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Why the PFI market is missing a trick with refinancings, by Andrew Date from David Wylde Project Finance

PFI debt refinan

Recent figures from Partnerships UK show that less than 50 PFI/PPP projects had been debt refinanced to date. Whilst material, this result must be considered below expectations given the time, effort and hot air extended to refinancing over recent years and the maturity of the market with in the order of 400 projects now in full operational phase.

Despite this current position, debt refinancing clearly makes sense as it generates shared refinancing benefit for the public and private sector driving added value from PFI/PPP. It also allows sponsors and financiers to recycle their investment into new projects, generates liquidity in the banking markets and also ensures that reduced risk dynamics and other proven market efficiencies are captured. Clearly, if the PFI/PPP market is to continue to grow and become more efficient and competitively priced then it is an essential ingredient that investors are able to refinance in order to generate this greater liquidity. Both sponsors and financial investors will soon run short of capacity in that they are unable to recycle their investments.

While debt refinancing may have been in the slow lane - especially in the last 24 months, interest in equity sales have represented the fast lane. The question is 'is this simply a reflection of an evolving market with equity being consolidated at secondary investor level prior to underlying debt refinancing catching up or, is it due to constraints within either the public or private sector relegating debt refinancing into the 'all too difficult' box'?

Of course this 'all too difficult' view can easily be reached given the disparate nature of sponsor consortia, costs and management time needed to refinance together with concerns over tax and accounting challenges when realising refinancing benefit. Additionally, and most importantly, the market also has to address the implications of various public guidelines culminating in the latest application note from HM Treasury issued in February 2005 against the backdrop of various NAO reports making this subject extremely high profile.

Arguably this consolidation of guidance has also increased pressure on public sector officers who when faced with refinancing proposals have to make public recommendations particularly justifying value for money. This combined with the recurring problem of limited public sector resource within individual client authorities conspires to make life very difficult for those officers in an environment where new primary deals and initiatives must take priority.

So, undoubtedly the market sits at a crossroads and where do we go from here? Is the market just 'froth' and 'hot air' or does it have real 'substance'. Are there real opportunities for both private and public sectors to realise gain in a partnership approach?

Well, the market dynamics are relatively simple and the answer is definitely positive. To illustrate this:

Secondary investors like primary equity sponsors need to maximise returns whether they are medium or longer

ing and ‘the 2005 crossroads’

term holders. Steadily the market will move towards pension funds or trade-able instruments with a blurring of the debt/equity distinctions. As alluded to earlier, equity consolidation assists this process and also mitigates problems associated with the small size of many projects and their disparate ownership.

The market requires time to be convinced of reduced risk with proven operational success and the establishment of effective risk management controls. However liquidity of debt and equity investment is the lifeblood of the PFI/PPP market and the plentiful supply of both to date is a reflection of the quality of the market risk, together with the position in the current investment cycle. The PFI/PPP industry needs to recognise that such markets are cyclical and indeed the best way to optimise the future is to best manage the present.

The public sector is a partner in an industry which generates substantial benefit for the wider community they serve. Efficiencies from refinancing can simply enhance this value for money benefit and overlooking such opportunities would be an error for the public sector.

As to whether the market can reap the benefits on a partnership basis will be seen. Put simply, the market dynamics for refinancing are excellent, the quantum is huge and the management of risk and financial sophistication are continuing to strengthen. The challenge will be the extent to which the private and public sector can work together within the regulatory environment that now exists. Alternatively we will almost certainly see continued development of stand alone equity and debt disposals rather than public sector inclusive basis. However these conditions should be able to foster harmonious public private partnerships which can only lead to significant opportunities to create additional value for money.

So what are the blockers?

Are there ‘icebergs’ in the debt refinancing market place and can they be solved?

From a private sector viewpoint a number of market issues are coming good. Equity stakes are being consolidated, quality risk management is building good track records, accounting standards are becoming clearer, financial markets are developing and new financial products are evolving. Future opportunities appear realistic and promising. Against this, some investors may decide to further delay debt refinancing, largely due to continued portfolio building, equity exit options or their perception of a reluctance of the public sector to engage given uncertainty on implementation of the latest HM Treasury guidance.

From the public sector viewpoint the issue is how officers can ensure refinancing proposals offer value for money as referred to in the guidance. This enforced value for money consideration now needs to assess the impact of increased levels of debt on the underlying project, the impact of debt levels on termination liabilities and upon

future contract flexibility. None of these matters are new or too difficult to assess but all too often a negative stance is the initial reaction. For example, the public sector should take great comfort from the critical need for the project to run successfully in order for equity or debt providers taking priority project risk to realise their returns. In the event of Project Company default, the level of debt and risk capital is irrelevant to the public sector as market value compensation prevails. However when assessing termination liabilities the important circumstance which must be focused upon is Authority Voluntary or Default termination. While default can be largely ignored, a realistic assessment of the likelihood of a voluntary termination of a successful project must be made. The challenge is that while value for money assessment is required no benchmarks are provided.

The Guidance also requires that other contract changes, for example operational or service changes, unitary payment variations or concession extensions are to be assessed separately. This is understandable and demonstrates the areas of greatest public sector sensitivity following recent NAO reports. Value for money has to be proved although particularly in the case of extensions the starting assumption is that it will not be proven.

Where does that leave us

The private sector is concluding that the latest guidance is against increased levels of debt, thus closing the door to the key ingredient of refinancing. However our discussions with PUK and HM Treasury reveal that the actual intent was to provide a recommended framework with guidance upon particular value for money sensitive areas.

Within the public sector the discipline now imposed upon authorities is clear. What is unclear is how they will apply the VFM analysis - by mathematical calculation or by subjective assessment based on good sense and experience. Consequently there is a need for quality independent advice, either from external advisers or from within the public sector.

Conclusion

To conclude, there is a real opportunity for the public sector to benefit from significant refinancing gains and enhance overall value for money but it is clear that in 2005 the market is at a crossroads.

There is an opportunity to accelerate the rather lack luster performance to date for which the dynamics of the current market place are crying out. The clear challenge is to build a track record of successful precedents clarifying the recent HM Treasury guidance. This requires private sector stimulus but also critically needs public sector commitment to ensure that efficiencies from debt refinancing can generate value for money for both parties. The concern is that for this to be achieved, both sectors need to commit to this initiative on a proactive partnership basis. ■