

public-private partnerships SOLUTIONS

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The U.K. Treasury Infrastructure Finance Unit: Supporting PPP Financing During the Global Liquidity Crisis

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Summary

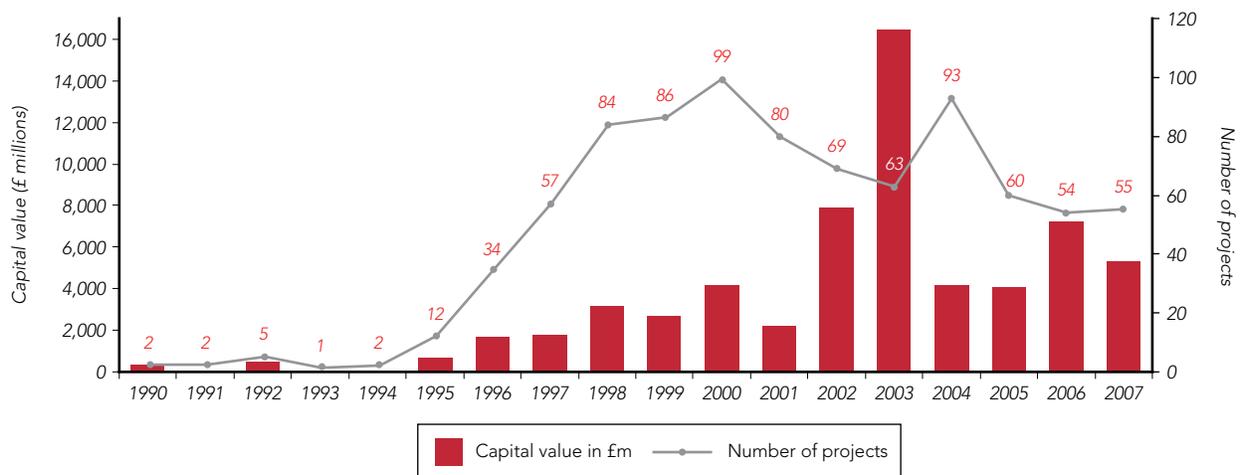
2008 and 2009 were challenging years to raise finance for Public-Private Partnerships (PPP) and Private Finance Initiative (PFI) schemes in the UK. The number of active lenders in the market was significantly reduced, and those that remained toughened their positions. A number of projects found it more difficult to reach financial close, and those that did close found that previously offered terms were no longer available.

HM Treasury's response was to ensure that projects went forward as planned, despite unfavorable financial market conditions, while also seeking to ensure appropriate risk transfer on acceptable terms overall. After some analysis, it was decided to focus on addressing the underlying problem of liquidity and to

provide a solution that would encourage banks to resume their long-term financing of projects. In March 2009, the Treasury created The Infrastructure Finance Unit (TIFU) with the objective of lending to PFI projects on the same terms as commercial lenders in the event that insufficient private sector lending was available.

This was successful in helping to inject confidence back into the market, as witnessed by the fact that projects have continued to be financed since the onset of the credit crisis. TIFU has only needed to lend once so far, but its presence means that banks that were prepared to lend as part of a club deal would be able to do so even if others were no longer able to do so, and that as a result the project would get to financial closure. However, despite this and some stabilization of the wider lending markets,

Graph 1. Evolution of signed PFI projects and capital value by financial to 2007



the PFI market remains fragile, and margins and other lending terms remain less attractive by (albeit highly competitive) 2005/06 standards, and are expected to remain so for some time. The monolines that had been active in assisting the financing of PPPs had given projects access to the capital markets. Following the exit of monolines from the market, a solution still needs to be found to connect PPP projects to institutional investors and the capital markets, and to provide a viable additional source of long-term funding to that of bank financing of PPPs.

Recently, HM Treasury announced that it would bring together of TIFU, the program and project delivery team of Partnerships UK, and the Treasury PPP Policy Unit into a single entity, Infrastructure UK (IUK), which will focus on the next stage of U.K. infrastructure development. One of IUK's early tasks is to identify new sources of private sector infrastructure investment.

The evolution of market conditions since 2007

The U.K.'s Private Finance Initiative (PFI) program has played an important role in the procurement and delivery of public services since the early 90's. By 2007, more than 870 projects worth £65.5bn had been procured as PFIs¹ (see graph 1). The program benefited from an increasingly competitive finance market with access to fixed rate, long term finance from both the banks and capital markets. Maturities of up to 40 years were possible and lending margins were as low as 75 basis points over gilts. For instance, just prior to the onset of the credit crisis, the Manor Hospital PFI in Walsall reached financial close in November 2007 with senior FSA-wrapped bonds worth just over £160m and a tenor of around 33 years (maturing in 2041), in addition to £15m-worth of variation bonds. The bonds were priced at 93.2 bps over gilts due to the AAA rating of the FSA wrap.

However in the course of 2008, conditions in the long term credit markets started to deteriorate considerably due to the onset of the global credit crunch. This impacted the PFI program in two important ways.

Decline of the monolines

During the period up to 2008, the 'monoline' credit insurers played an increasingly important role in the provision of cheap long-term bond finance as an alternative source of long-term finance to bank lending. Monolines are insurance companies whose sole product is a guarantee to investors of timely payment of principal and interest in exchange for a fee, a process known as 'wrapping'. By wrapping a bond issued by a PFI project company, the monolines converted the marginal investment grade credit rating of the project debt to a triple-A rating and therefore gave access to a wide pool of investors at a competitive cost.

Some of the early victims of the credit crunch were the monoline insurers who were perceived to have taken on risks in other sectors (not PFI) that severely impacted their credit ratings. Of six companies with triple-A ratings in 2007, four have since fallen below investment grade, materially impacting their business model, and the remaining two have merged to form one company with a split Aa3/AAA rating. The reduction of the industry to a single participant with a strong investment grade rating has effectively removed this important source of long-term debt funding, upon which the majority of projects with a debt requirement of over £100m had come to rely.

Retreat of the banks

At the same time, most banks, particularly those with limited retail deposits, were finding it increasingly difficult to source funding for their own long term lending operations, even for PFI projects where the risks were relatively low and well understood. Graph 2, which shows the evolution of LIBOR (essentially the rate at which banks will lend to each other) over this period illustrates the rapid deterioration in the inter-bank lending market at that time:

The impact on bank lending for PFI projects manifested itself in a number of ways:

- **Reduced number of lenders:** A number of banks withdrew altogether from the provision of long term finance to new PFI projects. Some of these were overseas banks who retreated to their priority domestic markets.

¹ www.partnershipsuk.org/puk-projects-database-search.aspx

Graph 2. Evolution of LIBOR (the rate at which banks will lend to each other)

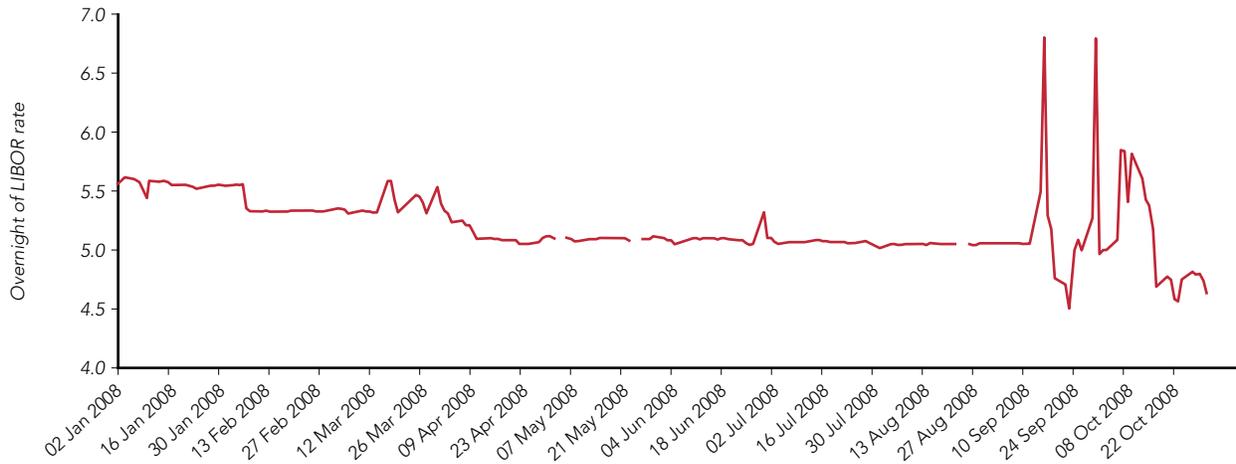
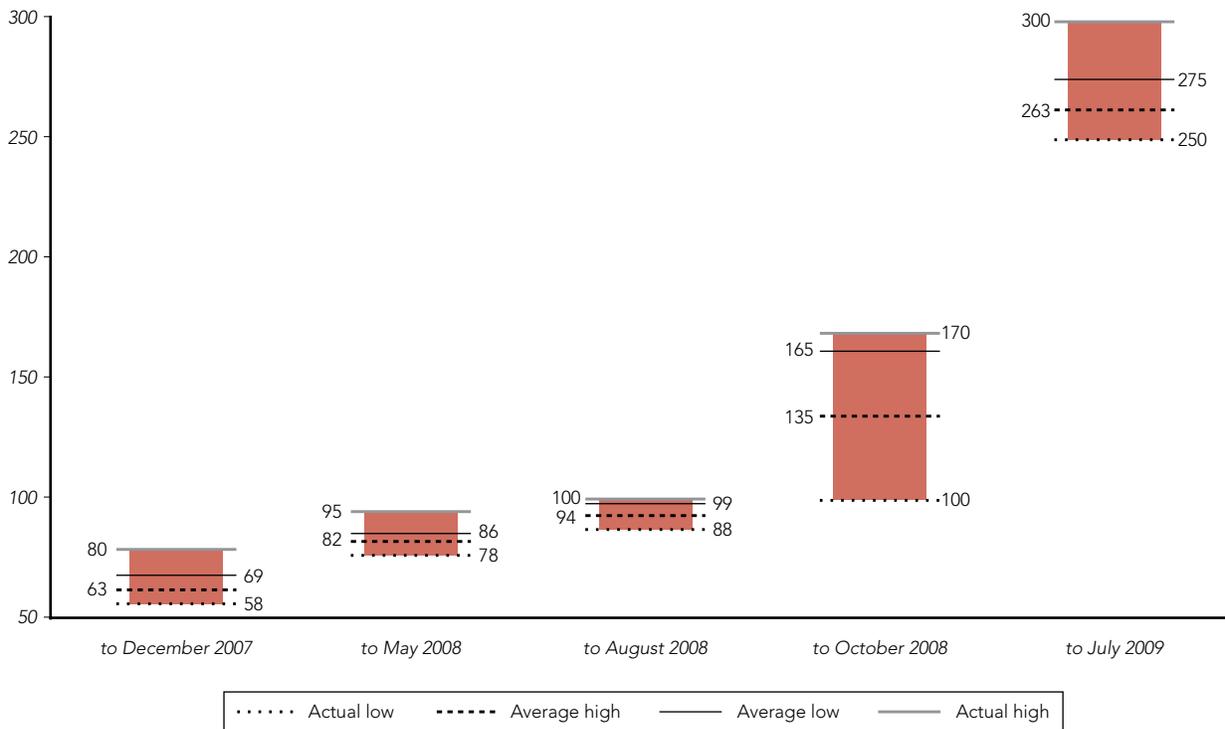


Chart 1. Evolution of debt margins for U.K. PFI projects



Source: Ernst and Young.

- **Complexity and delay in reaching financial close:** The process by which many banks had hitherto been prepared to accept lending terms agreed by a smaller group for each project ceased. This meant that securing the commitment of a group of banks became a much slower and more complicated process

as each bank sought individually to agree the terms of its lending.

- **Higher lending margins:** Margins for lending increased substantially, rising from around 80 basis points pre-crisis to over 300 basis points in mid 2009 for relatively straight-forward PFI projects with similar risks, threat-

ening their affordability. The chart below illustrates the increase in senior bank debt margins from December 2007 to July 2009.

- *Reduced tenor:* The maturity of debt also reduced significantly, raising risk and impacting returns for equity investors from the uncertainty of having to secure replacement funding or lower cost funding sometimes as soon as 5 years after financial close.
- *Accumulation of projects seeking finance:* The U.K. Government faced a pipeline of over 110 PFI projects worth £13bn, many of which were encountering difficulties in securing finance. These projects were already in procurement, and a key part of the U.K. Government's investment plans. The problem was potentially cumulative, as the backlog of projects was mounting, the chief difficulty being that financing was taking longer to arrange as club deals had become the norm.

The U.K. government response to the crisis

From late 2008 to early 2009 HM Treasury worked with Partnerships UK (PUK), individual authorities and the European Investment Bank (EIB) to develop a range of solutions to help PFI schemes reach financial close. The initial approach was to consider a series of different but traditional measures, including making larger public capital contributions, guaranteeing bank lending and increasing EIB funding (these options are briefly discussed in box 1). However the underlying problem was one of liquidity, not of the quality or risk allocation of the project themselves. What was needed was a solution that would encourage the banks to resume their long term financing of these projects, and to do so quickly.

The Infrastructure Finance Unit (TIFU)

HM Treasury's response in March 2009 was the establishment of The Infrastructure Finance Unit (TIFU) whose objective was to lend to PFI projects that could not raise sufficient debt finance on acceptable terms. TIFU would lend alongside commercial banks and the European Investment Bank (EIB).²

TIFU's lending is intended to be a temporary, reversible, and 'last resort' intervention. The Treasury's intention is to supplement bank/capital market funding, where it is available on acceptable terms, not to replace it or crowd it out. The Treasury envisages selling the loans it makes prior to their maturity when favorable market conditions return, which reinforces the imperative that its finance is done on commercially recognizable terms.

Structure

The Treasury decided that creating a co-lending facility was the most practical response to the credit crisis. The option of delegating the management of the facility to a commercial bank or even establishing a separate institution was considered. However, given (i) the fact that Treasury wished to retain the flexibility of TIFU as a potentially, though not necessarily, temporary solution for what may turn out to be a temporary liquidity problem and (ii) the need for an urgent response (TIFU made its first loan only 5 weeks after its creation), a co-lending facility based and managed within the government rather than a third party was believed to be the most appropriate response.

Operation

Although TIFU is a Treasury-based unit accountable to Ministers and wholly funded by Treasury, its lending activities are similar to those of any commercial bank. TIFU has a staff of up to 7 professionals with substantial private sector project finance experience. They consider applications for loans to PFI projects, negotiate the terms of any such loans on a commercial basis, and monitor and manage the loan portfolio, like a bank. TIFU has its own due diligence procedures and an internal credit committee composed of Treasury officials and independent banking professionals.

Lending policy

The main concerns that were considered with the creation of TIFU were (i) the danger of crowding out private lending, (ii) distorting the market, (iii) being able to exit its lending positions, and (iv) managing conflicts of interest with the public sector acting both as lender and project counterparty. In response to these concerns, TIFU has a very clear mandate to act

² For more information, visit www.hm-treasury.gov.uk/ppp_tifu_index.htm.

Box 1: Potential Remedial Actions by Government

Capital contributions[†]

Governments can provide up-front payments for PPPs in the form of capital contributions. This can improve the financeability of the remaining reduced private portion of capital raised. Such payments may also allow different public entities to adjust their respective contributions (for example, up-front payment by a central Government authority and a reduced unitary charge for the local authority in the case of availability payment-based PPPs).

However, the obvious drawbacks of capital contributions are their permanent up-front nature (i.e. once paid in they are not subsequently repaid by the project). Furthermore, when they represent a significant part of the total financing, they may distort the balance of risks, as the project risks have to be borne by a smaller private element: some of the financial benefit of the “free” public contribution may therefore be offset by increased private funding costs. Finally, they can raise potentially difficult inter-creditor issues and unwanted risk transfers, notably in case of default, where the public sector may require a repayment of some, or all, of its contribution.

Public sector guarantees

Another approach to mobilizing long-term private-sector debt funding is sometimes achieved through the public authority itself guaranteeing repayment of a portion of the project debt, even if the cause of the potential default lies with the private-sector partner—this is known as “debt underpinning.”

This approach may be part of a program to help stimulate the development of long-term sources of private-sector funding (it may also reduce the overall cost of funding to the project), while at the same time the portion that is guaranteed may be unlikely to be affected if the project gets into difficulty. It is important that the level of the un-guaranteed portion of the debt is a sufficient incentive to ensure that the lenders will have enough of their own funds at risk to the performance of the project and thus ensure that they carry out proper project due diligence and management of project performance, a fundamental principle of PPPs. This requires balancing the realities of the market and the strategic aim to encourage market development with the potential disincentives that debt underpinning may create for effective risk transfer. Clearly, as with any government guarantee mechanism, there may

also be significant fiscal implications as a result of the contingent liabilities that result from this approach.

MFI funding

Multilateral finance institutions (MFIs) are important sources of stability and market development, and as institutions in their own right may bring as much of the lender due diligence and monitoring disciplines as private-sector lenders. Indeed, given their public mission, they may also be sources of further policy support and quality control in PPPs over and above those required by commercial lenders. MFIs, as publicly owned entities, fall into this category—the European Investment Bank (EIB), for example, has a portfolio of over €29 billion of PPP projects across the European Union.[‡] Clearly the quantum of funding is determined by MFI policies.

Public sector co-lending facilities

Under this model, the public sector meets funding shortfalls through loans which may or may not be on identical terms to those offered by commercial banks. In some cases, the public sector lender may require additional guarantees or assume fewer risks. Sometimes the underlying principle may be that these loans will be sold back into the market as and when conditions “normalize” (TIFU, discussed in more detail, is such an example). The drivers can vary, responding either to perceptions of longer term market failure in the provision of long-term finance to more stimulative, market shaping, temporary policy responses.

The model is not without challenges for the public sector, however not least the practicality of establishing and managing an experienced lending unit or institution, the risk of crowding out (when is a shortfall a shortfall), and the implication of selling down public stakes in due course, or in some cases the limitations on the risks that can be accepted, not to mention the fiscal implications for funding such a facility or institution in the first place.

[†] For more information on potential remedial actions, read EPEC's report on “The Financial Crisis and the PPP Market” August 2009.

[‡] For more information on EIB lending, visit www.eib.org.

as a *taker* of price and terms from the market and to accede to the inter-creditor arrangements and protect its loans like any other lender. TIFU therefore considers lending where:

- A project cannot secure sufficient finance to reach financial close on a timely basis;
- The proposed private sector funding is not representative of terms and conditions generally available in the market; or
- A project is at risk of delay due to lack of genuine funder engagement.

Although TIFU can fund up to 100% of the debt finance required for a project, it prefers the private sector to raise all or most of the project debt and expects equity investors to continue bearing the primary risk in these projects. TIFU offers long-term loans on either a fixed rate or a floating rate basis, matching the same fees, pricing and tenor as other commercial lenders. It can also participate in or provide standard ancillary lending facilities for PFI projects.

Although TIFU's presence on certain deals may be useful for pricing, its intention is to address a *liquidity*—not a pricing—problem in the market. There is a bias against intervening on cost grounds alone, and TIFU has not yet lent in response to unacceptable private sector terms.

In terms of balance sheet treatment, TIFU loans would be treated as government assets like any other government loan, but this would not alone determine the public sector balance sheet treatment of the recipient PPP project.

Scope

TIFU was established to support the 110 PFI schemes that were already in procurement, although other PFI projects can also be eligible with Treasury approval. TIFU does not engage before the preferred bidder stage of a project (i.e. it cannot support any one particular bidder against another) and it can only be approached via the procuring authority and any relevant Ministry (i.e. not by the private sector bidder or banks).

Box 2: Greater Manchester Waste Management PFI

Summary

The Greater Manchester Waste Disposal Authority (GMWDA) project is the largest waste PFI contract in Western Europe, treating over 1.4 million tons of municipal waste per annum (c. 5% of the U.K. total) in a contract worth over £4bn during the 25 year concession, involving a capital investment of £795m.

The project

The GMWDA project achieved financial close in April 2009. The structure, with two SPVs working side by side, involved one being responsible for the production of fuel from waste and the other for disposing of the fuel. The project included building/refurbishing and operating some 44 different facilities including biological treatment plants, material recovery facilities, composting plants, transfer loading stations and household waste recycling centres throughout the Greater Manchester region.

History of the financing

When Viridor Laing was announced as preferred bidder in January 2007, two banks—Bank of Ireland

and NIBC—were in place to underwrite the deal and act as joint mandated lead arrangers (MLAs) with each envisaging an equal part of the commercial debt facility. However, a combination of (i) the size of the project, (ii) its complexity (there were a range of non-standard issues arising from the twin SPV approach), (iii) particular credit crunch issues affecting some of the original underwriting banks, and (iv) the timing of the credit crunch in relation to the project (the project was seeking to close at one of the most difficult points in the cycle), meant that as the credit crunch took hold, sources of funding had to come from a wider pool. This eventually involved EIB, capital contributions from the authority, in addition to the senior debt and TIFU.

The financing structure had a 79:21 debt to equity ratio. Debt tenor for the deal was 23.5 years, with the debt margin ranging from 325bps during construction, with margin ratchets every five years during operation, starting at 335bps rising to 450bps after year 16 to maturity. As with most PFI projects, there were no additional guarantees supporting the debt and the commercial banks still remain key long term lenders to the project.

Market reaction

The message sent by the Government with the creation of the TIFU was welcomed by the market. This message was reinforced when TIFU completed its first, and so far only, deal in April 2009, providing a £120 million loan for the Greater Manchester Waste Disposal Authority's (GMWDA) PFI project alongside the EIB and a group of commercial banks (see box 2). In this project a major lender pulled out at a critical moment near financial close, and without the financing provided by TIFU, the project could well have lost momentum and unraveled. TIFU has also shadowed several other projects in case a financing shortfall arose, but none of these required TIFU support (including the M25 project with a capital value twice the size the GMWDA) because private sector financing, alongside an EIB facility, proved sufficient.

The overall performance of TIFU should be measured by its impact on the market as a whole. Douglas Segars, Director at Partnerships UK commented "As an immediate effect, the participation of TIFU in the funding of the Greater Manchester Waste project gave the Government's initiative credibility, and provided confidence to the PPP/PFI market that the commitment was being delivered."

Adrian Ringrose, Chairman of the Public Service Strategy Board at the Confederation of British Industry agreed by saying, "What the creation of TIFU did was to encourage other lenders back into the PFI market. It created a fresh buzz of competition and helped instill much-needed confidence into the market. That has led to 13 PFI deals being completed since July. Nevertheless, it is fair to say that the market also at times expressed concern that TIFU could be used unfairly to compete with the banks. Over time, however, the way in which TIFU has operated in practice has calmed these fears and this reflects the fact that fundamentally TIFU is an instrument to encourage the banks to lend, not to replace them. In particular the presence of TIFU has provided confidence to banks who were prepared to lend in the event that the full club could not, or that one of the club members had to reduce their exposure (due to liquidity concerns). In other words, it meant that banks that were prepared to lend would be able to, even if others could not. But it means that the management of this sort of policy instrument

needs careful judgment and close and continuous understanding of the market.

While the PFI market does show signs of recovery, it remains fragile, and margins and other terms remain less attractive by the strongly competitive 2005/06 standards, with fewer banks in the market. Identifying and diversifying sources of long term private financing for infrastructure remains a core longer term challenge for which TIFU is by no means a comprehensive answer. This thinking lies partly behind the Treasury's decision to establish Infrastructure U.K.

The future—Infrastructure UK (IUK)

In December 2009, the Chancellor of the Exchequer announced in the Pre-Budget Report that a new entity, Infrastructure UK (IUK), would take on the role to advise the Government on strategic long-term infrastructure planning, prioritization, financing and delivery across sectors from energy and waste, to water, telecommunications and transport.³ IUK's focus is therefore on economic—as well as social—infrastructure. The Chancellor gave IUK a number of immediate objectives, including:

- 1) Developing a strategy for the UK's infrastructure over the next five to 50 years;
- 2) Identifying and attracting new sources of private sector investment;
- 3) Managing the UK's investment in the EIB's Marguerite climate change infrastructure fund; and
- 4) Providing support to HM Treasury and Department for Energy and Climate Change with their work to determine how the U.K. electricity market framework can most effectively deliver the low-carbon investment needed in the long-term.

To achieve these goals, IUK will bring together, under the Treasury umbrella, the program and project delivery capability of PUK, the lending capability of TIFU, and the policy development capability of the Treasury PPP policy team. IUK will give the Treasury a fluid structure that allows the movement of expertise among each of the groups. This

³ For more information, visit www.hm-treasury.gov.uk/ppp_infrastructureuk.htm

development has generally been welcomed by the market, which sees it as helping to ensure a greater level of coordination and long term planning across a wider range of infrastructure sectors. As part of IUK, TIFU will retain its lending function for as long as is necessary—there is no set date or explicit condition for its termination, and it will enable the finance specialists in TIFU to support the Government across a wider range of infrastructure.

This note has been prepared by Ed Farquharson, Project Director, and Javier Encinas, Manager, both of Partnerships UK. This note reflects Partnerships UK's views of HMT's policy and not HMT policy itself.

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