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The politic in PPP

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Demand for healthcare and social infrastructure PPPs is growing across Europe. Italy, Spain and Portugal have all tendered projects – some more successfully than others – though the deluge of deals forecast a few years ago still looks to be some way off.

The UK, on the other hand, having originated the model and developed a successful secondary asset market, is in a transitional phase with the government pushing for payment by results.

"There seem to be two forms of PPP initiative operating across Europe, principally driven by the scale of the pipeline. Those countries with a significant pipeline have to ensure that deals are structured in a way that international banks, investors and contractors are able to access the market and compete against local players, for example the UK, Ireland and Portugal," says Martin McCann, head of PPP at Norton Rose.

"Other jurisdictions, where the pipeline is less aggressive, are able to structure deals to the advantage of local players and hence do not benefit from many of the real advantages of PPP. This will be fine as long as they do not try and expand the market or benefit from international secondary market liquidity."

A clinical finish

A number of different approaches to PPP have been, or are being, attempted across Europe. Heralded as a pioneer of outsourcing clinical services to the private sector, Portugal came to market with a Eu3 billion PPP/PFI scheme for 10 new hospitals and a number of renovations. In addition to an ineffective legal framework and a tortuous evaluation and tendering process, the structure of the deals – a combination of infrastructure and clinical services – mitigated against any closing to date.

Nevertheless, Portugal's attempts at moving from traditional PFI-type structures to deals containing clinical risk are not seen as a complete disaster. "What the Portuguese have attempted to achieve in terms of healthcare PPPs is where the European market really needs to be," says a London-based PFI lawyer. And the UK is now looking at including clinical services in health PFI – although the political upheaval of such a move will probably prove too difficult for politicians to achieve.

The Portuguese market has been heavily criticized for its lengthy tendering process and a new code, to be enacted this year, is expected slash tender times by 50% from an average of 18 months. Hospital tenders will benefit from the streamlined procedures, which will focus less on the minutiae of how sponsors will deliver, and more on ensuring sponsors have the resources to deliver.

Most recently, Hospital Vila Franca de Xira – the fourth in the series of 10 hospitals still in tender – has come to market with a Eu590 million ($747 million) deal. Bids are currently in from five consortia: Somague with Jose de Melo, with BNP Paribas, Societe Generale and Caja Madrid providing the financial backing; Ferrovial/GPS, with Banco Efisa as financial adviser; the HPP consortium of Caixa Geral and Teixeira Duarte; Banco Espirito Santo and Mota Engil; and a consortium of CESPU and Soares da Costa, with financial support from Banif.

The Portuguese health ministry had postponed bids in order to introduce changes to the tender. A ceiling was introduced to the contract value and the clinical services concession has been cut from 10 years to eight years. The 30-year concession will involve availability payments. In addition, the government has ring-fenced the clinical services contract in order to make the projects more bankable.

Although Portugal is making steps in the right direction, not everyone is optimistic about the country's chances of closing its proposed PPP scheme. According to one industry expert, "Portugal really needs to go back before it can go forward; and it definitely needs to go a long way back."

UK struggles with clinical risk

Whilst Portugal is struggling to get its first healthcare deals closed, the UK healthcare sector has had to contend with a barrage of adverse publicity. In what can only be described as emotive language, the UK press has latched onto the accusation by pressure groups that private companies look to make around £3.3 billion from PFI deals. Moreover, it is estimated that the private sector will pocket £2 billion from around £10 billion in prospective deals.

"You have to remember that private sector involvement in social infrastructure remains a highly politically sensitive topic in many European countries. Having said that, most of these countries have developed successful transport PPP markets, which, on the whole, have not been contentious," says Paul Leatherdale, head of infrastructure finance at DEPFA Bank plc.

The privatisation of clinical services has also done little to endear the government's PPP/PFI programme. There is fear that once hospitals are fully privatised transparency will fall foul of commercial confidentiality and that cuts will be subject to market forces.

Although the trend is going towards clinical projects, the fact is that few lenders in the UK have come up with credible solutions to taking on clinical risk. Moreover, few are even comfortable with taking on an element of volume risk. Therefore, the current clamour against the outsourcing of clinical services may be somewhat premature.

"In terms of shaping public service outsourcing policy, it must be remembered that healthcare and education are close to people's hearts and there is a natural scepticism as to whether the private sector can deliver satisfactorily – naïve responses to private sector involvement, such as accusations of corner-cutting, look set to continue. PPP operators need to get the message across that they get paid by results and very often the specification of a building or the services to be provided is driven by the public sector entity's affordability constraints," adds Leatherdale.

Spain's diverse models

Spain is another jurisdiction considering outsourcing its clinical services. This year has seen the country's first foray into the hospital market with the Madrid hospitals programme, of which the Eu300 million Majadahonda and the Eu138 million Vallecas projects have already reached financial close.

However, the pricing on these transactions was impressively low, rivalling the record lows experienced in the UK. During its construction phase Majadahonda starts at 75bp, which is expected to rise to between 100bp and 115bp once the hospital is in operation. Vallecas has come in even lower, starting at 60bp. With such tight margins, these deals have little room for error.

That said, "from a public perspective, you have to question some of these deals. The health Madrilenian PPP program, for instance, which had a quite fine legal and risk structure, may be not so good from a VFM perspective, since banks seem to be overprotected. Firstly, with the capex fixed up to 60% of the availability payment, there is no risk for the bulk of the debt subject to the risk of payments. And secondly, in terms of termination compensation sums for contract default, the banks will receive the net value of the works prior to any deduction referred to damages and losses. Although this is not contrary to the concessions law, it seems to me to be against the spirit of the law," says Andrés Rebollo Fuente, partner at Asesores de Infrastructuras in Madrid.

The other four Madrid projects are expected to close over the summer, while a decision is imminent on a preferred bidder for Spain's biggest healthcare project to date, the Eu780 million Son Dureta hospital in Palma de Majorca.

Given that projects are tendered at regional rather than central government level, Spain has the potential to become a diverse market in terms of PPP product. Valencia, for example, is about to come on stream with a programme of 11 hospitals, five of which are being slated for PFI schemes. The programme currently includes Hospital de Campanar, Hospital Padre Jofre, Hospital Gandia, Hospital Comercial de l'Horia, Hospital de la Nueva Fe, Llíria, Campanar, Hospital de Dénia & Benidorm, Hospital Eiche–Crevillente & Torrevieja and Hospital Vall d'Uixó.

The Valencian programme is expected to outsource both management and services, and, to date, has not been replicated anywhere else in the region. "This may be for two reasons: first, because politically speaking it is a more difficult private scheme to sell. Second, it does not look very efficient as a procuring process. Since clinical services are included and this is a thinner market, the number of possible biding joint ventures is much reduced (up to three or four), and also is its financial feasibility due to the higher risk profile related to this wider scope of obligations (clinical services provision together with facility management)," adds Rebollo Fuente.

A further PPP structure for hospitals that is being looked at is based on the Calle-30 model, where the regional government retains a majority stake in the project company. Hospital Toledo is currently looking at the structure, while the region of Asturias is rumoured to have tried the structure.

Whether or not these deals stand up to the government's account controller IGAE (Intervencion General de la Administracion del Estado) is another matter. Eurostat initially rejected the Calle-30 scheme as a private financing, therefore the debt of the project had to be included in the public accounts as public debt. At the time it was thought that local governments in Spain would go back to pure PPP schemes rather than very complicated 'public-public-partnerships', but it doesn't seem to have had that effect.

Bonds are back

With UK bank project debt at a record low, it has become cheaper for the bigger projects to tap the bond markets. According to Leatherdale, "We are seeing increasing recognition that long-term bank debt (especially when wrapped by a AAA monoline insurer – which under Basel II will enable banks to allocate less capital) can be a very competitive alternative to traditional bond financing: bank loan structures enable more flexibility in the drawdown (construction) phase, and don't require a "Spens clause" (i.e. compensation for loss of future spread income when a bond is prepaid) which can therefore provide a more flexible refinancing option for sponsors."

The appetite for these deals among pension funds seems to be growing, with spreads of 50-60bp over Gilts in the secondary market the norm.

Given the shorter loan terms, Spain is the likeliest of the Continental jurisdictions to follow suit with a boom in refinancing expected in two to three years time.

"Although several of the bidders on the Madrid transactions have looked at bond financings, it is essentially an immature market because of the lack of a friendly regulatory framework. Having said that, bond financing could become a real alternative in next two to four years when we might expect a boom, especially since the specific rules included in the Concession law to protect bond holders," adds Rebollo Fuente.

Future development

In the next few years, PPP is likely to become the healthcare procurement option of choice. Even those countries that have been most opposed to PPP structures are likely to follow suit due to budgetary constraints and a longer living population.

It is rumoured that French construction company, Eiffage, could be on the verge of securing France's largest hospital PPP. The project is expect to come in at Eu330 million and would involve the build, finance and management of the

1,000-bed Sud-Francilien Hospital.

Yet for those countries with an established PPP track record, it looks like question of whether or not to outsource clinical services will continue to dominate the headlines. For the UK, however, funders and sponsors will be looking for new opportunities rather than standardised structures.

"Since the inception of PPP each year in the UK has carried very different themes. 2005 was, for example, the year for the secondary market. However, this market is now so aggressive investors are looking at alternative points of access. On this basis 2006 looks like being the year for M&A of infrastructure investors/contractors and operators," says McCann.