer and lender.
- The risk of public intervention displacing the banks’ market
- The impact on pricing and risk of “game playing” by lenders
- The practicality of the State eventually selling down its stakes
- The practicality of using this approach for new projects.

2.5. Guarantee facilities (Public guarantees to the private sector)

Direct public guarantees will not be an effective response where banks are looking for liquidity rather than protection against project risks. However, many banks are increasingly risk averse and are seeking some form of risk mitigation, which can be provided through indirect guarantees. Guarantees may also have a role to play in promoting capital market solutions.

2.5.1 Direct guarantees

Certain procurers, (e.g. France, Portugal) are offering comprehensive public guarantees to lenders, in order to facilitate banks participation in large projects by reducing their exposure to project risks. Unlike “underpinning” (see 2.5.2), such guarantees tend to be autonomous acts, rather than through provisions of the PPP agreement.

They are generally for a limited percentage of senior debt, leaving a residual risk to lenders. They may also contain other limitations and conditions on their call and repayment conditions, allowing them to be tailored for project specific circumstances.

PROS: One of the benefits of a guarantee facility, compared to a funding or lending facility, is its versatility:

- It can be used to provide direct guarantees to capital market funding or indirect guarantees on certain project features to adjust the risk sharing and facilitate the raising of bank debt.
- It can also be temporary and released upon the occurrence of certain pre-agreed events.
- It can be applied as primary or second guarantor.
- From a public sector budget and accounting perspectives, guarantees are contingent liabilities. They do not require immediate cash, nor are the guarantees themselves accounted for on the government balance sheet. (N.B. they may however affect the balance sheet treatment of the project as a whole).
- They are probably easier to implement than either state funding or co-lending.

CONS: They are generally more complex to document. They are of a more permanent nature than direct lending, to the extent that they cannot be easily withdrawn, except at pre-agreed conditions, or refinanced.

Pricing the guarantee is not a straightforward exercise, and the public sector is likely to have to demonstrate that pricing is done on an “arms-length” commercial basis.

A further argument against public guarantees when applied to capital markets is that they may cannibalise the corresponding public bonds markets. However, it can be argued that infrastructure bonds will attract a different set of investors.

2.5.2 Indirect guarantees

There are three main types of indirect financial guarantees, although state guarantees can be applied to any number of project features, through specific provisions of the PPP contracts. These are

- Underpinning
- Sub-sovereign guarantees
- Refinancing guarantees

Underpinning

This is when a portion of the financing is back-stopped by specific government undertakings, for example, favourable repayment provisions such as compensation on termination, or direct irrevocable payment by the authority post completion.

Examples are the French “Cession de créances”, or the German “Forfeiting” structures which have been extensively used over the last few years.

The underpinned tranches are likely to be cheaper and to attract a different sub-set of lenders, seeking low risk, quasi-government paper, and thereby increasing bankability. On the French market, the overall financial benefit appears to have been significant.

However, the irrevocable portions cannot attract performance penalties, which goes against one of the main tenets of PPPs. In practice it may prove difficult to peg the irrevocable portion at the right level, which will provide both a cost benefit and maintain the right performance incentives.

Sub-sovereign guarantees

This is a straightforward use of state guarantees, when the financial obligations (or certain specific obligations, such as payment of the unitary charge or of the compensation on termination) of a local authority are back-stopped by the central government.

Similarly, there could be “second level” guarantees, where a State entity guarantees a private guarantor (e.g. a bank). This could prove useful in the current context where commercial banks' ratings are under stress.

Refinancing guarantees

Because of shortage of long term debt and the extension of the mini-perm concept, a refinancing risk often has to be absorbed by PPP projects.

This refinancing risk is a new, largely un-controllable and significant risk which can only be mitigated:

- by allowing a sufficient time window for its implementation
- by testing the project viability in a down-side case where the refinancing does not occur.

This risk is generally passed through to the sponsors, although it often partially translates into an additional cost for the authority when the margin step-up is factored into the base case (see 1.4).

Many argue that, as this risk is of a macro-economic nature, it is best dealt with by the public sector.

However, unlike the two earlier forms of indirect guarantees, this is an untested approach. The first issue is to determine what exactly the public sector is guaranteeing. The procurer may be prepared to assume the risks linked to the variation of a benchmark interest rate (such as the Euribor), it should not accept the consequences of other events which may also influence the feasibility and cost of future refinancing, such as project performance since the contract signature.

In addition, the benchmark rate is only a part of the total interest rate, the other element being the banks' margin. In the current market, this margin does not only cover the risk and return of the bank but contains a sizeable funding cost element. This funding cost element is likely to come down very significantly when the inter-bank markets return to normal, from 150-200 bps today to tens of bps in a "normal" market. Again, if the procurer is to bear the benchmark rate risk, it will also want to benefit from the likely improvements in the funding costs. However, the movements of these funding costs cannot be easily measured as there is no recognised benchmark and rates are likely to vary from bank to bank.

Remedial actions facilitating the entry of new investors in the PPP market

There are three options, worth exploring, to revive the institutional funds market for infrastructure:

- Facilitate the unwrapped bond market through structural changes in the PPP model
- Revive the monoline model for wrapped bonds
- Develop a “debt fund” concept

None of these approaches is in a public procurer’s control but would require an impetus from governments or supra-national agencies and a confirmed appetite from the financial markets. Each option would require significant research and market testing before a workable model could be defined.

The limitations and advantages of bonds when applied to project finance (such as interest carry, refinancing costs or inter-creditor issues), are well documented and are not repeated below.



New Athens International Airport - Greece



3.1. Stimulate the unwrapped bond market

3.1.1 Improve credit quality through structural changes

The aim is to access the institutional market directly, by improving the project ratings, from the current low-sub investment grade to well into the investment grade category (BBB+ or A-). The assumption is that this could be achieved by reasonable structural improvements of the PPP model, such as lower gearing and better completion undertakings.

Such lower gearing can be attained, for example, by injecting a layer of junior debt, provided by a public or public-private entity, between the equity and the senior debt.

3.1.2. Develop “infra bonds” and organise liquidity

The concept is for governments to facilitate, through fiscal policies or otherwise, an “infrastructure bond” market. It could draw on public savings or, more likely, on institutional funds. A state agency could “organise” liquidity, in order to make this market attractive to a broader group of investors.

PROS: In theory, it is the most efficient and cost effective approach to attract capital markets. Direct risk participation of investors would gradually raise their level of awareness and understanding of the infrastructure market, improving its liquidity and facilitating its long term growth.

CONS: Accessing the bond market directly implies finding, through structural adjustments, the meeting point between investors’ appetite for more complex and structured products and “de-risked” project structures. This is likely to prove difficult and may only attract a set of sophisticated players. Construction risk, in particular, may remain a stumbling block.

The impact on affordability of the “de-risking” necessary to achieve higher project ratings needs to be ascertained.

Direct investment through private placements has proved to be difficult to implement in a tender situation.

Poorly structured projects may lead to defaults and jeopardise further issues.

In any event, the procuring authority can only influence the “project” side by engineering or imposing higher ratings and has little bearing on the investor’s side.

3.2. Revive the monoline model

The “monoline model” is where a guarantor, acting as principal investor, provides a credit enhancement to project bonds (or debt) by offering a comprehensive “wrap” against project risks. In effect, the bond rating is enhanced to the level of the guarantor’s rating, which was AAA in the case of monoline insurers. The credit crisis has shown the limits of this model, when most credit insurers lost their high credit ratings and left the bond holders with greatly devalued wraps, for which they continue to pay.

Notwithstanding, this concept could be used to design a public or quasi-public credit enhancer. This could be of significant benefit to the PPP market as it could re-open the very deep institutional funding markets to project bonds. There is however a credibility gap to overcome in light of past experiences. To be successful a new monoline-type product would need to be designed in a way likely to respond to the criticisms made of the former monoline model, such as insufficient access to project information by investors and the inherent downgrade risk. Additionally, it would require sponsors with high and secure credit ratings.

A public wrap could apply to capital markets or bank debt, as was the case with the monoline model.

PROS: It is a well tested model, with a proven track record of feasibility, efficiency (tender context included) and competitive pricing. Templates exist for the guarantee, and investor’s appetite and reactions are well documented.

It could be easily revived by the public sector, by designing a guarantee instrument similar to the one offered by monolines.

Wrapped bonds allow access to the deepest, and most liquid, plain vanilla, end of the market.

CONS: Wrapped project bonds may cannibalise the guarantor’s public bond markets.

Investors remain shielded from the project risk and do not develop independent project understanding and appraisal capacities.

The public guarantor would need to ensure the marketing of this product, as investors themselves are likely to remain passive.

Wrapped bank debt only makes sense if it provides additionality in that it allows banks which would not have participated otherwise to access the market. Otherwise it displaces banks from their core business without adding value.

3.3. Debt funds

Debt funds offer an alternative means to bring institutions' money to the infrastructure market. The concept is to transform standard institution funding into project debt, arguably the most adaptable instrument for financing PPPs.

The vehicle will, in turn, issue long term debt to project SPVs. It will probably be necessary to provide the fund with a liquidity facility to cover the mismatches between the disbursement and repayment profiles of the bonds.

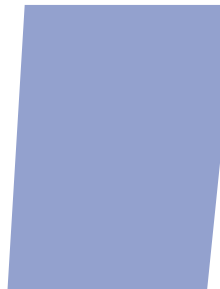
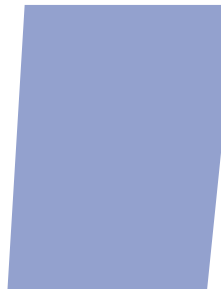
The vehicle will add its cost of capital and risk premium on top of its base funding costs (i.e. the cost of A rated bonds).

Another approach is to raise long term debt directly from institutions and pool it into a lending vehicle. The vehicle will provide structuring, due diligence and monitoring services to the lending institutions.

PROS: This could be a way to "transform" long term institutional money into plain project debt. Debt has proved to be the instrument most adapted to project finance.

CONS: Although often mentioned as an option, it is an entirely untested approach and many market participants are sceptical of its feasibility.

Investors may be reluctant to enter into complex securitisation schemes, with little or no visibility on the underlying projects.



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