Time to change Aussie PPP bank offerings?

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Australian PPPs are fit and healthy; so the deal book for the first half of this year would suggest. In the last few months three landmark deals were financed; the second phase of the Single Living Environment and Accommodation Precinct (LEAP) programme; the Royal Adelaide Hospital PPP; and the Gold Coast Rapid Transit Project (GCRT). The deals attracted more than A$3.5 billion in debt commitments.

The deals are notable for their diverse and less well-known jurisdictions. LEAP was procured at a federal level (only the third such deal), the Royal Adelaide Hospital PPP is the largest in South Australia (and only the third local deal) and GCRT is in Queensland (the fifth PPP to close). The incoming projects too are spread across the country: the Mundaring water treatment PPP and the QEII hospital parking PPP are in Western Australia; Sunshine Coast University Hospital is in Queensland; the Victorian comprehensive cancer centre and Bendigo hospital are in Victoria; and the Darwin marine supply base and New Darwin prison are in the Northern Territory.

None of the projects that have closed, and only two in the pipeline, are being procured by the governments of Victoria and New South Wales (NSW); highlighting a major shift in the PPP dynamic in Australia. The two states closed 43 out of the countrys 58 PPPs to date, but over the last six months have effectively halted PPPs after centre-left Labour administrations were replaced with Liberal-National coalition governments in recent state elections.

As the administrations have settled in there are signs that they are warming again to private sector involvement Victoria confirmed in June that the new Bendigo hospital would be a PPP. But the story of 2011 is the success of PPPs in new regions. While the states that did lead the way, notably Victoria and NSW, have not developed many big deals because of the change of state government, other states have stepped in with projects to fill the void, says Brad Vann, a projects partner at Clayton Utz.

State divides

The pattern highlights the regionalisation of PPP development in Australia. There is no overriding legislation for the model, so states have created their own contracts and progressed at their own speed. As an indication of the fragmented system, just three PPPs have been procured for assets that span different states; LEAP 1 and 2 and the defence headquarters joint operation command facility.

Ray Wilson, director at the Plenary Group, which sponsors LEAP 2, says the main challenge for the project was that it was the most geographically diversified PPP ever brought to the market. Construction expected to extend to February 2014 will take place at 14 separate locations in every mainland state and territory. Building in so many locations required compliance with a range of state and territory building legislation, Wilson remarks. A number of the construction partners were new to the PPP space and Plenary adopted a policy of partnering with regionally well-placed construction partners as a novel approach.

Many states have their own quirks in PPP contracts so projects procured in or across various states can fall foul of the differing regimes. Erin Wakelin, a partner at Freehills, notes that in South Australia a special purpose vehicle must have a building licence to develop a project, even though it is sub-contracting the building work, though this is not an issue in other states.

Some experts say it is not always apparent why such differences exist. While there is no national PPP legislation, there are federal-level guidelines, which were established in November 2008 as a collection of options permitting the States to take a different approach to the allocation of some risks. For instance, the guidelines permit different states to retain their own definitions of force majeure. While these differences are not necessarily radical, it does mean that project contracts change according to the jurisdiction, Wakelin adds.

There is a consensus developing about how to advance PPPs in the country without federal-level laws, according to Mark Birrell, the former minister for major projects and government upper house leader in Victoria, and now chairman of Infrastructure Partnerships Australia (IPA). There is now frequent sharing of policies and contractual frameworks between the various states and this common approach has led to much more cooperation on procurement, he comments. It is important that all levels of government are aware of this common approach or it would result in many agencies reinventing the wheel when it comes to PPPs.

The market seems keen on federal co-ordination. Plenarys Wilson argues that there is a need for a reliable pipeline of projects to be signalled to the market, adding it is promising that Infrastructure Australia the Government-backed body that helps develop PPPs nationally is intent on co-ordinating such a pipeline across the country.

Lenders are also keen on closer co-operation. Swati Dave, executive general manager in the global specialised finance group at National Australia Bank (NAB), says that confidence will improve with a more strategic and co-ordinated approach to a robust pipeline of projects. In our view there needs to be government commitments to a process, certainty that there will be an outcome as a result of the process and consistency of approach to PPP projects nationally, she says, highlighting the level of bid costs and resources required as the reason for consistency.

While there is some way to go with this, we have seen that successful projects tend to have some clear features: a champion within government at a political level to drive outcomes; confidence within the bureaucracy to execute; government support regardless of how the project is financed; and experienced advisers with specific sector expertise, she continues.

There is, however, concern that too much emphasis may be put on the federal government. Sources point to the new infrastructure finance working group, set up in June and chaired by Jim Murphy from the Australian Treasury. The group has been tasked with looking at reforms to PPP processes and procurement and while there are members from the federal government, Royal Bank of Scotland, KPMG and Alinta Energy, there are no representatives who currently work for state governments.

It is something Richard Foster, who led the partnerships unit at the Department of Treasury and Finance in Victoria before launching Foster Infrastructure in March 2011, believes could be an issue. He thinks the States have been the driving force behind PPP and many of the various bodies the Federal government established had state representatives who had developed policy and guidance.

So far, so good?

The political background has not affected the years PPP financings. The Royal Adelaide Hospital, an 800-bed facility awarded to the SA Health Partnership as a 35-year concession, raised A$2.6 billion of debt. The seven-year debts lead arrangers were NAB and ANZ and it is believed to consist of a construction facility priced at 260bp over BBSW that converts into a term loan priced at 245bp. LEAP 2 saw the Plenary Group close on A$750 million in debt, split between a five-year senior facility with ANZ, National Australia Bank and Natixis as well a subordinated loan from BTMU.

Underneath these successful financings, however, are familiar issues with funding PPP debt. Before the global financial crisis, PPPs could be financed with door-to-door bond solutions. Since the crash, loans have become more common, but the Australian banks which have enjoyed a dominant position in the market have rarely provided facilities of over seven years. International banks have been unable, or unwilling, to pressure local lenders to lengthen tenors.

While NABs Dave concedes that Australian tenors have been relatively short, she stresses it has not hindered closings for a significant volume of PPP projects over the last three years. The Australian banks have continued to demonstrate a willingness and capability to fund available projects in Australia, she says. We expect the institutional debt market to develop as the natural source for PPP funding.

Some PPPs benefit from government guarantees, which boost investment viability despite the short tenors, though such support has fallen out of favour as markets improved. Foster highlights the supported-debt model that Queensland used for its schools project, under which government refinanced the majority of the debt once construction was completed. There has not, however, been a follow up to this deal. Wakelin adds that while state governments were prepared to share the refinancing risk during the global financial crisis, on projects like the Victorian desalination plant, they are now no longer willing to offer such protections. As a result, projects are carrying refinancing risks and time will tell whether this is a risk that the private sector can bear, she says.

As such, the short tenors have prompted concerns regarding future refinancings. Some financings are nearing maturity, when some sponsors will face a margin step-up or soft maturity dates and there is now a danger that many could be hit with very high bullet payments. Refinancing is something that Wilson highlights as one of the challenges in the LEAP 2 funding. From a financing perspective, amongst the main challenges were the requirement to bank five separate construction companies, some of which were undertaking their first PPP, and the need to manage the senior debt refinancing risk, he says.

The refinancing issue coincides with some unwelcome attention on some of Australias headline PPPs. The Reliance Rail PPP, for instance, has not performed as well as expected and suffered from resignations and ratings downgrades. The Peninsula Link PPP Australias first availability-backed motorway deal was subject to a stinging report from Victoria auditor-general, Des Pearson, in June. The Victorian desalination plant has also been affected by industrial action over the last year and, according to local reports, could end up costing billions more than expected.

Not only could these woes affect projects refinancing chances but also lender willingness to fund new projects. Vann though, says he has no doubt that banks will lend to PPPs in the future if the risks are balanced. In the case of transport deals, they dont want to lend on a full market risk. They may be comfortable with part traffic risk and part availability, but they were stung on full traffic risk deals as traffic predictions in previous projects were too high, meaning that banks had to take a hair cut on debt, he says.

Foster points to the Royal Childrens Hospital as an example of a troubled PPP that was saved by strong structuring. The project, which closed in late 2007 when the sub-prime crisis had just hit, was won by Babcock & Brown and financed through bonds with a monoline guarantee from FGIC but, when Babcock became insolvent and the monoline guarantor was downgraded, the project was not affected.

Despite this, NABs Dave does not expect a bottleneck of PPP refinancings. She says that NAB does expect that the structure and composition of debt providers will evolve in light of market conditions regulatory changes.

International rescue

Gold coast Rapid Transit illustrates the changing composition of lending groups. Says Foster: The global financial crisis saw ... the pull-back of the international banks in Australia. This gave the big four local banks market power. Having such a strong hold on the market can limit competition.

Unlike LEAP 2 and the Adelaide Hospital, there were no Australian banks involved at the senior level for GCRT. The A$1 billion project was awarded to the GoldLinQ consortium, which included Marubeni and Plenary, and is for a 13km rail system running between the new Gold Coast University Hospital and Griffith University. It was raised a term loan from a group of non-Australian lenders, namely Intesa SanPaolo, Export Development Canada, BBVA and KfW IPEX.

Sponsors still point to national deals as needing Australian banks to participate in order to be successful. The composition of the LEAP 2 consortium militated against the use of a foreign bank-led financing group and Plenary deliberately sought and secured two of the big four Australian banks in NAB and ANZ to lead the senior debt, Wilson says.

Perhaps more significant then was the 18-year tenor of the GCRT debt. It is more than triple the length of the other two PPPs and a sign that international banks are willing to compete on such terms. Sources familiar with the market say that other sponsors are looking to work with non-Australian bank lead arrangers. They hope that international banks can also drive down pricing, which has dropped from over 300bp at the peak of the financial crisis to around 200-250bp.

The foreign banks seem to be a little bit more comfortable with longer tenors and are using this as a marketing tool to distinguish themselves from the domestics, Wakelin observes. The old school of thought, that there needed to be at least one lead Australian bank to manage the due diligence and documentation phase and to help syndication, is starting to change. Export credit agencies are also starting to back foreign sponsors and contractors in their Australian bids. The agencies, like the international banks, tend to offer longer tenors.

Birrell adds that there is also a lot of discussion about encouraging superannuation funds to get more involved in debt financings, just as AMP and IFM have done. Dave echoes there point: There is a clear opportunity and indeed an imperative to attract a more diverse investor base capable of funding longer tenor structures for the PPP market.

The 86 billion dollar question

The portfolio of closed PPP deals is dwarfed by Australias overall infrastructure needs. When Infrastructure Australia (IA) delivered its annual report in July, for instance, it included a new infrastructure priority list for 2011.

The list equates to A$86 billion of investments, mainly in the transport sector, with projects including the mammoth A$6 billion national managed motorways programme as well as Melbourne Metro One and Cross River Rail. Indeed, the latter deal is the only project specifically earmarked for a PPP. The A$7.7 billion Brisbane-based scheme is for an 18km rail line, 9.8km of which would be a tunnel linking Salisbury to Bowen Hills.

The list includes scores of big-ticket projects and IA has made it clear that the issue of which deals to select and how to finance them is vital. Action is needed to reform the way Governments choose the right projects, finance those projects, and operate and maintain them, said Sir Rod Eddington, chairman of IA. Governments must also improve the planning of major infrastructure projects and foster use of the current networks more productively by demand management and pricing mechanisms.

IA says in the report that one of its priorities for the next four years is to reform financings in Australia in order to attract more private funds into the market. The first step was establishing the infrastructure financing working group, the new body instigated to help assess the best ways to deliver and fund the projects. Even so, the concept of PPPs does not figure prominently in the report, but rather the general question about financing options. It highlights the growing disconnect between the governments reluctance to increase its debt and the cultural opposition to user-pay models such as on toll roads.

It suggested that new and alternative ways of funding the massive infrastructure requirements are needed, although it did not give any examples. Infrastructure Partnerships Australia (IPA), however, claimed the report is a wake-up call to Australias governments. The report makes a strong case for governments across Australia to begin having a real discussion with the public about why change is needed, particularly through user pays, asset sales and a radically enlarged scope for private investment in public infrastructure, said IPA chief executive Brendan Lyon.

Of course, PPP is one model that could be more widely deployed; IPA cites research from ACG/University of Melbourne in its report on the performance of PPPs in Australia. The figures, taken from a sample of 21 PPP schemes, found that while the average estimated upfront project costs were considerably higher than traditional procurement, the private sector was able to keep operational costs under greater control.

For example, during the period from contractual commitment to final outcome, the researchers found estimated costs for an average PPP (A$4.9 billion) were higher than a traditional procurement (A$4.5 billion). However, the privatelyfinanced deals were managed much more tightly, and costs only overran by 1.2%, pushing the final bill to A$5 billion. The traditional projects, though, had a hefty 14.8% overrun, meaning they came in more expensive than PPPs at A$5.2 billion.