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As a totemic project financing, Cross-Israel still exerts a certain pull. Toll road financings that grapple with the issues of electronic toll collection (ETC) still reference the project. The $1.35 billion deal was set to open up the Israeli market, and drew in interest from a Canadian sponsor, Canadian and US lenders, and UK and US law firms. It would provide a template for a slew of future financings, including several light rail concessions.

But that was 1999, and since then the performance of the market has been anaemic, with deals few and far between. Important to consider is the context – the second Intifada broke out in late 2000, and the Israeli economy has been sluggish for much of the intervening period.

Moreover, while in 1999 Israel was one of a number of emerging infrastructure markets, since then the field has widened and several countries have clearly pulled ahead. Canada, for instance, which also celebrated a headline financing – Highway 407 – in 1999, is now one of the more active global markets. Concession operators have identified several more willing jurisdictions in which to develop businesses.

At the same time, several of the banks and law firms that had invested so much time in the market have since lost interest. "It's not really a market that we're following that closely any more", notes a partner at one firm that worked on Cross-Israel, before adding hastily "although we'd look at any new projects that came along". His reaction is understandable – in the last 12 months alone his firm has brought in fees on several billion dollars in projects in the Gulf Region.

The first rail

Two projects were identified in 1999 as potential outlets for private finance – both in the light rail space. Tel Aviv and Jerusalem would be much more complex than even the ETC-based Cross-Israel. The plan was for bids on Jerusalem to be in by May 2000, with the winner to be announced at the beginning of 2001.

Jerusalem Light Rail (JLR) ultimately went out to tender in July 2001, to four prequalified bidders: Pasim (Vestra, Deutsche Bahn, Siemens, Africa-Israel, and Feuchtwanger); Adanim, (Bombardier, HTM, Hahandasa, and Building and Properties); City Pass (Alstom, CGEA, Astrom, Elco, and Poalim Investments); and Ariel (SNC Lavalin, CAF, SSB, Dankner Investments, Delek Group, and Baran).

By the following year the field had narrowed to two groups – City Pass and Pass Jerusalem (formerly Pasim) – and City Pass, now comprising Vivendi, Alstom, Polar Investments and Ashtrom, prevailed. The private sector element of the project's NIS2.5 billion cost was NIS1.7 billion ($350 million), with the public sector providing the remainder.

The project was a long time in gestation, a reflection of the back and forth between sponsors and government over revenue support. As such, it likely reflects a broader global reconsideration of the ideal risk profile of light rail projects. In 1999, governments were largely optimistic about the amount of ridership risk that the private sector would bear, but since then, many have been called upon to rework concessions.

The financing, as it was completed in the first quarter of 2005, retained several of the original features, but also included

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a series of milestone payments that made the project more akin to a straight government credit. JLR, when complete in 2006, will run from Pisgat Ze'ev (the north part of the city) into the city centre and out the other side, finishing in southern Jerusalem.

The financing featured funding in a mixture of Euros and New Israeli Shekels, and came from Bank Leumi and Bank Hapoalim. The deal is still waiting for the project to meet some conditions precedent before formal financial close. In many respects it looks like a legacy of the earlier, more optimistic phase of the PPP programme in Israel – Deutsche advised the sponsors and Ernst & Young the government.

The government draws breath

But few local players deny that Israel has slipped far down the list of priority PPP destinations, both because of the economic difficulties that the economy experienced, the continued political unrest in the country, and the continued decline in the dollar, which has made several US firms much less likely to participate in the market.

This might be seen as virtue – several markets (Chile is an example) have intertwined their infrastructure programmes and the development of a robust local institutional debt market. However, the government has said explicitly that it would like to encourage greater offshore bank involvement in the market.

Its incentives are likely to include interest rate support, as well as some form of protection against lenders' foreign exchange risks – a feature on the Cross-Israel financing. It has also engaged the state-owned Inbal Insurance Company to evaluate the viability of projects before issuing a request for proposals (RFP), after noting that too many PPP tenders had been cancelled as a result of detailed scrutiny.

The government also announced in September that it would take several steps to make concessions more attractive to sponsors, including holding informal discussions with bidders before issuing an RFP. This last element, while easy to dismiss as window dressing, is in fact, along with the Inbal decision, a recognition that earlier concessions were frequently not as palatable to potential operators as the ministry of Finance had hoped.

More substantively, the MOF has also addressed a peculiarity of the value-added tax (VAT) law by eliminating the need for sponsors to raise a dedicated VAT facility. The government will now make VAT payable at the end of construction, and simply transfer the relevant payment to the concessionaire for this purpose.

Taken together, the fine-tuning has been welcomed by bankers active in the market. Tzahi Cohen, the manager for telecommunications and infrastructure in the business division of Bank Hapoalim, says that "we do not see the new rules as eliminating the main banks as sources of funding, but expanding the number. At least initially, we think that the institutions will come in alongside banks, but that banks will do much of the work of structuring and putting together the deals." The assumption at two main banks – Hapoalim and Leumi – is that institutions will likely not be interested in maintaining a high enough headcount to chase after lead roles.

The new PFI template

In the circumstances the outcome of the most recent high-profile RFP – for the Highway 431 build-operate-transfer concession – is understandable, if a little underwhelming. 431 is intended as a clear statement of the new priorities of the MOF – a cleaner, more straightforward, and well-structured concession. It is also intended as an all-Israel affair.

"We're not sure why the government decided to issue the bid documents only in Hebrew, but attracting Israeli bidders was their clear intention," says one Tel Aviv-based lawyer. The successful bidder, Danya Cebus, won out against three other consortia – Shafir Civil and Marine Engineering, New Kopel and Gandir Investments; A. Arenson, Ramet with Roichman Bros' Shomron Infrastructures; and Ashtrom Engineering and Construction with Solel Boneh Building and Infrastructure.

The concession has a cost of NIS1.5 billion ($318 million), and takes the form of a 25-year design-build-finance-maintain (DBFM) contract to build Highway 431. It closely resembles the UK PFI means of financing road construction, and the bid documents focused on the lowest unitary payment that the state would pay to the road operator. Danya Cebus bid a

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semi-annual payment of NIS58 million – NIS25 million less than the state's estimate of NIS75 million.

The road will run 20km from Rishon LeZion, past Ramle to Modi'in and the Cross Israel Highway. Since it does not feature any traffic risk, banking it is likely to be much easier than Cross-Israel, and institutions are likely to form a major part of the funding for the road. Indeed, the bids included an indicative term sheet from banks, and the MOF says that financial close is possible within six months.

When the MOF first looked at its funding options for the stretch, it said that an AA- rating was possible, and was able to secure an indicative rating to this effect from local agency Maalot. The deal looks straightforward enough to interest the second tier of Israeli banking – United Mizrahi, First International Bank of Israel and Mercantile Discount Bank among them.

Moreover, the government's decision to restrict the bidding to Hebrew-speaking players does not seem to have dampened the enthusiasm of potential bidders – the MOF says that the projected price of the project has been reduced, as well as the project's return – now at 5.3%. Streamlining the project's parameters has also sharply reduced the length of the bid process to one year. By contrast, the (admittedly much more complex) Tel Aviv light rail and Carmel Tunnels concessions are two and ten years, respectively, in the making.

Tel Aviv has attracted a healthy list of pre-qualified bidders, despite the recent upheaval, and the RFP went out to four groups in September 2003. The consortia are:

- Siemens with AECON, HTM, Africa Israel Investments and Egged;
- Bombardier with Bouygues, RATP, Assets & Construction and DAN;
- Alstom with CGEA Connex, Ashrom, Housing & Construction Company Ltd and Polar Investments; and
- Ansalso with Daewoo, Shafir Engineering, AVIV, Granite Hacarmel and Bateman Engineering.

The concession involves the construction of the Red Line – a 22km stretch of railway in central Tel Aviv that includes 10km of uninterrupted underground tunnel, 10 underground stations and 22 above-ground stations. It has a 32-year length, and is much larger than JLR, at $1.8 billion. It is likely to be financed through a mix of government grants and milestone payments, much like the Jerusalem deal. The preferred bidder is likely to be announced within the next few months.

The MOF is also proceeding with plans to bid out a prison at Beersheva. This 800-bed facility, designed to hold medium to low security inmates, was bid out in August 2004 as a PFI project. It is a joint effort between the Ministry of Finance, the Ministry of Public Security, and the Prisons Service, and the tender envisages the private sector having a large element of operational control, although judging, punishment and regulation remain the preserve of the state.

But, notes one banker active in the sector "the main difficulty in this tender is that the government has asked for the private sector to have a wide range of experience running prisons. But the prison is not large enough to interest some of the larger international prison operators." Couple this with the rising dollar and the potential shortlist looks small.

Water in the works

The most progress so far in Israeli infrastructure has been in the promotion of desalination projects, an understandable outcome given the centrality of water to the region's politics and economy. The first large desalination project – the $200 million Ashkelon deal – attracted almost one hundred participants. The government is anxious to follow up on this success, and has since bid out a further two projects.

The first of these, Palmahim, is, at 30 million cubic metres, much smaller than the 100 million cubic metres Ashkelon. Hapoalim provided the debt financing for project company Via Maris alone. Via Maris' shareholders are Tahal (26.5%), Granite Hacarmel (26.5%), Ossif Investments (21%), Middle East Pipe (21%) and Oceania Marine Works (5%). The next tender, for the Hadera project on the grounds of the Orot Rabin plant, is likely to be the same size as Ashkelon.

The build-own-operate concessions for the desalination plants have not been without frustrations. The Israeli authorities were forced to call upon performance bonds from several bidders that were unwilling to perform under their contracts,

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including the Carmel group, made up of Ionics and the Baran Group. Carmel had to hand over NIS35 million ($7.78 million) to the government in compensation, after the government ruled that it had not moved towards financing and construction on the plant, which it had won at the same time as Via Maris.

Slowly or surely?

The Israeli government, however, has also been behind a fair number of altered or cancelled tenders, including the Carmel Tunnels, which market rumour suggests might return to market in a radically altered form. Carmel Tunnels involves the excavation and construction of two parallel 4.7km tunnels under Haifa, the upgrading of the three interchanges and the installation of ETC technology.

Carmel Tunnels was first floated in 1995, shortly after the passage of Israels' first Toll Road Law. The concession was initially awarded to Dragados, the First International Bank of Israel, Nekhasim Ubinyan and Ashtrom. On 19 April, however, Ashtrom bought out its partners and is preparing to transfer a 45% interest in project company Carmelton to Housing & Construction Holding Company.

Government support in the latest variation will, according to one market participant, be much more akin to a PFI deal, reflecting the fact that the project, at NIS1.15 billion, is too large and complex to go forward with sponsors assuming uncovered traffic risk.

The government has also stepped back from plans to bring in a private operator for a gas pipeline concession between Ashood and Dor. The project, a 65-mile trunk pipeline, would bring gas produced off of the coast of southern Israel to industrial and electrical customers in the north of Israel. Ultimately, however, the Ministry of Finance decided to own the pipeline itself, and borrow the necessary financing directly from Citigroup, with political risk insurance from the Overseas Private Investment Corporation.

This $250 million loan will also involve undertakings from the Israel Electric Corporation (IEC), which is the pipeline's biggest customer. IEC will reap savings of roughly $200 million by using domestically produced gas. Nevertheless, it represents a step back from the earlier, more ardently pro-privatisation rhetoric of the Israeli government.

Nevertheless, IEC is clearly a bankable counterparty – as demonstrated by the Yam Tethys gas monetisation. The deal is a 8.5-year, $275 million 144A bond issue, led by Credit Suisse First Boston. It monetises the 53% stake that various Delek Group companies own in Yam Tethys, a joint venture with Noble Energy.

The project is located on the Mari B reservoir, which has estimated proven reserves of 25.6 billion cubic metres, and began commercial operations in February 2004. It will be Israel's only source of natural gas until at least 2007, and benefits from a ten-year take-or-pay sale and purchase agreement with IEC. It is also understood to feature a hedge from J Aron – Goldman Sachs' trading arm – at $2.47 per million BTU.

Credit support comes from a bank guarantee or letter of credit of $30 million until July 2005 and $50 million after then. The issue breaks down into a $175 million 5.326% fixed-rate tranche and a $100 million floating-rate tranche priced at 110bp over Libor. The notes, which begin to amortize from May 2005, gained a Baa3/BBB- rating.

The bonds were used to repay $106 million of debt, fund the credit support and gas hedging, prefund $13.5 million of capital expenditure to be spent on a receiving terminal for the gas, and pay shareholders a dividend. It was a mandate that Citigroup, Goldman and CSFB all grappled with, before CSFB completed the issue.

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