Standards and Best Practices in Financing PPPs

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SOCIETE GENERALE
Corporate & Investment Banking

Overview

- When to employ PPPs
- Potential disadvantages of PPPs
- Best practice in implementing PPPs
- Mobilising domestic bank debt
- Accessing the bond market
- Conclusion

When to Employ PPPs

- PPPs are an effective way of mobilising private sector capital and expertise to provide public services but they are not a panacea for everything.
- PPPs work best when:
  - Right size, not too big or too small.
  - Appropriate level of risk transfer.
  - Good balance of risk.
  - Most of the capital expenditure and funding is incurred up-front.
  - The risks are largely known and can be accurately assessed up-front.
  - Ongoing operations are not too complex or risky.
  - Involve proven technology.
- You need to get the risk allocation and incentives right.
- Many failed PPP projects were not suitable for being implemented as PPPs in the first place.
- Failed projects are bad for all parties and the industry.

Potential Disadvantages of PPPs

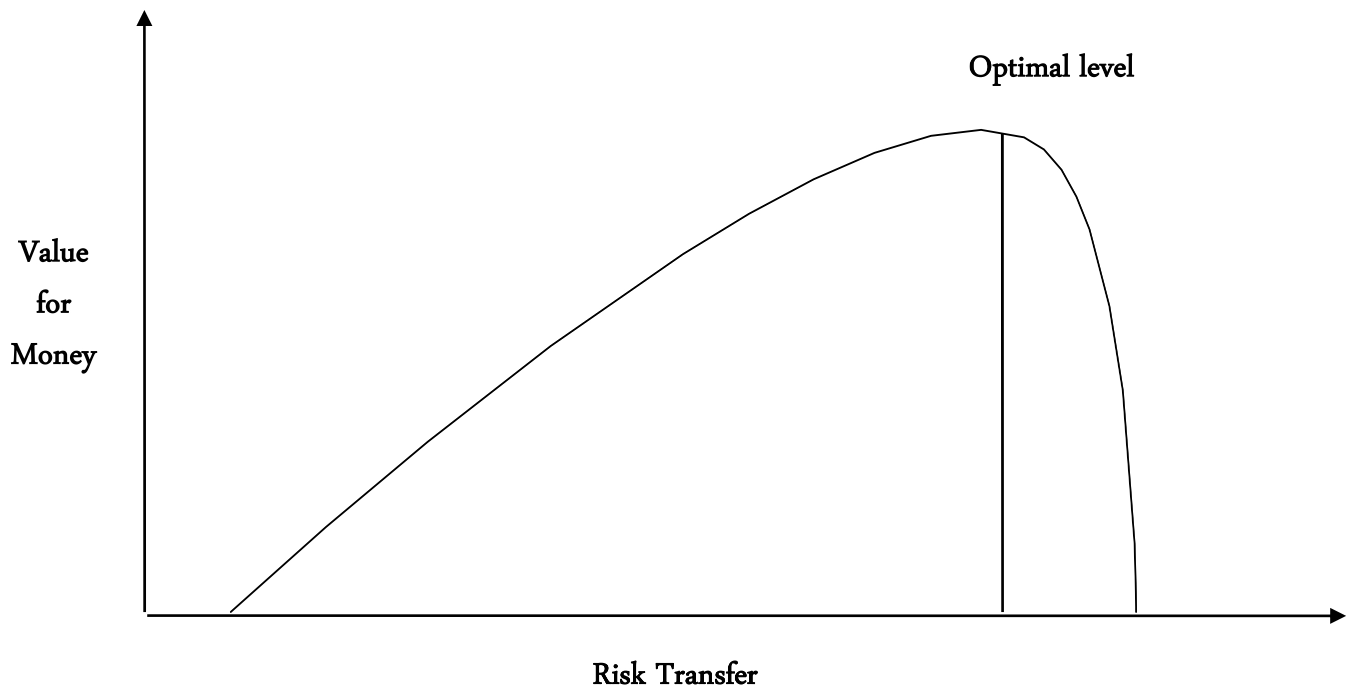
- PPPs involve a long term commitment, usually around 30 years, so it is vital to get the structure and mechanisms correct.
- There is the risk that circumstances or requirements could change over the period of the concession.
- Early termination for convenience can be expensive.
- Need to ensure that the private sector operators will not make excessive profits or windfall gains out of providing a public service.
- Ongoing contingent liability to pay compensation in certain default scenarios.
- The government usually have to assume the role of insurer of last resort.
- Need to ensure that the asset is handed back at the end of the concession period in good condition.
- Payment mechanisms denominated in foreign currency, typically USD, can prove very expensive and difficult to manage if the local currency weakens.

Best Practice in Implementing PPPs

- Have political commitment from all stakeholders.
  - Central government must be involved to ensure consistency across government departments and local governments.
- Establish the required legal and regulatory framework.
  - The framework must give comfort to investors that the government will support the project for the life of the project.
  - The government must be committed to the framework. The time to complete a transaction can be long, especially the first few transactions
- Introduce standard form contracts in line with international standards.
- Conduct a sound analysis of the underlying business case for the project.
  - Detailed analysis and evaluation of project risks.
  - Aim for optimal risk transfer not maximum risk transfer.
  - Provide appropriate financial support.
- Establish a pipeline of transactions.

Risk Transfer is Key

- Too much risk destroys value and will ultimately make the project un-bankable.



Better Management of the Tender Process

- Establish a transparent and reliable bidding process.
- Appoint experienced and competent advisors.
  - The learning curve can be shortened by using advisers with experience in the international market.
- The change in procurement process requires a change in mindset.
  - A move away from detailed control of input specifications .
  - Development of core requirement (output specifications e.g. lane availability, ride quality etc).
- Be committed to the implementation timetable.
- Appoint an empowered negotiating team.
- Set up a subsidiary relationship with funders and sub-contractors through Direct Agreements.

Mobilising Domestic Bank Debt

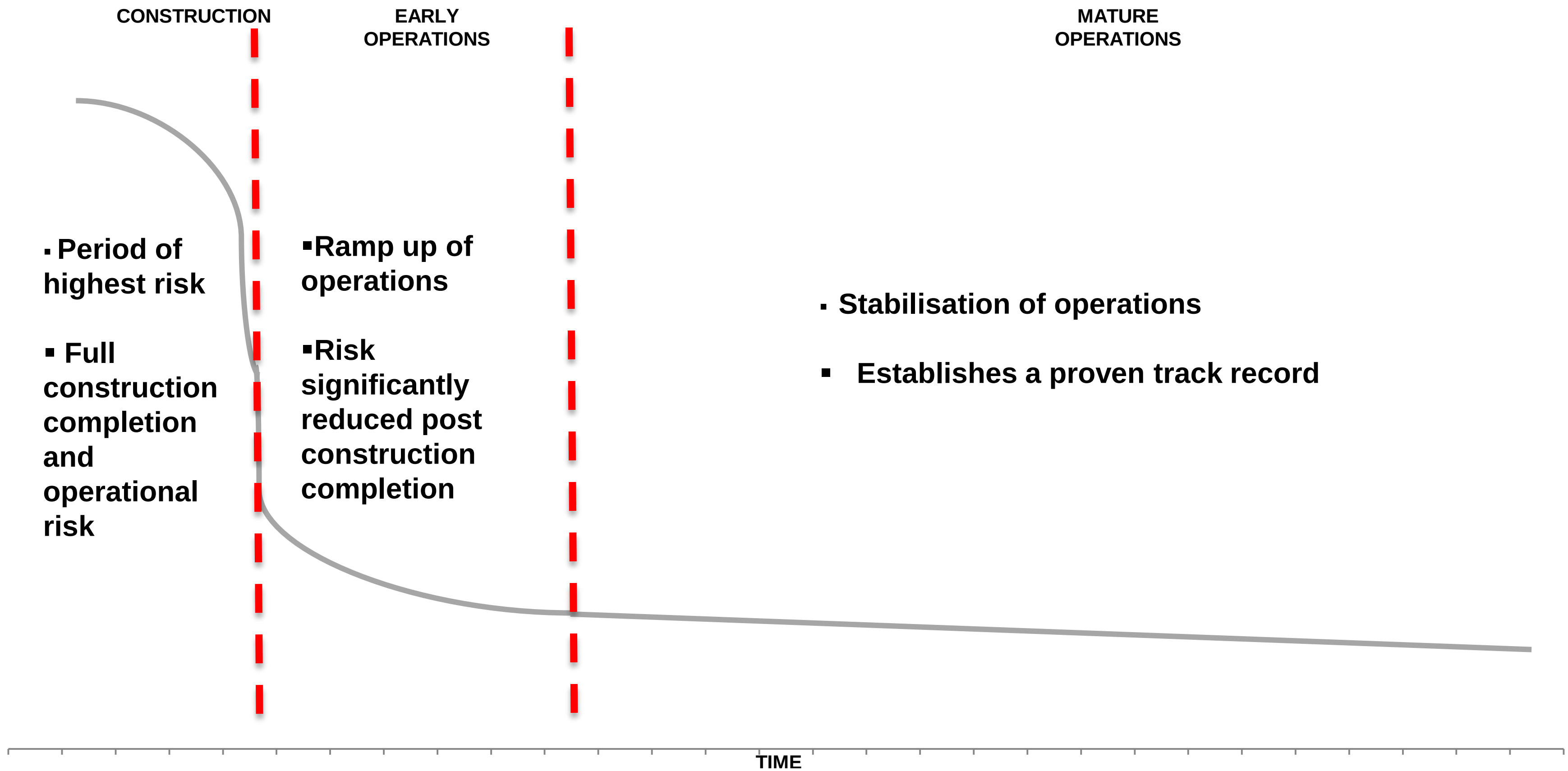
- The most readily available source of funding for PPP projects is in the domestic bank market.
  - Provides funding in local currency, thereby avoiding foreign exchange risk.
- Banks in emerging PPP markets may lack the experience or sophistication to properly analyse complex credit structures.
  - Local banks are usually keen to be involved with high profile public projects.
  - Involvement of DFIs can help get them comfortable with the unfamiliar risks.
  - Experienced international financial advisors can also help.
- Longer maturities are likely to be a challenge.
  - Only really the European banks that provide 25+ year maturities.
  - Basel III regulations will make longer maturities more challenging.
  - Sponsors and lenders will increasingly have to manage re-financing risk.

Accessing the Bond Market

- Before the 2008 financial crisis, a large number of projects were successfully financed in the capital markets, particularly in the UK.
- Almost all such bonds were guaranteed by AAA rated monoline insurers which provided credit enhancement.
- The demise of the monolines has made this source of funding far more difficult to access.
- Key features of PPP financing are not attractive to typical bond investors:
  - Low investment grade ratings.
  - Greenfield status of most project borrowers usually combined with construction risk;
  - Highly structured nature of the credit and the complex “credit story”
  - Long maturities or the alternative of taking re-financing risk.
  - Lack of a liquid market to price and sell project bonds.
- However, there is a relatively liquid and developing project bond market in the USA and Canada.
- The natural risk reduction as a project matures makes the bond market more appropriate for re-financings.

Typical PPP Project Risk Profile

- Most risk is concentrated in the early years of the project.



Conclusion

- PPPs are an effective means of delivering public services in appropriate circumstances.
- Thorough preparation and transparency are necessary to ensure effective implementation.
- Bank debt remains the most readily accessible source of funding.
- Despite the obvious attraction of bond market funding, accessing it remains challenging.