



Financing PPPs with project bonds

Issues for public procuring authorities

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Financing PPPs with project bonds: issues for public procuring authorities

1. Introduction

Until recently, the European PPP market relied to a large extent on project finance debt provided by commercial banks and/or public financing institutions (e.g. the EIB). Since the onset of the financial crisis, commercial bank debt has become more difficult to secure and lending terms (e.g. pricing, tenors, loan volumes) have deteriorated significantly, affecting the bankability and value for money of PPP projects.

In current financial market conditions, bond financing can play a major role in bridging the financing gap for infrastructure investments. In a nutshell, project bonds are debt instruments issued by PPP project companies and typically bought by institutional investors (e.g. pension funds, insurance companies). They are sometimes tradable on secondary markets. While bond financing plays a significant role in some PPP markets outside of Europe (e.g. Canada), “true” project bonds¹ are still in their infancy in Europe and raise a number of issues, in particular for procuring authorities during the project procurement phase. The public sector has a key role to play in facilitating the use of project bonds in PPPs.

This paper is aimed at PPP procuring authorities (“authorities”) and PPP public stakeholders generally. It highlights the key characteristics of bond financing and identifies the main issues that authorities will typically face when PPPs are to be financed with bond instruments.

2. Key characteristics of bond financing

Several features of bond financing need to be taken into account when considering it as an alternative financing solution for PPPs, including:

- **Maturity/refinancing risk** – Bonds are by nature long-term financing solutions. Institutional investors which invest in bonds seek long-term assets to match their long-term liabilities. For PPPs, this can translate into financing solutions that near-match PPP contract maturities and entail no refinancing risk (as is the case with projects financed by short-term “mini-perm” commercial bank debt);
- **Pricing** – In current market conditions, the “all-in” price of bond financing often compares favourably to that of bank financing. Such a pricing advantage can therefore contribute to improving the value for money of a PPP project and its affordability for the relevant authority;

¹ “Wrapped” project bonds (i.e. bonds guaranteed by “monoline” insurance companies) were relatively common in PPPs, in particular in the UK, until the demise of the monoline insurance companies in the late 2000s.

- **Credit quality** – Bond investors typically invest in high quality assets (i.e. with a low loss probability). To meet investors’ expectations, the “arrangers” of bond issues (usually banks) involve rating agencies and seek to structure their transactions so as to achieve a credit rating of about A- or above.² As the typical PPP project is structured to achieve a BB+ or BBB- rating, bond financings are likely to involve “credit enhancing” instruments (e.g. the EU 2020 Project Bond Initiative³, debt tranching, fuller performance bonds) to achieve the rating required by investors;
- **Transaction size** – Because of their costs, complexity and investor appetite, bond financings are only suited to PPP transactions of a significant size (e.g. with a bond financing in excess of EUR 100 million). Bonds are generally placed on the market either via public offerings or by private placements. Public offerings may be contemplated for very large transactions. Private placements are more suited to smaller transactions as they involve lower costs and less on-going administration;
- **Preparatory costs** – Bond financings involve significant preparatory costs such as that of obtaining a credit rating for the bonds, preparing the bond placement documentation and marketing. Legal costs can be significant especially in the case of public offerings, where a listing of the bonds on an exchange is foreseen;
- **Deliverability and pricing uncertainties** – The deliverability and pricing of bonds are normally only firmed up upon actual issuance. For PPPs, this means that some uncertainties inevitably remain throughout the procurement process. As a result, authorities will often find it difficult to seek fully committed bond financing offers at bid or final offer stages;
- **Cost of carry** – As the bond proceeds are drawn at once upon issuance, the private partner in a PPP will need to invest these proceeds until they are actually required by the project over its construction period. This typically results in a “negative carry” because the interest received by the private partner is generally lower than that paid to the bond holders. This contrasts with traditional bank financing where funds are drawn over the construction period as and when required;
- **Termination provisions** – In the case of early repayment, the bond terms will generally call for a prepayment fee in addition to the return of the amount outstanding to put the bond holders in an equivalent position as if the bond had run to maturity; and
- **Controlling creditor** – Traditional PPP bank financings grant the lenders the opportunity to exercise, during the project lifespan, decision rights in a coordinated/regulated manner (e.g. in the case of restructuring). In the case of bond financing, a “controlling creditor” needs to be appointed to take care of the interests of a multitude of bond holders.

² This paper uses Standard & Poor's rating scale (from excellent to poor): AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, B+, B, B-, CCC+, CCC, CCC-, CC, C, D.

³ See <http://www.eib.org/about/news/the-europe-2020-project-bond-initiative.htm>

3. Issues for procuring authorities

Authorities procuring PPP projects may wish to incentivise bidders to consider bond financing (with a view to increasing competition and/or promoting diversification) or may have to evaluate bids that rely on bond financing. They will therefore need to understand the implications of this form of financing and ensure that bond solutions are on a level playing field with bank solutions in the procurement process. Without certain adjustments to the procurement process and PPP contract terms, securing bond financings may be compromised.

Expert advice for procuring authorities

As mentioned above, bond financing has a number of particular features. Authorities need to rely on expert advice to analyse bond-specific issues such as deliverability, pricing comparison and documentation (see below). Authorities should ensure that specific bond instrument know-how is available to them early in the procurement process. This may require the appointment of a specialist adviser as typical PPP financial advisers may not have direct experience of bond financing.

Procurement steps

To enable or facilitate the recourse to bond financing, when planning their PPP procurement process authorities should take account of the following points:

- At project preparation stage, authorities should assess the suitability of the key features of their proposed PPP project for bond financing. This high-level preliminary review should be carried out with the support of the authority's financial adviser;
- In order to inform bidders, promote equal treatment or incentivise the private sector to explore all possible financing options, authorities should mention the possibility/acceptability of bond financing solutions at project announcement stage (e.g. OJEU publication);
- At bid stage, bidders should be given the choice of submitting an offer based on a bank or a bond financing. In the event that an authority specifically wishes to investigate the potential of bond solutions, it may request bidders to submit an offer based on bank financing and a second offer based on bond financing. In this case however, the authority should bear in mind that preparing two financing offers is costly for bidders. The authority will need to commit to choosing a financial solution at some point either before best offers are submitted or when appointing the preferred bidder. It should also consider whether it is appropriate to reimburse part of the costs associated with preparing bond financing proposals; and
- At final offer stage, the authority will need to carry out a thorough analysis of the deliverability and pricing of bond proposals (see below).⁴

Assessing the deliverability of a bond financing

In a standard PPP procurement, bidders have to demonstrate (as part of their bid and/or their final offer) the deliverability of financing solutions. This should equally

⁴ See the annex for an example of the key procurement steps for bond-financed PPPs.

apply to bond solutions. As noted above, ensuring the deliverability of bonds prior to their effective issuance is difficult as the “underwriting” of bonds by their arrangers is not common practice. As a result, the commitments obtained from banks at bid or final offer stages may be – or appear to be – stronger than those obtained for bond solutions.

However, authorities can obtain some comfort that a bond solution can be delivered by requiring bond arrangers to provide letters of support at bid or final offer stages and relying on the expert opinion of the authority’s adviser. The terms of the bond arranger support letters should therefore be set with care.

In addition, at final offer stage, to help in mitigating the deliverability risk, it is advisable that authorities require bidders to obtain a “pre-rating” on their proposed financial structure. The authority may also ask bidders to (i) submit evidence that a minimum rating sufficient to drive investor demand (e.g. A-) is achievable and (ii) accept the risk of any price increases associated with failing to eventually secure the targeted rating.

It should also be noted that authorities may have to compare bond proposals from several bidders. They will therefore need to be able to score differences in placement capability during the bid evaluation phase.

Assessing pricing and managing the pricing risk

At bid and final offer stages of a PPP procurement process, authorities need to evaluate and compare the pricing levels and pricing features of the various financing solutions. This process is complex for bond financing as the pricing of bonds is only firmed-up upon issuance (i.e. at financial close). As stressed above, expert advice is of paramount importance on pricing issues.

In order to be able to carry out a proper comparison of financing offers, an authority procuring a PPP should, in the tender documents, require bidders to submit an explanation of the pricing methodology used for any proposed bond solution (detailing the various pricing components). The pricing methodology should refer, to the extent possible, to market prices for similar bond issues or baskets of bond issues.

When seeking final offers, the authority may consider providing indicative bond pricing data on which bidders can base their offers. Bidders would use such pricing in their financial models to derive the price of their offer. Such pricing data should break down information according to different rating outcomes and other key features of the financing (e.g. maturity).

As bond pricing is market-driven, the risk of price fluctuations between final offers and financial close will in most cases lie with the authority. Contrary to bank solutions (in which the uncertainty is only on the “reference rate” – e.g. EURIBOR), the price risk with bonds applies to both the “reference rate” and the “risk spread”. As a result:

- Risk-sharing mechanisms between the authority and the private partner should be discussed with bidders at an early stage of the procurement process. Such mechanisms may also be left to the bidders’ discretion as part of their bid strategy;
- At final offer stage, the authority should set a pricing range within which the PPP remains affordable and the bonds would be issued. Outside of this range, the authority should retain the prerogative of not concluding the transaction; and

- Post preferred bidder, the authority should require the preferred bidder to track pricing movements and inform it on a regular basis up to financial close.

Timetable

To enable or facilitate the recourse to bond financing, authorities should ensure that the PPP procurement timetable caters for such a possibility:

- Bond solutions require more time to prepare than bank solutions as there is a need to obtain credit ratings⁵, prepare the bond placement documentation, market the bonds with investors and meet regulatory requirements;
- Bond financing may involve obtaining a pre-rating at final offer stage and a final rating at financial close. A rating process typically lasts for about four weeks. However, the preparation of the required supporting material needs to track the progress made in developing a bid. As a result, the process of seeking a pre-rating can only start once the deal structure (e.g. risk sharing, other key terms of the PPP contract) is stable and is unlikely to change materially. Likewise, a final rating can only be sought once the project documentation is virtually finalised; and
- Overall, once a preferred bidder has been selected and the project documentation is finalised, seeking a final rating and marketing the bonds may require four to six weeks over what a bank deal involves.

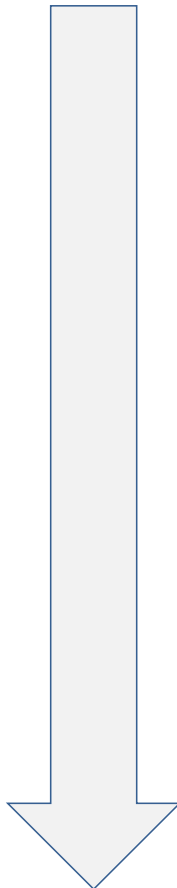
PPP contract termination provisions

In a PPP, the private partner may have to prepay its bond financing, for example in the case of voluntary or authority default termination of the PPP contract. Upon such termination, the bond terms will generally call for the prepayment of the bond and the payment of a prepayment fee to put bond holders in an equivalent position as if the bonds had not been prepaid. This prepayment fee is usually calculated by assuming a reinvestment of the prematurely repaid investment for the outstanding period and subject to a floor on the par value of the bonds (the so-called “Spens clause”). The termination provisions of a PPP contract relying on a bond financing therefore need to reflect this. The relevant contract clauses may follow the UK’s “modified-Spens clause” approach which mirrors the traditional Spens clause except for the setting of the reinvestment rate (the aim being to reduce the breakage costs owed on termination).⁶

⁵ Except for private placements for which a credit rating is usually not necessary.

⁶ See http://www.hm-treasury.gov.uk/d/pfi_spensguidance120506.pdf

Annex – Example of procurement steps for bond-financed PPPs



Pre-OJEU: assess fit for project bonds

OJEU: mention the possibility of project bonds

Bid invitations:

- mention/request project bond offers
- set out the terms of the arrangers' letters of support

Bid submissions: assess offers

BAFO invitations:

- request pre-rating and arrangers' letters of support (placement strategy and pricing building blocks)
- possibly, provide bidders with indicative bond pricing data

BAFO submissions: assess offers (e.g. deliverability, pricing)

Preferred bidder phase:

- opt for a financing solution
- require final rating
- set price range and monitor pricing movements within affordability/value for money range

Financial close