

PFI/PPP Report

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Developing a Market for Unwrapped PFI/PPP Bonds – the Canadian Example

Key Points

- the existence of a monoline bond insurance model in Europe resulted in PFI projects designed to achieve BBB ratings
- the absence of a monoline bond insurance model in Canada resulted in PFI projects designed to achieve A ratings
- the Canadian PFI market has been shaped by a number of local considerations, but there other general considerations such as the approach to government support that could be applied on a more consistent basis across jurisdictions
- the demise of the monoline model has served to highlight differences in approach to credit risk that have developed in different jurisdictions
- BBB ratings could be a barrier to the development of an unwrapped PFI bond market in Europe
- PFI projects are characterised by very stable cash flows and low levels of default when compared to other similarly rated infrastructure projects
- the role of the contracting public authority is perhaps given greater recognition in the assessment of PFI risk in Canada compared to Europe

Introduction

Following the demise of the monoline bond insurance model, institutional investors have been largely absent from funding new PFI/PPP transactions in Europe.

Commercial banks (often together with the EIB) have been able to meet the funding needs of new PFI projects in Europe over the past year or so, albeit the volume of signed projects has been significantly reduced from the levels seen in previous years. Nevertheless, concerns regarding continued exposure to risk from commercial bank lending activity across different sectors together with likely regulatory requirements to avoid future over-exposure to risk, raises questions about the banks capacity to meet the funding needs of PFI in Europe over the longer term.

The demise of the monoline bond insurance model was an “change event” for the PFI funding market that raises a number of questions about the assumptions underpinning funding arrangements, the underlying credit ratings, and the role of investors.

The loss of the AAA wrap provided by the bond insurers has left many investors holding bond insured paper with credit risk commensurate with the underlying credit risk associated with the PFI project. The PFI project ratings were not always made public, and were not always surveilled on an annual basis by the credit rating agencies. Consequently many investors are still trying to assess the level of risk they are carrying, and attribute values to the amount of loss they are facing as a result of losing the AAA monoline insured ratings.

The monoline bond insurance model allowed investors in Europe to lend to PFI projects without investors needing to commit significant resources to detailed documentation negotiation and financial modelling work, and to the on-going surveillance and servicing of the project. Many investors do not have specialist teams they can call on to quickly assess the risks they are now holding, and until this type expertise is built up, or a replacement to the role of the monoline insurer is found, investor appetite for investing in PFI bonds may be limited.

That said, in jurisdictions outside Europe, for example in Canada where the monoline insurance model did not develop in the same way, investors have been prepared to invest directly into PFI projects. Importantly the credit ratings awarded to unwrapped PFI transactions in Canada are generally higher than the underlying PFI project ratings for monoline wrapped transactions in Europe, although the risk profiles in certain cases appear to be broadly the same.

Development of PFI in Europe

PFI developed first in the UK and local banks typically funded the earliest transactions. By the end of the 1990's, alternative funding of larger PFI transactions through the monoline wrapped bonds had started to take place.

Bonds with a monoline wrap were issued with AAA ratings, which meant the price of the bonds was competitively low because the assumed risk associated with the monoline insurance policy was low. It also opened the PFI market up to a range of investors seeking to invest in AAA paper. The PFI market benefited from this alternative source of funding and nobody paid much attention to the underlying PFI project ratings, which in many cases were not made public to the investor community.

The monoline insurance business model is dependent on the credit rating agencies maintaining high credit ratings of the insurers. To achieve high ratings, the monoline insurers need to set aside sufficient capital to

cover the cost of paying out under their insurance policies if a number of insured projects default. In order to assess the likelihood of default, each insured project needs to have its own credit rating. The likelihood of default was significantly higher if the PFI project ratings were judged to be non-investment grade, so the monoline insurers therefore sought low investment grade ratings (BBB ratings) from the ratings agencies for the PFI projects in order to secure the most efficient funding solution for themselves and add the most value to issuers.

The rating methodology for project finance risk had been established in the US for a number of years, and was the basis for the approach to rating the first PFI projects in Europe. There are, however, a number of fundamental differences between the risk profiles of rated infrastructure projects in the US and availability based PFI projects in Europe. For example, most PFI projects are characterised by relatively low levels of construction risk and limited technology risk compared to say power plants or tunnelling projects. There is also limited market risk associated with PFI projects because once a facility is built and is maintained to a reasonable standard, payments are essentially contractually guaranteed by government or a government related entity. This means that the project cash flows are typically very stable and do not suffer the same degree of volatility that may be the case with a project that is exposed to volume/market risk.

Where there is a higher likelihood of project cash flow volatility, the risk profile of a project is driven more by financial considerations such as cover ratios and debt service reserves. It is fair to say that the ratios and reserves are in many cases lower for BBB investment grade ratings in PFI compared to BBB investment grade ratings other sub-sectors of project finance, but relative to the stability of the PFI cash flows they still may be considered to be high in certain cases.

An accepted approach to rating PFI transactions therefore developed with BBB investment grade ratings assigned to the underlying PFI projects. This allowed monoline insurers to provide their insurance wraps to PFI bond issues without incurring onerous capital charges needed to protect the monoline insurers' own high ratings. The monoline insurers did not seek to get higher ratings for the underlying PFI projects, and there was relatively limited scrutiny by investors into the rating approach to PFI projects. That said, if the investor market was concerned about the underlying project risks of a particular PFI transaction, then this could be reflected in some pricing differences between different AAA insured bonds.

The demise of the monoline bond insurance model had nothing to do with any failure of PFI projects. Monoline insurers' exposure to other sectors, such as commercial property, resulted in downgrades of monoline insurer ratings. In a number of cases the ratings of the monoline insurers ended up being lower than the underlying ratings of the PFI projects. This "change event" has meant that the PFI project ratings are now coming under more scrutiny from a range of interested parties.

Despite the recent economic turmoil, PFI projects have been shown to be robust, supported by the availability based payment mechanisms and income streams from highly rated governments and government related entities. There have been very few recorded BBB PFI defaults compared to other BBB rated project finance bonds such as for power plants. The only high profile "PFI" default was Metronet Rail in 2008. Metronet carried out station, signalling, and rail upgrades on the London Underground, but the project was in fact unlike most typical PFI transactions in that it was a long-term partnership arrangement with fixed contractual review points, on-going arbitration between parties, and what turned out to be a relatively poorly defined series of outputs. Following default, the project was transferred back to the public sector and the actual losses suffered by the investors were in fact minimal as the government paid out 95% of outstanding bank debt and 100% of outstanding bondholder debt.

PFI should not be looked at on the same basis as other project financings that are exposed to greater market and technology risk. Although PFI does transfer a certain amount of risk to the private sector, the assets that are built under PFI typically fulfil important public policy objectives and respective governments are very

supportive of the projects. As with most forms of credit analysis, there is a certain degree of subjectivity that underpins credit decisions. Where PFI has developed in other jurisdictions, there appears to be subtly different approaches to assessing PFI credit risk that fits better with the demands of the local market, but which can make comparisons of risk assessment between different jurisdictions problematic.

Development of PFI in Canada

The development of significant PFI deal flow in Canada is a relatively recent phenomenon, in part due its history of municipal finance at the provincial level for public sector projects. Precedents started in the late 1990s through early 2000s, with “one offs”, mainly large scale, strategic transportation projects (roads & bridges) in Ontario and infrastructure projects to support the 2010 Winter Olympics in Vancouver, British Columbia. Many of the early projects were generally awarded as concessions, rather than legislated under PFI frameworks, and many relied upon user-based revenues (real tolls) to service debt payments post-construction. After a lengthy development period, the establishment of PFI frameworks at the provincial and national level evolved in the mid 2000s mainly to facilitate accommodation projects (such as hospitals and courthouses), relying on public authority funded availability payments.

During the early years of PFI development, Canadian provincial governments had not given the monoline bond insurers licences to operate in Canada. As a result, there are relatively few rated, monoline insured PFI transactions in Canada. The Canadian funding landscape is also characterised by a relatively conservatively regulated banking sector. For example, Canada has much tougher leverage and higher capital adequacy ratios that made it more difficult for Canadian banks to justify the long term lending arrangements that characterised bank lending to PFI projects in Europe. Furthermore, with respect to individual PFI transactions, Canadian banks would typically have a more conservative approach to structuring a deal and a more conservative covenant package than was often the case with European banks.

Canada has a smaller banking system than Europe, and the regulator is able to have a close relationship with individual Canadian banks. This pro-active regulation may have resulted in Canada seeing less innovative forms of bank funding, including long-term lending arrangements. On the other hand, the Canadian banks have been more resilient in the current financial crisis than many European banks.

With a relatively limited local banking market willing to fund long term projects, sponsors targeted unwrapped bond issues to institutional investors. Because of pricing differences between BBB and A rated bonds, A ratings were targeted to get best value for issuers. The history of municipal issuance throughout Canada also may have contributed to investors being comfortable with taking public sector backed project risk as compared to, for example, the UK market.

A number of PFI transactions were awarded A ratings, but there appeared to be a number of credit features that may be considered to be weaker than BBB project ratings in Europe. For example minimum cover ratios could be lower, and minimum cover ratios of around 1.2x could achieve A ratings. In other areas the risk profile appears stronger for Canadian PFI projects, particular regarding the construction security package where combinations of letters of credit and performance bonds often exceed 30% of contract value. However, this feature was put into place to mitigate the weaker credit profiles of Canadian construction firms, as many are smaller companies compared to European contractors.

The emphasis of the Canadian approach to risk therefore appears to be more concentrated on the construction related risks rather than cash flow volatility considerations post construction. Similarly in the operating phase there appears to be a greater emphasis on third party liquidity support, again in part reflecting

weaker credit profiles of some Canadian operating companies. Much greater emphasis also appears to be given to the low credit risk of the contracting public authority in Canada.

If the Canadian approach is correct and most of the risk in the credit analysis of a PFI project lies in the construction phase, then it would be logical that the credit risk profile reduces post construction. This does not appear to be the case regarding the credit rating approach to European PFI projects, where credit ratings have mostly been maintained in the BBB category even after several years of successful operation. This does not help the possibility of attracting investors into an unwrapped bond market to refinance bank funded PFI projects post construction.

PFI and Government Support

The role of government support in the assessment of PFI risk appears to be more prominent in Canada, but may be under-played in Europe. Although there is a large area of subjectivity in this matter, credit ratings may be considered to have been “notched down” from government ratings in Canada, and “notched up” from stand alone project ratings in Europe. In a few examples there have been explicit notches for government support in European PFI projects, but in both Europe and Canada the ratings tend not to be transparent in this area.

The role of investors in different jurisdictions may also have played an important role in this approach. For example, Canadian investors are typically more comfortable with public sector related risks given their experience of investing in public sector debt, compared to say UK investors.

Rating agencies have in the past amended the ratings of whole sectors to reflect changes in views on certain credit considerations. For example the ratings of government related entities (GREs) have been amended to reflect the degree of support provided on an extra-ordinary basis by governments. If PFI projects are considered to strongly benefit from government support, particularly because PFI assets fulfil an important public policy role, then there may be an argument to amend the ratings accordingly and achieve greater consistency between jurisdictions on the basis of a shared approach to government support.

Conclusions & Next Steps

There appears to be differences of approach to the assessment of PFI project risk in different jurisdictions. These differences have only been recently considered in any detail following the demise of the monoline insurance model. The re-appraisal of the approach to PFI risk is further supported by the desire to encourage institutional investors back into the long term funding of European PFI projects.

The differences in approach to risk assessment appear to have developed to suit the requirements of different capital market funding models and investor risk tolerances that have been established in particular regions. The range of risks considered and the degree of subjectivity associated with risk assessment in certain areas has added to the complexity of comparing outcomes across different jurisdictions. Nevertheless there may be certain fundamental differences in approach, such as the degree of assumed government support, that make differences in credit assessment of PFI transactions between jurisdictions more likely to occur.

Further research may be warranted regarding a more detailed comparison of particular Canadian and European PFI transactions, including contractual and financial features, pricing, and rating outcomes.

An independent survey of Canadian and European institutional investors may also be considered in order to understand investor risk tolerances for PFI transactions, and their views on the role of government support in these transactions and whether the current rating approaches adequately reflect this support.

Example Canadian PFI Transactions

Project Name	Year Closed	Sector	Province	Debt Funding Model	Initial Senior Debt Rating(s)
407 International Inc.	1999	Real toll road	Ontario	Unwrapped Senior & sub. bonds	A category
Serco DES Inc.	2003	Driver education & exam services (w/market risk)	Ontario	Unwrapped bonds	A category
Abbotsford Regional Hospital & Cancer Centre	2004	Hospital	British Columbia	Unwrapped bonds	A category
Golden Crossing Finance Inc.	2006	Availability based Bridge	British Columbia	Wrapped bank loan	AAA (BBB) underlying
Plenary Health Bridgepoint LP	2009	Availability based Hospital	Ontario	Unwrapped bonds and bank loan	A category

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