# Highway maintainence PFIs, UK

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Three UK highway maintainence PFI projects closed in the space of two months between August and September this year.

These projects reiterate the importance of rehabilitating brownfield infrastructure in the UK and once again prove that banks are comfortable with long-term lending. Having said that it is important to remember that the debt requirement on these PFIs was not that large.

The market witnessed a hiatus in highway maintainence PFI projects after the Portsmouth Highways PFI closed in 2005 but a pipeline followed a few years later. Birmingham City Council tendered its highway maintainence PFI in 2007 and closed it in 2010. All three of the recently closed highway deals - Sheffield, Hounslow and Isle of Wight - were tendered aroupnd three years ago in 2009 and reached financial close this year.

Industry experts are convinced that both the UK and Europe needs to upgrade a lot of its existing infrastructure, however a firm pipeline is not on the near horizon yet, they fear.

**Project background**

**Sheffield highway maintainence PFI**: The 25-year PFI contract includes the improvement and the ongoing maintenance of the city's 1,180 miles of road, 2,050 miles of footway, 36,000 highway trees, 480 traffic signals, 68,000 street lights, over 18,000 items of street furniture and 12,700 street name plates.

The contract also includes services such as street cleaning, winter gritting and landscape maintenance. Refurbishment and repairs will be carried out in the first five years and maintenance in the remaining 20 years.

The procurement process for the project took three years from publication of the contract notice in April 2009. It was delayed several times, most notably in 2010 when the new coalition government reviewed transport PFIs and reduced the cost of the Department for Transport's commitment towards availability payments.

Amey was named as the winning bidder in April 2012, beating rival offers from Carillion, Mouchel and Scottish & Southern Energy to win the project.

**Hounslow highway maintainence PFI**: The contract includes a range of rehabilitation and maintenance services to be delivered over a 25-year period, including the upgrading and improvement of 432km of roads and 763km of pavements and the maintenance of footways, streetlights, signs, bridges, drains, gutters, street cleansing, graffiti removal, highway grounds maintenance, advertising boards, street furniture such as benches and bollards, and related environmental maintenance of the highway.

A technical adviser, Mouchel Management, was named for the project in April 2009, and bidding for sponsors was opened in December that year after PFI credits were secured. Four teams bid for the project in 2010 and they were narrowed down to three in June 2010 and two in May 2011. Vinci was finally named the winner in March 2012. The runner up was Balfour Beatty.

**Isle of Wight highway maintainence PFI:** The Isle of Wight project includes the management, refurbishment and maintenance of 821km of road surfaces, plus footways, cycleways, bridges and other structures, and 11,700 street lighting columns. It also includes traffic signals, signs, street nameplates, road markings, street cleaning and winter maintenance. The first seven years of the contract period will see £20 million a year spent on improving the network.

**Procurement**

The authority tendered for a technical adviser in 2009 before moving to a pre-qualification process the year after. Three consortia were invited to submit bids and in early 2012 three became two, namely Vinci and the Wight Highways Partnership led by Bouygues. Vinci was named preferred bidder in June before financial close in September.

The three highways PFI deals reached financial close within a two month period in August and September 2012. Jon Hart from Pinsent Masons, who worked as a legal adviser to the sponsor on the Hounslow and Isle of Wight projects for around two and a half years prior to financial close, said, while the projects started about six months apart, they converged to within a month of each other by the end. This was “a reminder of the halcyon days” when advisers could jump from one PFI project to the next, Hart said.

The processes were also streamlined because of the overlap of individuals involved. Pinsent Masons advised the sponsors on the Hounslow and the Isle of Wight projects (it advised a losing bidder, Carillion, on the Sheffield project); Vinci led the winning consortium in both cases; BTMU, KfW and DZ Bank were common to both. There was some to-ing and fro-ing; Helaba was initially involved in the Hounslow project but backed off, and SMBC joined the three banks in the Isle of Wight. In the case of Sheffield, KfW and SMBC were present again, this time joined by Lloyds and Nord/LB.

This created a “set of known entities”, Hart believed. The banks were familiar with Vinci and its Ringway subsidiary and also knew Meridiam, the co-sponsor for the Isle of Wight PPP, well. The authorities, meanwhile, were well-resourced, Hart recalled, and faced the challenge of how best to use external advisers. There was little collaboration between the authorities, however.

**Financing**

In terms of negotiations, the fact that the projects were brownfield rather than greenfield meant that determining the risk profile of the deals was crucial for the banks and the authorities. “Because we were talking about an existing asset, the state of the asset was an extra risk, and the banks understood this well,” Hart said.

However, some sources also pointed out the fact that technical due-diligence is burdensome in highway projects. All three projects belonged to three different local authorities which had their own standards to be met. Also all three local authorities were quite different in area as well. So the geological issues to be dealt with during due-diligence were different for all three. "Bidders have to do close observation and so that makes procurement cumbersome," a source said.

All three highway maintenance PFIs required senior debt of between £100-200 million which was provided by a club of three to four banks on each project. The bank groups were roughly similar but did undergo some changes over the long procurement period of the projects. Sheffield highways started out with a club of 10 banks but eventually ended up with just four.

While the market gets nervous when bank groups change or banks drop out, sources who worked on the lending side of these deals suggest that financing PFIs in the region of £200-400 million is still quite feasible. It’s the £400 million plus deals that are getting harder to finance in the current banking environment.

| Project | Banks | Senior Debt (£, mn) |
|---|---|---|

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|---|---|---|
| | | |
| Sheffield Highways | Lloyds, NordLB, KfW, SMBC | 212 |
| | | |
| Hounslow Highways | BTMU, DZ Bank, KfW | 110 |
| | | |
| Isle of Wight Highways | BTMU, DZ Bank, KfW, SMBC | 115 |

Financing the deals was not complicated according to banking sources, since most of them had prior experience with highway maintenance brownfield deals like Birmingham Highways and Portsmouth. However the risk profile of brownfield projects and the long-term debt tenor required for the projects were elements that both sponsors and banks had to get comfortable with.

One source said, “The main risk for such deals on the financing side is that the operational leverage is higher.” These deals would typically have investment split in two parts – core investment period and post core investment period. The core investment period is about five to seven years which is similar to the construction period but in the case of these projects involves rehabilitation of existing assets.

While the period on most projects is around three to four years, a five to eight year period on these deals also means a longer draw-down period for loans and in the present market many banks are finding it hard to make loans available for a period of eight years.

The post core investment period is also different for highway maintenance PFIs because it involves maintenance of old infrastructure which turns out to be expensive and bumps up the entire lifecycle cost of a project as opposed to a greenfield project.

In terms of margins, sources suggested that the projects were priced at “very close to new-build levels” which would roughly be anywhere between 250-300bps. “Today pricing is driven by cost of funding of a project,” one source said. All three projects had loan tenors between 24-25 years and that is also understood to be a key determinant of the cost of funding for banks.

Project partner Natasha Luther-Jones from DLA Piper, which advised Sheffield County Council during the PFI negotiations, thought that the banks were well prepared in regards to the risks of the project, sometimes drawing on their experience of the Birmingham highways PFI project which reached financial close in 2010. But the council, also, “knew its asset base well and transferred a lot of the risk”.

Particularly, the council’s strategy was to get most of the issues resolved before the preferred bidder was chosen, and “new points weren’t raised after the preferred bidder was chosen”. She thought that the council negotiated a strong position on latent defects and also the road surveying regime. There was a minor delay with the scheme engineer but “there were no lessons to learn about the timetable”, said Luther-Jones.

From a legal point of view, there was a difference in the contracts with the Hounslow contract based on a Department of Transport template and the Isle of Wight and Sheffield contracts longer and more bespoke, based on the earlier PFI in Birmingham. This meant that there was an element of “reinventing the wheel, which lawyers are sometimes accused of”, said Hart.

**More similar deals in the offing?**

The banks were clearly happy with the deals on offer. A larger number than those that ended up lending to the three projects were known to be interested at one point or another. For Sheffield, Nationwide, Santander and Bank of Ireland dropped out, apparently dissuaded loan tenor, while the council may not have been happy with the high margins offered by the banks. BBVA, Natixis and NIBC were also linked to the Sheffield project at an earlier stage. For Hounslow, Helaba was thought to have been involved before dropping out ahead of the financial close.

Helping the deals along was the funding from central government for the Sheffield and Isle of Wight deals. The

Department of Transport will contribute £1.2 billion in availability payments over the life of the Sheffield project, and pay £487.3 million to the total cost of the Isle of Wight project, including a £30 million subsidy at the debt raising stage. For Hounslow the Department of Transport is providing £14 million a year towards availability payments.

The consensus among industry figures is that the model does indeed work. “There is still long-term debt out there,” said Luther-Jones. “The model is very successful and it transfers risk to the private sector, which is good.” As for the lack of public funding and the lack of pipeline for similar projects in future, Hart considers it "such a missed opportunity”.

What is considered most important for these deals and PFIs in general is the underlying strength and pocket size of sponsors, and once players know and are comfortable with the risks in brownfield projects, financing is smooth.

After the successful close of Portsmouth and Birmingham many more deals were expected and even though these three came, there are apparently no more such in the offing. However since there is a focus on economic infrastructure in the UK, there is some hope for a healthy transport pipeline in the coming months.

As mentioned above there is a definite need for brownfield maintenance projects in mature infrastructure markets, and there will always be pressure to maintain existing infrastructure. So while experts are of the view that there is a good appetite for brownfield projects, there is a caveat that there is lesser happiness about long-term financing.