DLR Woolwich: Fab prefab

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The 30-year Docklands Light Rail (DLR) Woolwich Extension concession provides strong evidence that Transport for London is the most sophisticated PPP concession awarder around.

One of the principal criticisms of complex PPP deals is the, sometimes considerable, difference between the shape of the preferred bid and that of the eventual concession. In the past that there have likely been instances when a bid has been won on pricing and specifications offered in the knowledge that these will be revised on award. And once the prospective construction contracts change, then so can the funding package.

While the DLR Woolwich Extension did involve a negotiated procedure from the award of the concession on 24 December 2004 through to May the following year, the specifics of the term sheet were largely in place before the preferred bidder was announced. Transport for London (TfL) and Docklands Light Rail had decided to tap the EIB for a significant portion of the debt, to ensure the most competitive pricing possible for the commercial tranche.

EIB is providing £100 million ($176 million) of senior debt over 28-years and RBS lead-arranged £115 million of 28.5-year senior debt and an additional 9% of subordinated debt, in a £24 million equity bridge loan. The commercial tranche is priced at 105bp over Libor during construction and 87.5bp rising to 95bp during operation. After two years in operation a 75% TfL guarantee kicks in, reducing the margins on £86.25 of the senior debt to a notch above TfL's corporate borrowing rate.

RBS brought aboard six banks in a limited syndication that signed at the end of September. AIB, Bayerische Landesbank, BBVA, Depfa, Dexia and SMBC came in for £12.5 million each.

The project entails a 2.5km extension to the DLR that will run from King George V station in North Woolwich (now being constructed under a PPP concession as part of the London City Airport extension) under the Thames, to Woolwich Arsenal. The concession is based on availability payments that are partially linked to inflation. The project will involve construction of bored tunnels and a new DLR station at Woolwich Arsenal that will provide an interchange with main line rail services and other transport modes. The project should be operational in 2008.

Together with the eventual winners WARE (Amec), the three other pre-qualified bidders – MVBB Consortium (Morgan Est, Vinci Concessions, Bachy Soletanche, Barclays), WA Rail Link (Mitsui, Mowlem, Nishimatsu), Woolwich City Link (Hochtief, HSBC, Innisfree) – were asked to submit bids that included two fixed prices for DLR to exercise a call option to terminate the concession at two specified dates. (TfL also asked the bidders to prepare an additional bid where TfL is used to lend credit support – more on this below.) The first option in year eight coincides with the expiry of a DLR operating contract, and the second in year 16 when another DLR concession – the Lewisham Extension – expires.

The rationale for the fixed equity options is to overcome the problem of having multiple concessions along the same infrastructure and have a less fettered path to bringing the assets together. There are now three PPP DLR concessions. The fixed price options limit the termination costs to DLR, which, if it decides to exercise an option, will pay WARE transaction costs plus senior debt outstanding plus option for equity. Crucially, under WARE's bid, this works out cheaper compared with a voluntary termination where the concession is performing at base case.

This structural feature – the fixed price equity options – goes a sizeable step forward beyond the City Airport DLR concession (also won by Amec and RBS) that shares almost identical commercial terms. For the City Airport concession, DLR has the right to voluntarily terminate at any time but has to factor in the concession's future cash flows, so if the concession is outperforming DLR would bear an uncapped cost: The £178 million financing for the City Airport Extension signed April 2003 with Bank of Ireland, Dexia and Allied Irish Banks coming in as co-arrangers.

DLR was also able to save on the funding cost by taking advantage of TfL's AA credit-rating. This is not dissimilar to TfL's 95% guarantee on Tubelines. On Woolwich Extension, TfL is placing a series of put options with lenders that effectively guarantees 75% of the debt. The options come into force two years after construction, once the largest risks have dissipated – TfL therefore takes advantage of municipal-like pricing over the majority of the loan while keeping the construction risks with the private sector.

And the construction risks on this project are sizeable, with twin bored tunnels running under the Thames. In fact, the project encountered a patchy insurance market due to a number of high-profile tunnel collapses. However, after detailed negotiations, some of which centered on the cultural difference with insurers unfamiliar with the PPP market, a group of insurers led by Swiss Re and Munich Re came in on the deal.

The 75% guarantee threshold was thought to be about the optimum level, given that all lenders have bought in pro-rata to the covered and uncovered portions – so they equally have something to lose if the project is in trouble rather than nothing to lose and the need for complex intercreditor agreements if some are wholly covered and others not. (Compare the importance of Ambac's role after the Tubelines refinancing - search 'Tubelines').

DLR Woolwich Extension
Status: Closed 31 May, syndicated 30 September
Description: A 30-year concession for the construction and maintenance of a 2.5km extension to the London City Airport route to a new exchange at Woolwich Arsenal
Size: £240 million total project costs – 90% senior debt (£115 million commercial bank facility; £100 million EIB facility)
Sponsors: WARE (Woolwich Arsenal Rail Enterprises – AMEC (50%); RBS (Royal Bank Project Investments) (50%)
Lead arranger: RBS
Sub-lenders: AIB, BayerischeLB, BBVA, Depfa, Dexia, SMBC
Legal counsel to TfL/DLR: Ashurst
Sponsor counsel: Pinsent Mason
Lender counsel: Freshfields
EIB counsel: Allen & Overy
Insurance adviser: JLT
Technical adviser: Jacob Gibbs