The shape of PFI to come

01/04/2001

Forget political rhetoric, £4 billion of private money is expected to be pumped into UK public assets this year ? possibly the best measure yet of PFI at work.

2000 saw a number of benchmark transactions, including central government accommodation, bundled secondary schools in Glasgow and increasingly complex health care deals. This year should see the MoD's innovative Ro Ro Ferry deal reach financial close, followed by its ambitious Skynet satellite and Aquatrain (provision and management of water and waste water over 2500 MoD sites) projects. A number of transport projects are also in the pipeline and 29 new proposed hospitals have also been announced.

But there is still considerable uncharted territory to cover ? particularly for the public sector. Refinancings are emerging and government departments are trying to push the boundaries of what is PPP-able. That PFI will remain a component of public procurement is a certainty. But its path to maturity ? linked as it is to political agendas ? is still uncertain.

A maturing market

The PPP process has matured. Stabilisation of risk allocation is reflected in the terms of the standardised contract. The public sector no longer attempts to dump as much as possible on the private sector, but rather strives to achieve value for the system as a whole. This marks considerable progress from the original Conservative government initiative, under which PFI was regarded as a replacement for all forms of public procurement.

Current deal flow demonstrates, not only a realisation of risk best managed by the private sector, but also the development of a range of different financial partnerships between public and private sectors. And Partnerships UK (PUK), the Taskforce's successor soon to be partially privatised, aims to progress that diversity (See Box). Ian Wootton, healthcare specialist at PricewaterhouseCoopers, suggests that, within the health sector, large accommodation deals will continue to follow the established path, but the provision of certain services or equipment may be better suited to other methods, such as private placement.

Contract standardisation, first championed in GOGGS, the high profile PFI renovation of the Treasury Headquarters, has been applied to different sectors with varying degrees of success. Feeling in the banking community is that although specific points of risk allocation and termination have been clarified, contract standardisation has not been as effective as was hoped in shortening time spent negotiating. For example, the prison sector in the UK, unlike health and education, has a centralised procurement centre and should thus lend itself well to standardisation. However, bankers involved in recent deals claim the Prison Service has been unwilling to standardise, attempting instead to push the envelope of risk out further each time. And given the typically small size of most prison deals, the time and resources spent on negotiating may start to make them unattractive.

Finding funds

As the PFI market expanded, funding inevitably became more competitive. Given the lasting nature of the assets in question and the perceived safety of the lending environment, PFI transactions have typically been highly leveraged and characterised by long tenors. This trend has increased markedly as PFI has matured. The average tenor has lengthened from between 18 and 25 years to over 30, whilst margins during construction have come down from 1.5% to around 1%.

Although in part due to increased understanding and competition among providers of project debt, the primary force in crunching project margins has been pressure from two new market entrants ? mortgage banks (ex-building societies) and monoline insurers.

The mortgage banks, with a history of lending over long periods, could offer tenors that some investment banks were not prepared to compete with. And the added cost of a monoline wrap is offset by very aggressive overall pricing in addition to a natural maturity of 30-plus years.

The relative value of bond and bank debt is dependent on the gilt versus swap markets at the time of financing and over the last few years in the UK this has been tipped in favour of bonds. Further, bonds can be index-linked to match payment flows, creating a natural hedge.

However, some bankers are anxious about the bond bandwagon claiming there is little flexibility over the course of repayment. For example, Gershon Cohen, deputy director, project finance at Halifax, believes hospitals, which may often need to be updated and changed in line with NHS policy, should not be exclusively financed through bonds. Others point to the difficulties of refinancing deals funded by bonds. As the first refinancings start to emerge, this may figure as an increasingly influential factor when choosing the financing path.

The second half of 2000 saw close of two debt water deals in Scotland. Aberdeen Wastewater closed in August with a senior debt totalling $156 million arranged by CIBC and Halifax and comprised of term loans and credit facilities. Ayr Wastewater Treatment Project closed in November and had its £136 million debt was arranged by Abbey National. The Levenmouth Water Purification Scheme, which closed around the same time followed in the footsteps of the majority of its predecessors with a bond issue.

Weighing up the relative benefits against their associated price is still in experimental phase. No PFI deals have actually run their entire course and best matching situations and solutions will become clearer as the market matures.

GOGGs signalled a benchmark not only in the development of standardisation but also as the first major PFI deal to hold a funding competition, seen as one way for the government to achieve best value. Consortium EP were initially awarded the tender in 1996 but the project was subsequently shelved when the new government came into office. When negotiations resumed in 1998 EP was allowed to continue as preferred bidder on the condition it held a funding competition, the outcome of which was a £127.9 million bond issue by UBS Warburg and insured by Ambac, which also put up a mezzanine facility. Although this method has not been seen since, Mike Gerrard, head of PPP at PUK, states that it did create good value on the GOGGS transaction and may be applied in specific situations in the future.

Refinancing

Refinancing is the subject of much discussion amongst PFI players. Construction of the first wave of projects is nearing completion and contractors now have an operating track record to leverage for better terms.

In 1999, Fazakerley became the first prison PFI project to be refinanced. This was very much a pilot transaction and subject to a National Audit Office report. The terms of the refinancing secured by consortium Fazakerley Prison Services Limited (FPSL) included an extension to the tenor of the loan, a reduction of the margin, the establishment of a fixed rate of interest and early repayment of the subordinated debt to the project's shareholders.

Although the original PFI document did not give the Prison Service a contractual right to benefit from refinancing, it did state that FPSL was obliged to obtain consent for arrangements that could increase the termination liability. Based on this premise, the Prison Service was awarded £1 million of the projected £10.7 million benefits to be received by FPSL's shareholders as compensation for the increase in the project's bank debt. These terms were generally regarded as very favourable for FPSL, but were approved by the prison service on the grounds that the consortium took considerable risks in taking on the first PFI prison project.

Fazakerley has subsequently been refinanced a second time and a trickle of others have slipped through, including Premier Prison Services, innovative in that it rolled together five previously separate financings, achieving considerable returns for shareholders. It is likely that subsequent refinancings will be as favourable for the private consortiums. Public sector entities have awoken to the potential benefits and are starting to demand a greater cut. PUK is currently working on a manual for refinancing and there are many projects in the pipeline waiting for its release.

This influx of refinancings signals an important step in the development of the UK PFI market. Moreover, Jeff Thornton, managing director, public sector finance group at The Royal Bank of Scotland, points to the need for refinancing in order to free up liquidity demanded by the growing number of projects both in the UK and abroad. This is particularly the case with regard to subordinated debt.

Way forward

In terms of deal flow, the UK PFI market UK is dominated by accommodation based deals in the health, prison and education sectors. Despite considerable experience gained of such deals, many insiders grumble that they are still taking a long time to close, citing inefficiencies in the process and lack of public sector experience.

To continue attracting private sector interest on the smaller of these deals, this will have to be ironed out ensuring a favourable trade-off between investment of resources and returns. Margins have been coming down and maturities lengthening for some time, but this trend may actually go into reverse if the private sector pulls out of the market.

Similarly, Wootton points to potential repercussions for funding if a project was to default. It may force a re-analysis of a particular sector or it may cause lenders to take a step back from PFI altogether. Moreover, given the typical length of the concession period, there may be a limit to the number of projects the public sector wants to embark on at any one time.

But the arena for safe lending on small deals with diminished returns is at one end of the spectrum of PFI. Larger, pioneering, transactions that are less commoditised are likely to achieve greater returns for investors. The defence sector is leading the way, a pattern seen over the development of PFI and largely a product of the MoD's great breadth of activities and de-centralised procurement. (See Box).

The transport sector, incorporating volume risk and considerable construction costs, is also likely to see a number of innovative deals. The BNRR's flexible structure and unusually long concession period (currently in syndication) is a good example of this. As congestion charges become integrated into urban lifestyle, toll roads could become a major source of deal flow. There are also a number of light rail projects in tender. Passenger flow on the Croydon link, the first rail DBFO to be tendered, has not even reached the most conservative estimates and this fact is likely to be reflected in future financings.

At the extreme end of the market are huge deals, of which the proposed London Underground PPP is probably the most high profile. The progression of this is a good example of the political charge still surrounding the transfer of services and assets regarded as inherently public responsibility. Huge resistance has been proffered on both ideological and economic grounds and it may be that the market is still not ready to deal with projects of this scale.