PPP Finance and Legal Issues

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Modes of Finance

Sovereign Finance

Corporate Finance

Full Recourse

Public Sector

Private Sector

Project Finance

Non Recourse
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)

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (US$Bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>27</td>
</tr>
<tr>
<td>1996</td>
<td>48</td>
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<tr>
<td>1997</td>
<td>75</td>
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<td>2002</td>
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<td>2003</td>
<td>102</td>
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<tr>
<td>2004</td>
<td>145</td>
</tr>
<tr>
<td>2005</td>
<td>167</td>
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</table>

*Source: Project Finance International*
Borrower rationales for using Project Finance

1. Isolate specific risks (e.g., 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 (e.g., contractors)
6. High gearing for lower tariffs and increased ROE
7. Avoid consolidation of debt into sponsors’ accounts
Project Gearing (Leverage)

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

<table>
<thead>
<tr>
<th>60 / 40</th>
<th>90 / 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>High market and / or operational risks</td>
<td>Low market and / or operational risks</td>
</tr>
</tbody>
</table>

* 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

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>£120</td>
</tr>
<tr>
<td>- Costs</td>
<td>- £108</td>
</tr>
<tr>
<td>= Cash Available for Debt Service</td>
<td>£12 = 1.2 x Annual Debt Service</td>
</tr>
<tr>
<td></td>
<td>£10</td>
</tr>
</tbody>
</table>

### Loan Life Cover Ratio

As above, but PV of cash flows for life of Project

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
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</thead>
<tbody>
<tr>
<td>PV of Annual Cash Flows</td>
<td>£135 = 1.35 x Loan</td>
</tr>
<tr>
<td>Loan</td>
<td>£100</td>
</tr>
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</table>
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

Shareholders

- Equity Agreement
- Construction Contract
- Contractor

Government
- PPP Contract
- Concession Agreement

SPV

Credit Agreement
- Facilities Management Contract
- Contractor

Premia
- Lenders
- Bondholders

Monoline
- AAA Gtee
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

[Graph showing cash flow over time with categories: Operating Costs, Debt Repayments, Debt Interest, Tax, Shareholder Returns, Service Payments]
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

- Cost of Finance
- Construction
- Bed down/ramp-up
- Operations

Risk (variation from base case)

Time
What: Types of Risk

### Traditional procurement
- Design & construction
- Availability of service
- Quality of service
- Maintenance & renewal
- Market
- Force majeure
- Obsolescence
- Residual value
- Regulation/policy

### Typical PPP/PFI
- Design & Construction
- Availability of service
- Quality of service
- Maintenance & renewal
- Market
- Force majeure
- Obsolescence
- Residual value
- Regulation/policy
Where: Risk Distribution

- **Government**
  - Residual value, Regulation
  - PPP Contract
  - Concession Agreement

- **SPV**
  - Authority risk
  - Contractor risk
  - Life cycle
  - Inflation
  - Tax

- **Shareholders**
  - Construction cost, Delay

- **Construction Contractor**
  - Event risk

- **Hard FM Contractor**
  - Maintenance cost
  - Availability

- **Soft FM Contractor**
  - Performance Availability
  - Service cost

- **Lenders**
  - Credit Agreement

- **Insurers**
  - Event risk

- **Residual value, Regulation**
  - Force majeure
  - Insurance costs (Demand)
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 (public 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

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<th>Risk</th>
<th>Bidder</th>
<th>Authority</th>
<th>Lender</th>
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<tbody>
<tr>
<td>Flood delays construction of Project</td>
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<tr>
<td>Strike in the construction industry</td>
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<tr>
<td>Due to increased terrorism, Insurance premiums increase by 250%</td>
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### Risk Apportionment

#### Questions

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<td>The Contractor has a bad claims history and his premiums increase by 250%</td>
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<tr>
<td>New health and safety legislation means that all buildings need to be modified</td>
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</tr>
<tr>
<td>A Shareholder sells its stake in the SPV to a third party during the construction period</td>
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Answers to these questions will be provided at the presentation.
Session End