Evolving devolving

01/10/2003

Last month Northern Ireland announced the panel of advisors for its new Strategic Investment Board (SIB) that will ultimately report to local government post-elections, and is mandated to speed up PPP in the province. A German steering committee also finalised its report on PPP cost evaluation and the necessary reforms for standardised PPP implementation at federal and lander level. And in the Netherlands, preferred bidder status on the second PPP roads scheme - the Eu125 million N31 - has been announced by the Province of Friesland fuelling anticipation that Dutch PPP at local level is not a one-deal wonder.

All are moves symptomatic of the growing trend towards PPP as an alternative to municipal bonds and other traditional local and regional government funding instruments. But all are also timely reminders that the expertise and the funding to implement and evaluate PPP have been, and in some countries continue to be, in short supply in local and regional government.

As Jan Sijnave, director at the Flemish Centre for Excellence, says: "Central governments need to educate so that there is the expertise to evaluate these deals at local level. Standardisation of the whole process is also key." Even in the UK - the most developed PPP market - documentation standardisation only came into force relatively recently.

The latest German move towards standardisation and PPP education is good news for the Lander (regional governments) which have previously had to develop their own, expensive, models for deals on an ad hoc basis and made concepts like umbrella transactions all but impossible.

The report - submitted last month by PricewaterhouseCoopers and Freshfields Bruckhaus Deringer on behalf of the Private Finance in Public Building Steering Committee to German Minister for Transport, Building and Housing, Manfred Stolpe - calls for far-reaching German legal reform in public procurement law, subsidy law, municipal law, tax law and budgetary law. The highlight of the five-volume work is a practical guidebook representing the individual phases in the preparation, planning, and eventual execution of PPP projects. And a PPP taskforce to help regions and cities standardise models is also expected to come into being before the end of the year.

But even with standardisation, issues like the sharing of profits between public and private sector from PPP refinancings remain unresolved in most national, let alone local, jurisdictions outside the UK. And perceptions of what constitutes PPP vary.

Stimulating a competitive market

The latest Dutch road deal - the N31 - is a case in point. Waldwei.com - a consortium comprising Dragados, HBG, Dura Vermeer, BAM-NBM and Ballast Nedam - has been made preferred bidder with Royal Bank of Scotland as financial advisor. The N31 is a BOT deal with an availability payment to the sponsor and little traffic volume risk. NIB and Bank Nederlandse Gemeenten (BNG) are to provide project funding.

The deal is likely to be a repeat of the structure employed for the first Dutch PPP - the A59 - when ING and BNG arranged Eu145 million of 16-year project debt. BNG is owned by Dutch local authorities and on the A59 it took the bulk of the risk under a quasi-sovereign guarantee at a margin to match.

At the time it was claimed that BNG had been brought into the A59 deal to ensure cost of funding on this first time deal was in line with the Public Sector Comparator (see Project Finance, June 2003). However its participation in this latest deal begs two questions - why bother with a local PPP deal if the debt provider is going to be the local government bank? And how can other private sector consortia backed by private sector banks compete with bids that use quasi-sovereign-backed funding? The answers are don't and can't.

Whilst the Dutch deals have undoubtedly attained very cheap pricing for the tenders, they are also setting a precedent that prevents the growth of a competitive and broad PPP market like that of the UK where constraints on public sector debt are not holding back project flow.

And the long-term benefits of the competitive model are clear. UK debt pricing has reached an all time low. According to a recently released PricewaterhouseCoopers (PWC) study for the Office of Government Commerce (OGC) into rates of return bid on PFI projects in the UK between 1995 and 2001, average bank lending margins declined by about 30 to 40 basis points to around 100 basis points over the swap rate and debt service ratio cover ratios declined from 1.4x to 1.25x.

But it is not just lack of expertise or conservatism that are holding back municipal PPP development. In many instances there is a gulf between the aims of central and local government PPP policy. The majority of central governments promote local PPP for all or some of the following reasons - pushing projects off the central government balance sheet, the competitive economics of private sector management and, arguably, a political distance from local funding shortfalls.

In simple terms local PPP at central government level is all about reducing the burden on voting taxpayers. That means that while the empowerment and responsibility to go PPP may be devolved -bigger local budgets may not. As Michel Camdessus, ex-managing director of the IMF and architect of the Camdessus Report, notes, "local governments need funding to get PPP in place."

Delays in payment, and constraints on central government subsidy, have already partially prompted the move in the social housing sector to securitisation in Europe. The sector has boomed since 1998 with deals originating from social housing associations and regional governments in Belgium, Austria, the Netherlands, Italy and Sweden. The City of Gothenburg's Framtiden programme alone has issued Eu1 billion in MBS.

But securitisation is not the complete solution. It is an expensive process unless the conduit is topped up with new assets, which restricts its use to large portfolio deals like housing. The majority of PPP asset deals tend to be one-off projects in their own right.

Similarly, what seems like a streamlined process at national, or even regional, level can prove difficult to implement locally.

For example, in an attempt to create economies of scale combined with project timing flexibility the UK's NHS has been encouraged to start batching PPP schemes. The idea is that three or more hospital projects are placed in one batch and the winning bidder on the first project then repeats its proposal for the other schemes. However both schemes proposed to date - East Kent and Northern - have hit local planning hurdles, which is unsettling for investors with another two deals waiting down the line.

Political sticking points

Central government planning also tends not to take into account politics at local level, which can become sticky. In Germany the municipal authorities have long been tapping the US cross-border lease markets with deals that produce an NPV benefit on existing assets that are then used to top up local investment budgets. Misinformation on such deals - that they employ a true sale and leaseback to US equity investors (in effect privatisation by the back door) - has prompted pressure groups to derail a number of what are, ironically, US tax plays and an indirect form of US subsidy into the local German economy.

The most recent deal to be blocked is the City of Frankfurt's plans for a rail infrastructure lease. The Green Party, which had originally supported the deal alongside the Christian Democrats and the Liberals, changed its position following the success of the anti-lease movement led by Attac, the anti-globalisation pressure group. Attac forced a public examination of the transaction after raising over 45,000 signatures in protest.

With an estimated size of Eu2.4 billion ($2.8 billion), the tragedy is that the Frankfurt subway deal would have been one of the largest rail infrastructure leases to date and raised at least $80 million for the city treasury to invest elsewhere whilst retaining full economic ownership of the asset.

Attac is also making its presence felt in other areas of Germany. A planned lease-to-service contract on the wastewater treatment facilities and sewage system of the City of Bergisch-Gladbach, near Cologne, has also been abandoned. Babcock & Brown was arranging the deal, estimated at Eu200 million ($234 million), which was expected to yield a net present value benefit of Eu7 million. The anti-globalisation pressure group organised a petition and forced a public referendum, where over 96% of the votes opposed the US lease. Bergisch-Gladbach has cancelled its deal.

Similarly, in highly state-backed countries like France - the local government system is not designed to promote PPP. Local artisans, architects and project managers have traditionally been used for local development contracts and the economies of scale implicit under PPP are perceived as putting them out of business. The problem even disseminates into how things are built. Local architects on municipal deals have traditionally expected more fees from redrawing plans a number of times as schemes develop - PPP does not allow for that kind of expense.

Many developing PPP municipals are equally wary of employment issues thrown up by private sector operation. In the UK, the Walsgrave Hospital deal piloted the Retention of Employment (ROE) model, under which staff stay within nominal NHS employment, with strict provisions for pension rights and working practices.

To give unions and workforce even greater comfort the latest UK Hospital PPP - Derby - has taken that a step further with ROE implemented, prior to the operational phase. Ancillary provider on the project, Medirest, took over the management of non-managerial staff through a Mobilisation Service Agreement with the Trust. This agreement will fall away once full operation begins and be incorporated into the PFI contract. The advantage of the system is the ability to settle staff concerns long before operations begin.

Concerns also persist over PPP profits. In the UK's PWC/OGC report, while debt margins have gone down, equity returns are suspect. Of 64 sample projects, forecast project internal rates of return that are 2.4% above the appropriate weighted average cost of capital before various adjustments. That suggests some element of excess project return - although the report also highlights a number of mitigating reasons for this, notably factors that limit competition and high bidding costs.

Founded or not, the political concerns over PPP profits are spawning non-profit distributing variants on PPP. The Argyll and Bute Schools pilot project, co sponsored by Partnerships UK, will have no equity dividend. As Riona Bell, deputy director, Financial Partnerships Unit, Scottish Executive, notes, the not-for-profit structure is actually designed to maximise profits and plough them back into education whilst also "formalising the involvement of the community and education stakeholders as a right." Additional benefits include making the deal at least as cost effective as a standard PPP whilst retaining a normal profit level for sub-contractors.

The Eu100 million package will be purely senior and sub-debt funded and will likely close before year end - final bids from the three pre-qualifiers are due in this month. And Bell is bullish about its prospects: "If it works it will bring two more deals in the pipeline back into the market."

Emerging markets

Beyond Europe, progress in some emerging markets is more advanced than their developed counterparts. Since the Camdessus Report on financing water for all, the emerging markets water sector has witnessed a spate of PPP innovations. As Peter Woicke, managing director of the IFC, notes, "Dexia and IFC recently arranged an innovative water deal in Mexico [Tlalnepantla Water Company - see Project Finance, August 2003] where the consitution actually prohibits municipalities from incurring obligations in foreign currencies or obligations from foreign issuers. The solution combined using a private trust with credit enhancement."

Similar PPP water innovation, promoted largely by development banks, is demonstrated in the St Petersburg water deal and Sofia Water (see Project Finance, January 2001 and September 2003). However, the biggest problem is not getting multilateral cash but "getting sub-sovereigns to a point where they can not only analyse and design projects, but fully understand the spectrum of opportunities available with private participation, tariff structures and risk management techniques, such as limited intercepts of fiscal transfers to give lenders partial security," adds Woicke.

Many cite the Camdessus Report as creating the building blocks of local emerging markets PPP regimes: where possible the central governments should consider reducing the restrictions on sub-sovereign borrowings; reforms should be tied to incentives that improve the quality of data and reporting from the sub-sovereigns - to both the central government and the rating agencies; and central governments need to explore the creation of credit pools for sub-sovereigns and to facilitate the entry of credit rating agencies and bond insurance or financial guarantee companies into domestic capital markets.

But while the reports; processes and PPP policy recommendations are numerous and useful, the future of local PPP in both developed and emerging markets will be in the detail. The irony is that creating the expertise at local level to understand and manage that detail requires the one thing central governments are trying to avoid - more funding.

Project Finance thanks Dexia/FSA, Kommunal Kredit, Moody's Investors Service and Sidley Austin Brown & Wood for their support.