Going local

01/04/2006

The prospect of more devolution of infrastructure and social welfare budgets across European markets is attracting more lenders and equity into the local and municipal finance arena under the guise of PPP.

Longstanding cross-border municipal/public sector lenders like Dexia and Depfa, and local banks, continue to dominate Europe's local public finance markets. But with the proliferation of PPP beyond national government to regional and local government, many lenders are becoming more focused on deals at local level and setting up equity funds and local debt practises.

In Spain, for example, both Banco Santander and Grupo Ahorro Corporacion are looking to increase their equity holdings in regional and municipal PPP projects. And in Germany, Dusseldorf-based Lindner Immobilien Asset Management has set up the ImmoSafe fund for assets such as schools, courts, town halls, and prisons.

Similarly, the local PPP debt market is attracting new players. Hypo Public Finance Bank was set up in January as a spin off from Hypo Real Estate Bank and has hired Mark Puckett from KPMG to establish an infrastructure and energy team for Europe and the Middle East. The new bank is capitalised at Eu275 million, but has the balance sheet backing of its parent with Eu2.6 billion of equity. According to Puckett, the team will specialise in structured finance – bonds and debt – for PPP and be able to take very high hold positions.

What traditionally have been perceived as local/regional banks are also going cross-border for PPP. Caja Madrid – a major PPP player in Spain and Portugal – is participating in its first deal in the US PPP market. Conversely, Lloyds TSB has begun to make its presence felt in the Spanish PPP market.

Local-specific legislation needed

But while local/regional government PPP markets are growing in importance as sources of dealflow – they also present a number of hurdles in terms of creditworthiness and solid legislation.

In Italy for example, the benchmark Mestre hospital deal last year was made far more complicated by lack of legislation and the uncertain creditworthiness of Italian local health care authorities (ASLs). In the UK, the local creditworthiness problem is solved by the Residual Liability Act, whereby the government effectively guarantees an agency acting as an arm of the state.

There is no such law in Italy. Instead, the lenders on Mestre concluded that although there is no explicit provision or contract, such is the importance of the hospital to the local population that the Veneto regional authority was a de facto guarantor of the ASL with regards to its payments to the project.

Fortunately for the Mestre project the Veneto region is AA rated by S&P – but had it not been, the deal would have struggled even more than it did.

The importance of tight PPP legislation at local level is high on many European government political agendas. On 15 March the Czech Republic adopted the Act on Concessions which includes the devolvement of decision making and awarding of PPPs under CZK500 million to regional authorities and anything below CZK250 million can be solely decided by municipalities and local government.

The legislation is far-reaching. It also ups the minimum concession value from CZK2 million to CZK20 million – which is considered the threshold below which long term concessions are not economically viable – and lays out a host of guidelines on how concession agreements, not previously covered by Czech law, should be structured.

Although in the midst of an election in which the opposition party Fidusz has adopted an anti-PPP manifesto, Hungary's incumbent Socialist government has also tendered a number of advisory roles to look at drafting a new legal framework that would enable PPP to be implemented at local government level.

The Hungarian Ministry of Economy and Transport and the EBRD are to work alongside the advisors to conduct policy discussions on the country's future PPP regime, how to update existing procurement law and a number of sub-laws to boost PPP efficiency at local authority level.

Even developed markets are looking more closely at local PPP and how to smooth is implementation.

With EU funds expected to reduce substantially by 2007, Spanish national and municipal governments are looking to private sector cash to bridge the budget gap. According to some industry experts the amount needed to cover the impending shortfall will be somewhere in the region of Eu3.5 billion, and during last year PPP started rolling out into hitherto untapped Spanish sectors like prisons, schools and accommodation.

A number of Spanish Autonomous Communities are looking to enact supplementary legislation to get deals off the ground. Most PFIs in Spain are carried out using the framework provided by the national Administrative Contracts law. Recently, some Autonomous Communities have implemented additional pieces of legislation applicable to their own projects to further protect project participant interests.

Madrid sets the local PPP template for Spain

Madrid has led the way in Spain. The flagship Eu2.5 billion Calle 30 Madrid ring road financing (for more details search 'Calle 30' on www.projectfinancemagazine.com), closed last December, was the first major PPP by a town hall as opposed to a regional government. And Madrid's hospital programme has set the template for the rest of the country.

But while Spanish PPP moves into middle age by going regional and local it also demonstrates a major headache for newcomers to the municipal PPP market. Traditional municipal debt has been very cheap and with bank liquidity rife around the world, local and regional PPP is very competitively priced – some would argue too competitively.

The Madrid hospital deals are a case in point. Majadahonda, the first of Madrid's eight hospital PPPs, closed last month. ACS-Dragados is sponsoring the project after Comunidad de Madrid awarded it the 28-year concession last year. Dexia, ING and Ahorro Corporacion are the mandated lead arrangers for the Eu210 million project debt.

The deal priced very tightly given it is the first in Spain – 75bp during construction, when a completion guarantee is in place from the sponsor; 95bp at the beginning of operations; 105bp for years 5-10 and 115bp after 10 years of operation. Base-case average DSCR is 1.25x, with a 1.20x minimum.

The second hospital deal – the Eu112 million 30-year Vallecas concession – has come in even tighter. Sole arranged by Santander, with Ploder as lead sponsor, the Eu98 million of 28-year senior debt is priced at a wincing 60bp and Santander is rumoured to be having trouble finding takers in syndication.

The deal's pricing reflects the total priority of lenders over cashflow, both above shareholders and the project operating costs. Prospective lenders are said to be having difficulty believing, especially given the potential political fall-out – that they would really have priority over the project's operating costs.

The remainder of the Madrid deals are expected in the market in the coming months and the programme has already prompted similar local PPPs in other regions: The Eu275 million Burgos hospital project was awarded to an OHL-led consortium earlier this year and will close in five months; and bids were in on 31 January for the Son Dureta hospital in

Palma de Majorca.

Local PPP has also spread Spanish to prisons and administrative real estate. Last December, the Eu287 milion wrapped debt financing for the Ciudad Judicial Barcelona 35-year DBFM contract between the Generalitat de Catalunya and the URBICSA consortium – comprising FCC, Ferrovial, OHL, Copisa and Emte – for administrative buildings, including the future headquarters of the Barcelona courts and the Hospital de Llobregat, reached financial close. All-in pricing (wrap plus debt) was 80bp rising to 100bp over term.

The pricing and structuring on both Ciudad Judicial Barcelona and the Vallecas and Majadahonda hospitals are symptomatic of the lack of benchmarks and disparate way PPP is beginning to develop at local level in Spain.
The hospital projects will receive annual unitary payments – Eu45 million per annum, adjusted for inflation, on Majadahonda and Eu15.44 million for Vallecas. But without local benchmarks, some local bankers fear the deals may have been priced too competitively by the sponsors and again by lenders. Conversely, and ironically, some bankers speculate that the Ciudad Judicial Barcelona might have been cheaper without the wrap given the liquidity in the Spanish bank debt market.

Despite the growing local and regional social infrastructure market the transport sector remains the most solid temperature gauge of Spanish PPP – and margins are also falling there with bankers predicting sub-100bp pricing on a number of the regional shadow toll tenders expected in the coming months.

Sacyr is expected to set the benchmark with the AS18 in Asturias and the CV35 in Valencia expected to close at the end of April. HBoS, Caixa Geral and Banesto are arranging the debt for both brownfield projects.

The 60km CV35 road, which runs from Valencia to Losa del Obispo, is backed by Eu130 million ($158 million) of project debt with an 85% gearing. The length of the concession is 35 years, including construction, which began last summer and is scheduled for completion in June 2007. Sacyr holds an 80% stake in the project. The remaining 20% is owned by local contractors Construcciones Negares SLL and Servicios y Contratas Prieto SA.

The debt for the AS18 project, a 20.8km road running between Oviedo and Gijon, will be Eu100 million. Sacyr holds a 75% stake in this project, which is a 30-year concession with two years for construction. The local contractor holding the other 25% is Sanchez y Cago.

Local innovation

Although PPP at local level can be more problematic than flagship national programmes, local and regional deals often also spawn innovation – if only because local and regional governments are often more hard-pressed for cash than central government which normally assigns their budgets.

For example, last November,Miejskie Wodociagi I Kanalizacja w Bydgoszczy (MWiK), the municipal water company of Bydgoszcz became the first in central and Eastern Europe (CEE) to use revenue bonds to finance an infrastructure investment programme (for more details search 'MwiK' on www.projectfinancemagazine.com).

Similarly, in the painfully slow German PPP market, much of the innovation has been at local government level.

The relative autonomy of state, municipal, and regional governments has led to a variety of approaches to structures as well as speeds at which PPP has developed. Nevertheless, a number of the deals that have slowly moved the German PPP market forward and set benchmark financings have been spawned at local, rather than federal, government level.

For example, Offenbach initiated the first wave of German school projects with two groundbreaking deals for the refurbishment and operation of 90 schools. Since then Monheim, Frechen and Witten have come to market, with the first pilot projects for Nordrhein Westphalen.

Further German local and regional deals are in the pipeline. In addition to launching a tender for feasibility advisers on the proposed Hamburg bridge crossing, the city is talking to banks about a PPP for a new concert hall complex – the Eu200 million Elbe Philharmonie project.

With so much PPP expected from local and regional government in the coming years, and national government making efforts to smooth the process, further innovation in local/municipal finance and new markets are a certainty. But for lenders, these markets often present unique risk/reward equations and bankers looking for high stake takes at high stake margins will likely be disappointed.

Even in Europe's undeveloped PPP markets this business will be about repeat business long term, at low margins and with a high volume of piecemeal transactions – basically like the UK.