PPP Finance and Legal Issues

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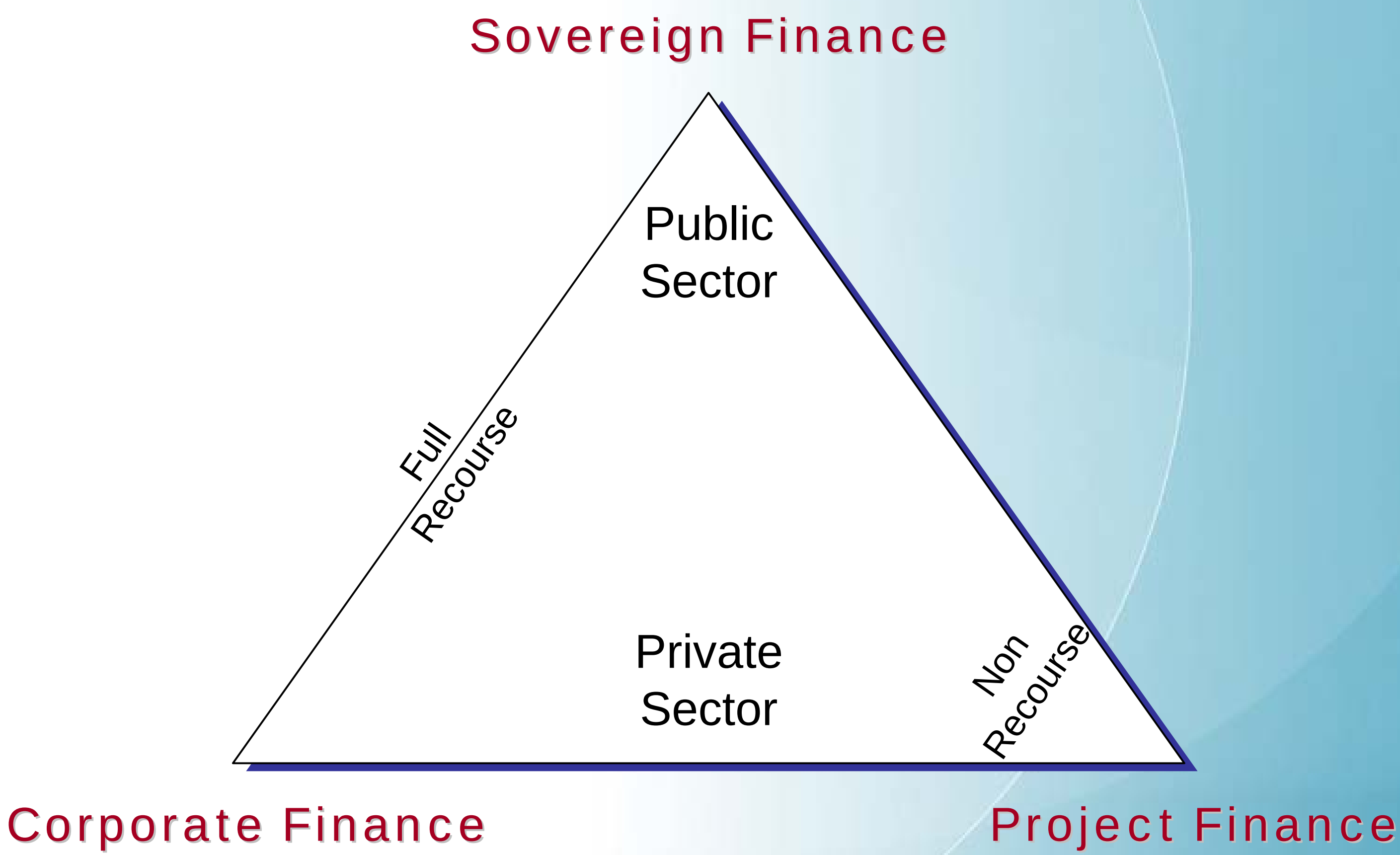
Modes of Finance



Agenda

- Role of Project Finance
- Debt
- Equity
- Refinancing
- Risk
- Contract Issues
- Exercise

Project Finance Market

Limited Recourse Loans Achieving Financial Close (Worldwide, banks plus bonds)

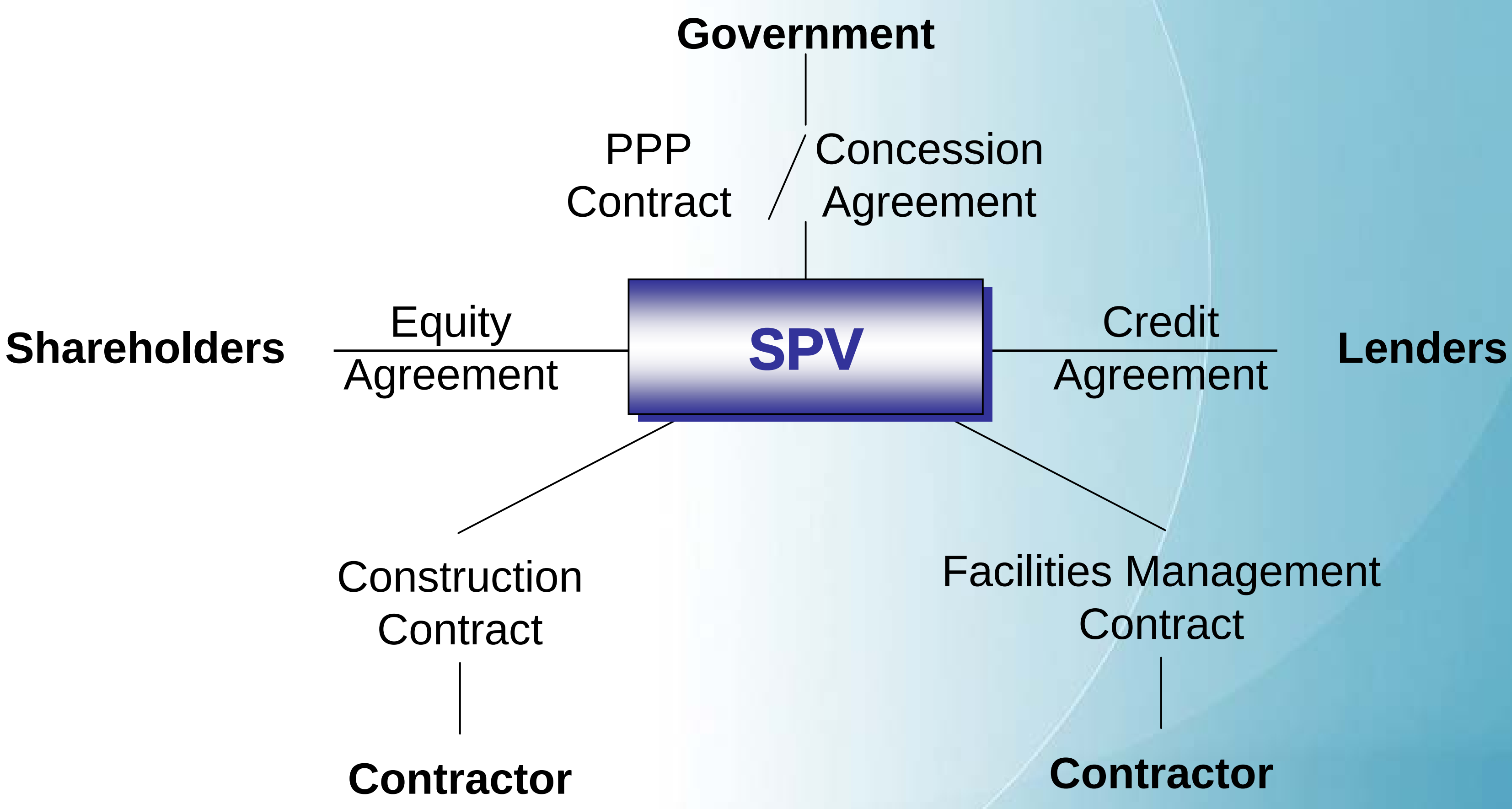
1995	US$	27Bn
1996	US$	48Bn
1997	US$	75Bn
1998	US$	64Bn
1999	US$	92Bn
2000	US$	132Bn
2001	US$	134Bn
2002	US$	76Bn
2003	US$	102Bn
2004	US$	145Bn
2005	US$	167Bn

Source: Project Finance International

Borrower rationales for using Project Finance

1. Isolate specific risks (eg., country risk)
2. First-time partnership between companies
3. Large corporates – debt capacity constrained
4. Project large in relation to small and medium sized corporates
5. Only way to create business (eg., contractors)
6. High gearing for lower tariffs and increased ROE
7. Avoid consolidation of debt into sponsors' accounts

Principal Contract Structure



Project Gearing (Leverage)

Project finance global average Debt: Equity* ratio : 80 / 20

60 / 40	90 / 10
High market and / or operational risks	Low market and / or operational risks

* Includes all junior capital (eg., subordinated debt)

PPP Funding Structures – Key Objectives:

For Sponsors:

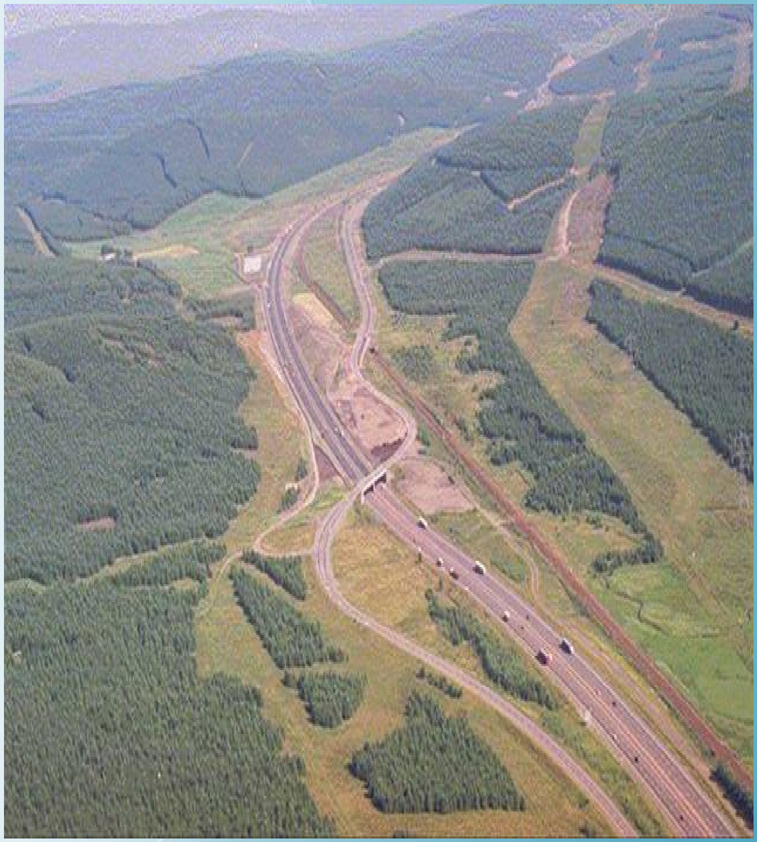
- Maximise return
- Minimise own investment
- Minimise risk

For Public Sector:

- Optimise affordability and value for money
- Discipline of private finance

For Lenders:

- Meeting internal return criteria
- Avoid risk – and specifically uncontrollable risk



Characteristics of senior debt

Lenders require risks transferred are:

- understood
- controllable
- finite
- appropriately allocated in the project structure

Role in due diligence

Senior Debt Terms

Key Terms

- Pricing
- Debt Service Cover Ratio (DSCR)
- Loan Life Cover Ratio (LLCR)
- Contractor Guarantees/Bonding/Liability Caps

Debt Cover Ratios

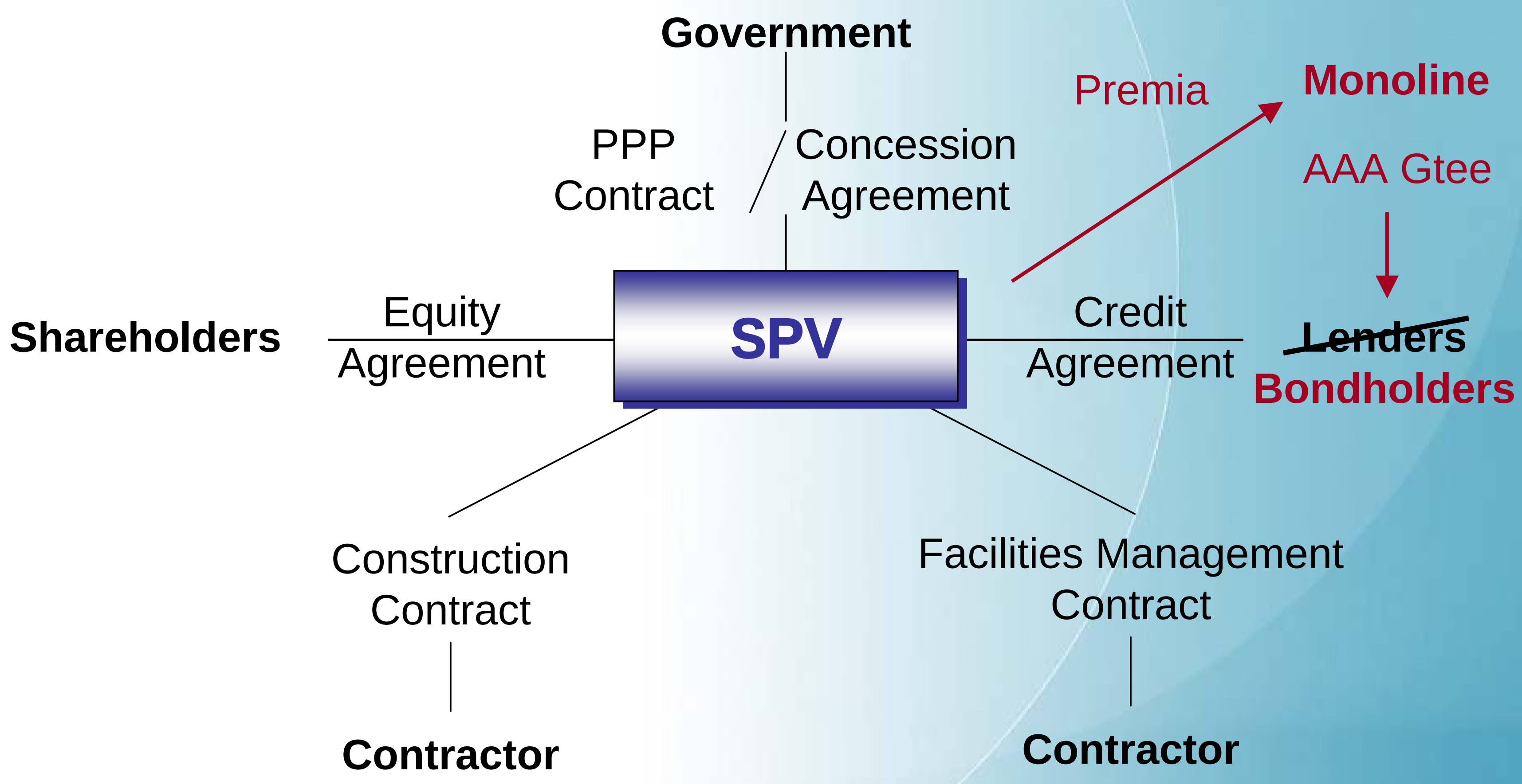
ANNUAL DEBT SERVICE COVER RATIO	Revenues	£120
	- Costs	- £108
	= Cash Available for Debt Service / Annual Debt Service	£ 12 / £ 10 = 1.2 x
LOAN LIFE COVER RATIO	As above, but PV of cash flows for life of Project	
	PV of Annual Cash Flows / Loan	£135 / £100 = 1.35 x

Sources of Debt Finance

- Banks
- Capital Markets
  - Role of monolines
  - Role of rating agencies
  - Identity of investors

Source of finance is often determined by size and complexity of project.

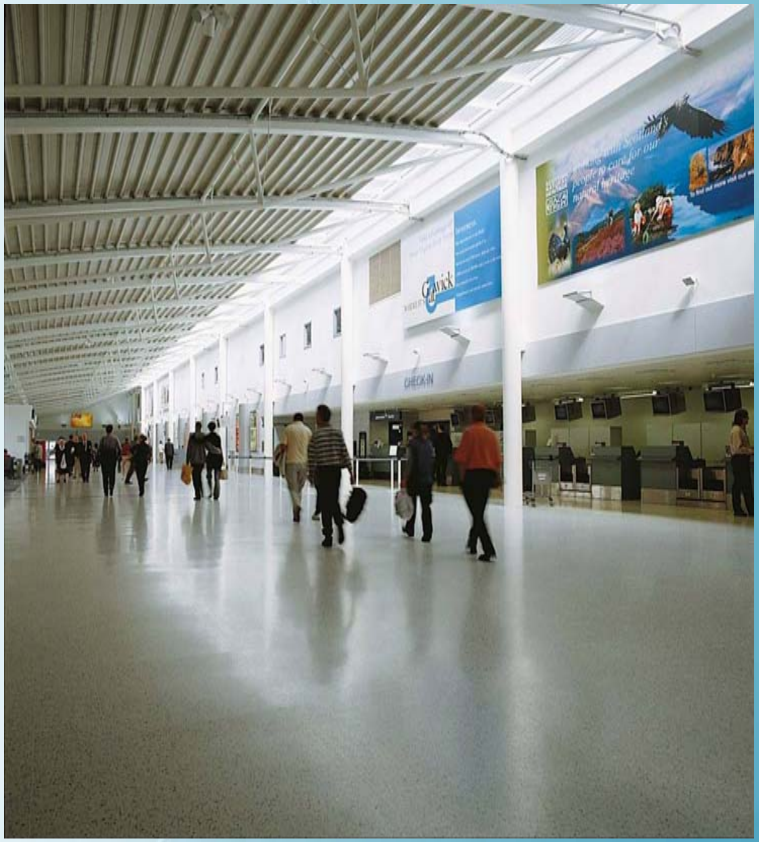
Principal Contract Structure



Characteristics of Equity

Equity is the risk capital

- Adequate return for the risk undertaken
- Limited upside potential from PFI contracts
- Readily identifiable valuation characteristics (limited market risk)
- Marketable commodity



Sources of Equity

- Lead contractors
- Primary institutional investors
- Secondary market funds

What is a Refinancing?

- Any change in the terms of third party debt financing of a PFI Project (to the benefit of shareholders):

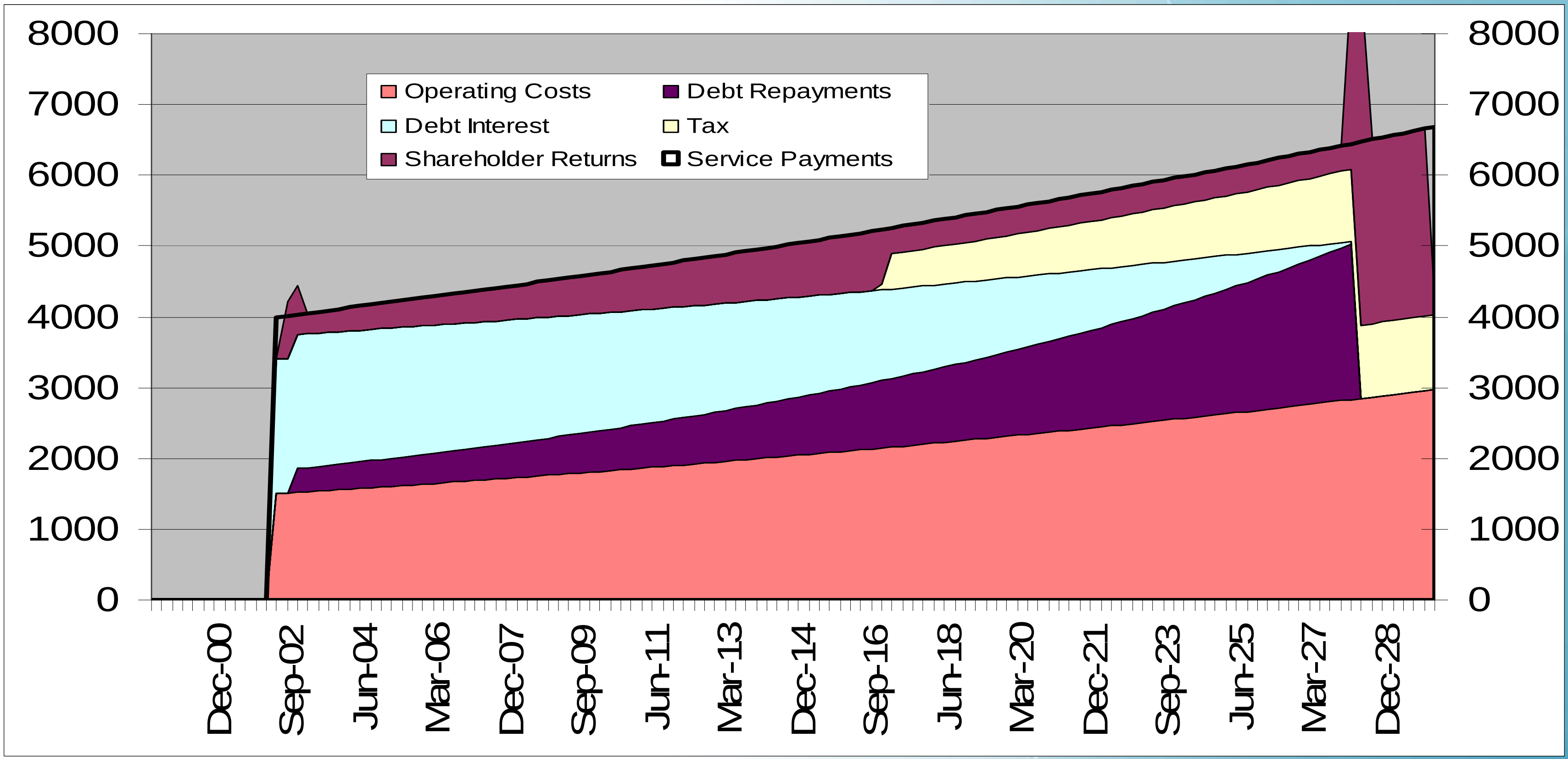
  – Any change in or any waiver on any aspect of none shareholder funding;

  – More commonly it is the repayment of senior debt by the raising of new debt (when long term viability is proven – lower risk);

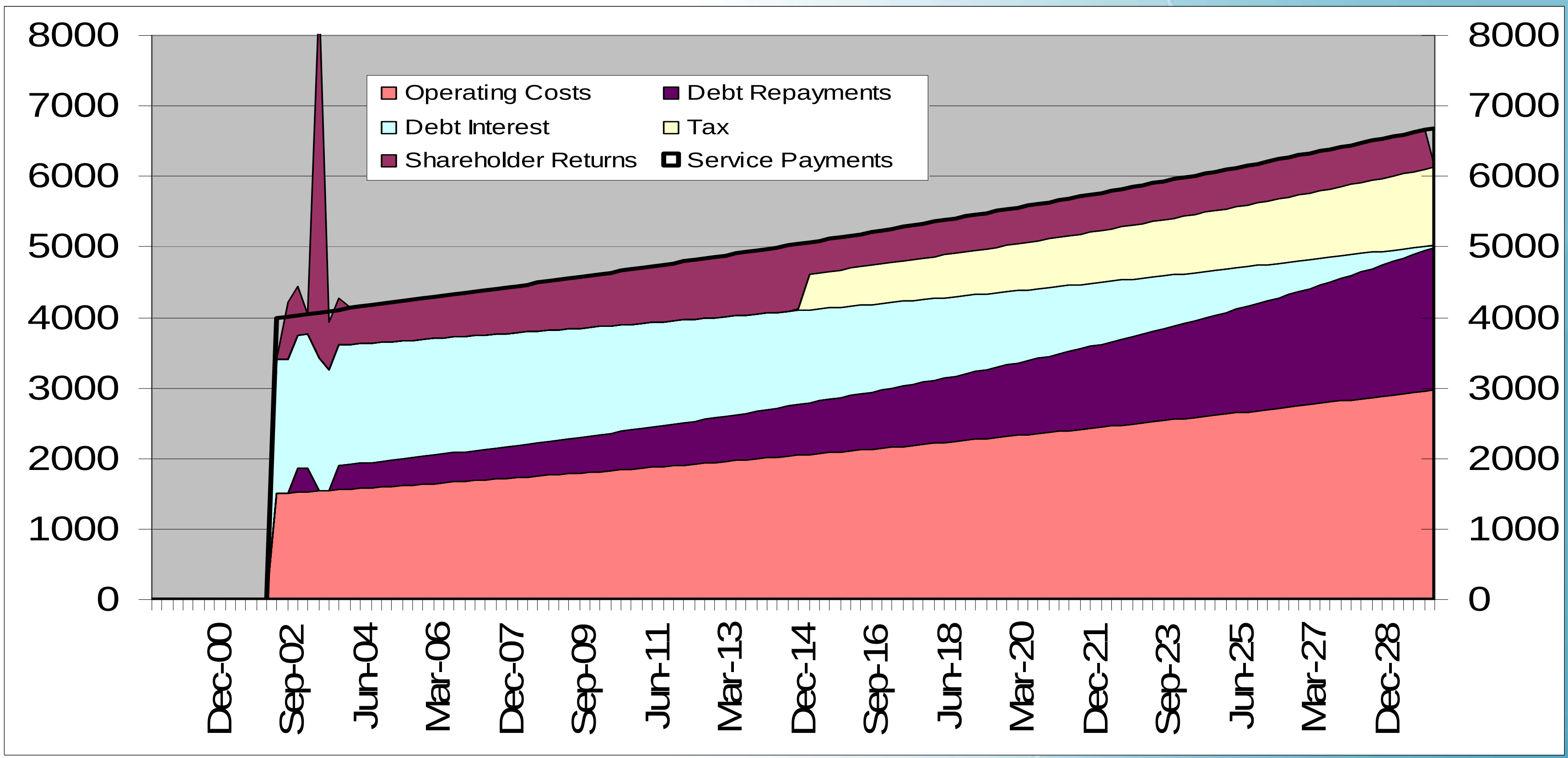
    - on more advantageous terms;
    - repaid over a longer term;
    - larger amount of debt.

  – Analogous to changing mortgage on your home.

Typical PPP Cash Flow ($'000) - Pre Refinancing



Typical PPP Cash Flow ($'000) - Post Refinancing



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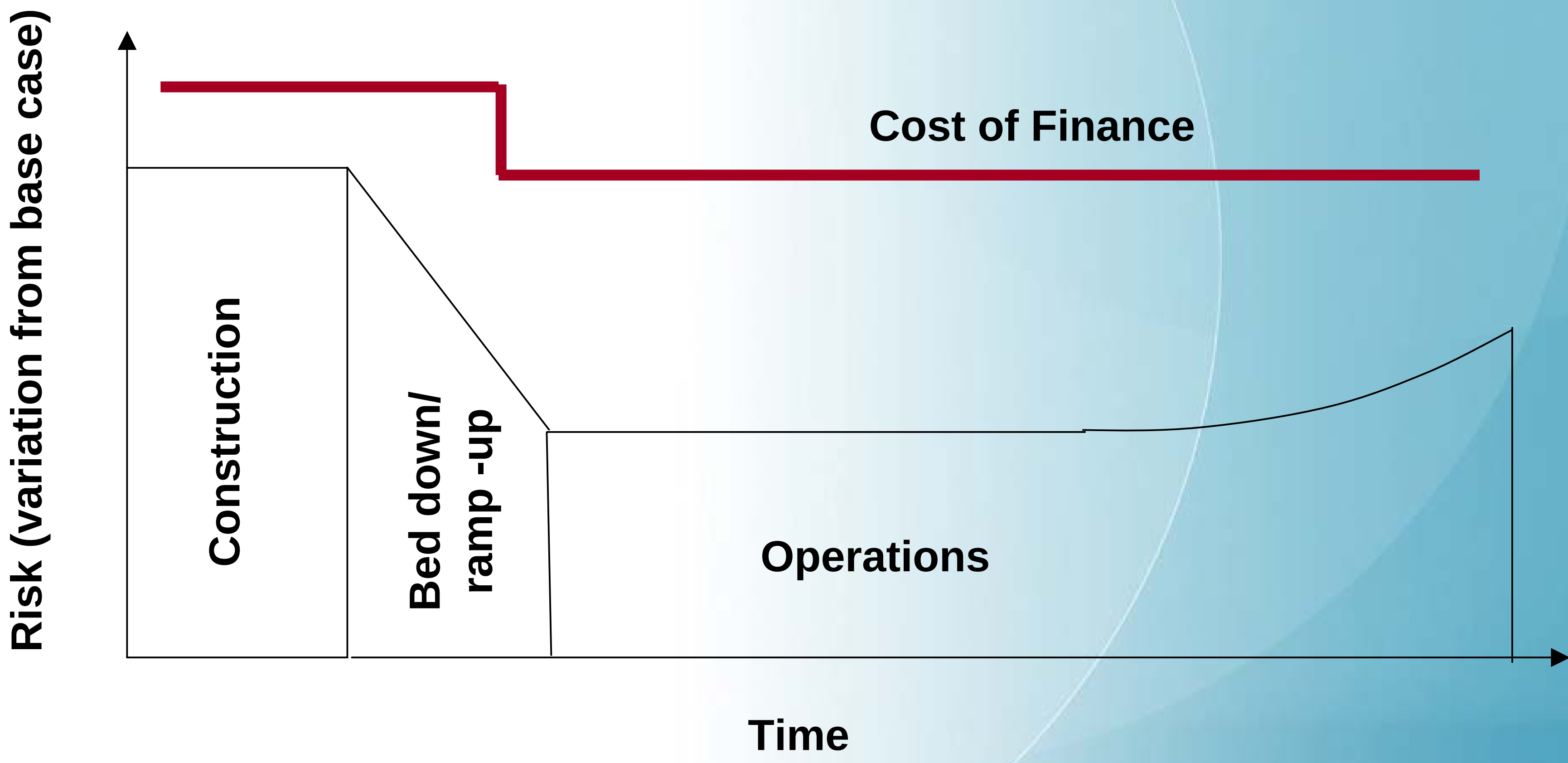
Why is the Public Sector entitled to a share of Refinancing Gain?

- Market that has been developed by the Public Sector so allowing gains to be secured through cheaper debt funding.
- Partnership between Public and Private Sectors so sharing structure is appropriate.
- Politically unacceptable for the Private Sector to make windfall gains out of PFI projects

Risk

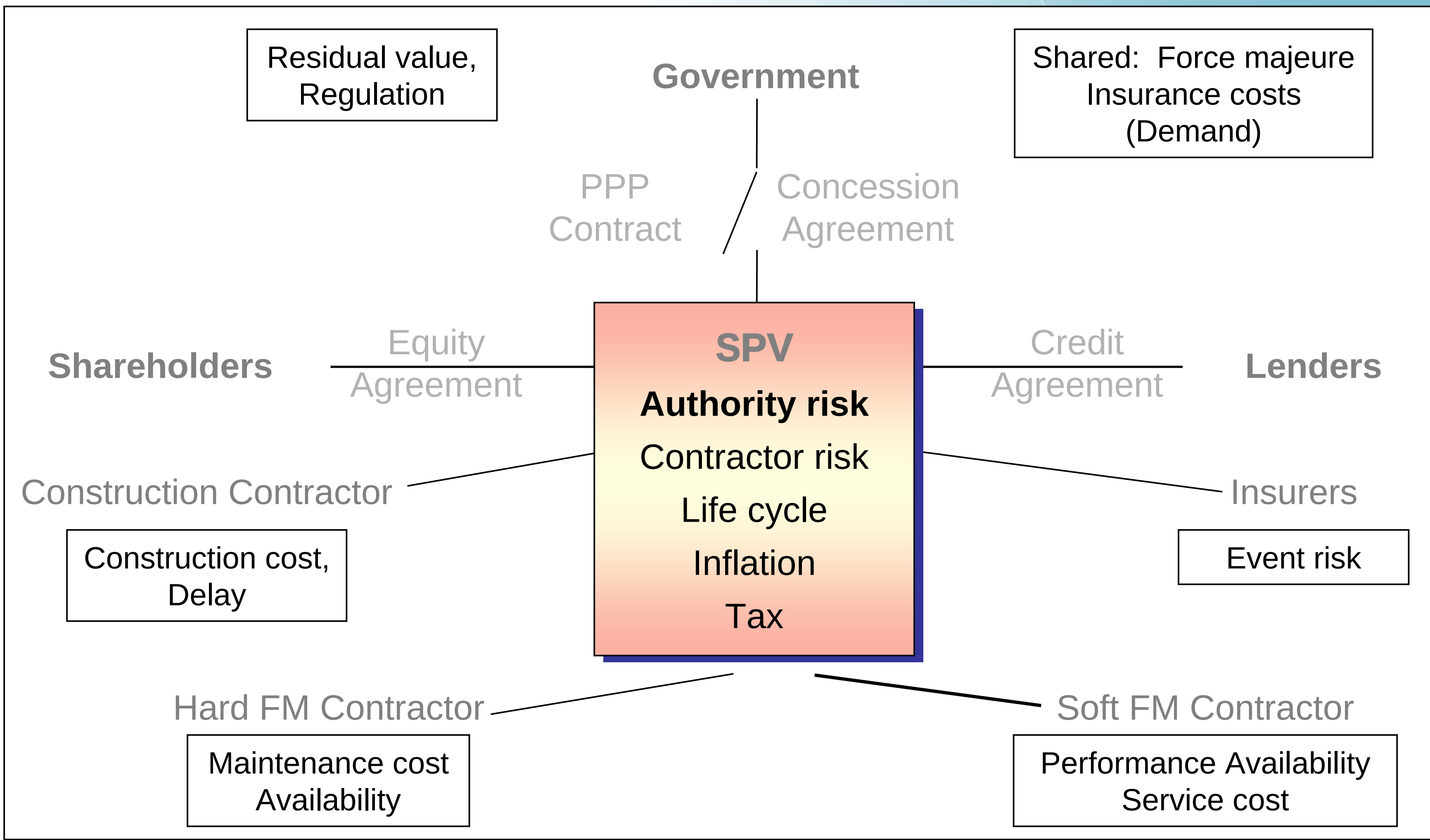
When: Life cycle risk profile



What: Types of Risk

Traditional procurement		Typical PPP/PFI
Design & construction	Private Sector Risk	Design & Construction
Availability of service		Availability of service
Quality of service		Quality of service
Maintenance & renewal		Maintenance & renewal
Market	Public or Private	Market
Force majeure	Shared	Force majeure
Obsolescence		Obsolescence
Residual value	Public Sector Risk	Residual value
Regulation/policy		Regulation/policy

Where: Risk Distribution



Operating Risk

- Pass through of performance related revenue deductions to subcontractor
- Hard FM: Life cycle costs at SPV level
- Soft FM: Benchmarking » how long term? » market testing
- Anti-dote to hyperbolic discounting (perceived value usually declines sharply with time in public sector thinking)
- Discipline of exposing long run finance to long run maintenance (pubic sector interference in design choice!)
- Maintenance reserve accounts (implication for bidding process if too aggressive: low price = higher risk for public sector)
- How much debt needs to be exposed to operating performance?

Construction risk

- True risk transfer
- Risks to government: delays, variations, poor specifications
- Risks to financiers: contractor credit risk, contractual mismatch, caps on liabilities, contract complexity and the replacement issue, inherited design risk

Market Risk

- The illusion of risk transfer – usually budget driven than risk driven
- Questioning of the vfm of the risk premium charged for assuming uncontrolled market risk » trend to availability based schemes e.g. in Eastern Europe ….
- … Market risk, accountability and efficiency

Some PPP Contract issues

Principles of a “standard” PPP project

1. Authority transfers responsibility and risk for asset/ service to Contractor
2. Contractor takes on obligations for c.20-30 years
3. Contractor designs, builds, manages, maintains asset and provides service
4. Lenders fund Contractor on limited recourse basis
5. Authority pays “Unitary Charge” for available/ acceptable service
6. The PFI Contract (and associated documents) must regulate a network of relationships

Some Common Issues

- Certainty of legal framework
- Legal capacity of public sector to contract
- Ability to accommodate market changes
- Dispute resolution mechanisms
- Step in rights
- Standardization

Aims of PPP Contract

- Specifies performance
- Allocates responsibility
- Accommodates change
- Penalises failure
- Maps out Termination
- Dispute resolution procedures

Early Termination

Possible Categories

- Authority Default (Breach)
- Authority Voluntary Termination
- Contractor Default (Breach)
- Force Majeure
- Corrupt Gifts and Fraud
- Breach of Refinancing Provisions

Early Termination

Compensation on Termination for Contractor Default

- Market value approach
- Compensation based on market value of the unexpired term of the Contract
- Incentivises Lenders to step-in and rescue projects rather than relying on termination payment
- No windfall gain for Authority
- Meaning of "liquid market"

Supervening Events

- Three categories of events where fair to relieve Contractor of liability to commence/provide Service:
  - Compensation Events
    - time and money
  - Relief Events
    - relief from termination
    - deductions can still be made
  - Force Majeure Events
    - termination after a limited period (e.g. 6 months)
    - deductions can still be made

Risk Apportionment
Questions
Answers

Risk Apportionment

Questions

Risk	Bidder	Authority	Lender
Flood delays construction of Project			
Strike in the construction industry			
Due to increased terrorism, Insurance premiums increase by 250%			

Risk Apportionment

Questions

Risk	Bidder	Authority	Lender
The Contractor has a bad claims history and his premiums increase by 250%			
New health and safety legislation means that all buildings need to be modified			
A Shareholder sells its stake in the SPV to a third party during the construction period			

Answers to these questions will be provided at the presentation

Session End