

### Financing PPP/PFI opportunities across Europe

Almost a year has passed since the European financial markets started to really feel the impact of the turmoil that started in the US in late 2007. The subsequent credit crunch constrained most of the European economies. After modest reviews of forecasted growth rates, the economic situation deteriorated on an almost weekly basis.

All of the economic sectors were supposedly affected, but has the PPP market really suffered a downturn? And what are the prospects for PPP projects in the pipeline?

#### Diagnosis

According to data provided in *Infrastructure Journal's PPP/PFI Outlook 2009* (March), we could assert that the PPP market had a good year in 2008. The number of deals was similar to the year before and deal volume increased nearly 30% from €41bn to nearly €52bn.

However, considering the storm other sectors have gone through, this deserves more detailed analysis. In fact, activity gradually diminished between the first and second quarters of the year; with 93 projects completed in the first quarter and just 64 in the second. The European region as a whole also ended with a slight decrease in activity from 2007.

Western Europe can still boast that it is the most dynamic PPP/PFI market worldwide. The UK's abrupt slowdown in the number of PPP/PFI projects that reached financial closure was compensated for by a remarkable increase in the number of deals signed in other European countries. For example, while in the UK 69 deals reached a close in 2008, Spain, France and Portugal together accrued 49 deals. Eastern Europe also showed a significant increase in PPP/PFI projects, continuing the trend from 2007.

Regarding activities by sector, data analysed showed no significant changes. Transport and social infrastructure still accounted for more than 95% of overall investments in infrastructure. In fact, transport sector deals made up more than 60% of the global PPP/PFI market. Not only did the value of projects grow strongly (nearly 73%), but also the number of deals increased (up from 34 to 56). Spain and Portugal emerged as the most active markets, accounting for 21 of those deals.

Regarding social infrastructure, 2008 was marked by a sharp drop (approximately 34%) in the number of PPP/PFI market deals. As the first half of 2009 progressed, the global recession and financial crisis had an increasing impact on the overall infrastructure market, which has seen a decrease of more than 37% in the global volume of investment in comparison to 2008's first quarter figures. Regarding PPP/PFI deals, these have only suffered a modest 6% reduction in deal volume (from €25bn to €23bn), but a positive increase in the number of deals in comparison to the previous quarter (from 66 to 72).

#### Impact of the financial crisis on PPPs

Broadly speaking, the current economic crisis is, according to our understanding, affecting the PPP/PFI market in two opposing ways: one positive and one negative.

##### *The positive effect*

The positive effect is that public budgets are being used to increase public expenditure in order to offset the severe contraction in private investment and consumption.

There is a general consensus that appropriate infrastructure investment is one of the best ways that any public administration can boost economic activity. This is not only in the short- to medium-term, by way of creating demand for equipment and new jobs, but also in the long-term, by positively contributing to the country's increase in economic productivity and competitiveness, as well as encouraging inter-regional and social cohesion.

This consensus has led to several European governments implementing stimulus packages and interventionist policies.

Even though the European Stability and Growth Pact is still in force, the seriousness of the economic slowdown and the rapid rise in unemployment have led to an almost universal breach of the two key criteria that signing members committed to observe in order to maintain fiscal discipline and guarantee a strong Euro currency.

However, European institutions are maintaining that this will be temporary and countries will be asked to return as soon as possible to annual budget deficits and national debt levels within the limits imposed by the pact. Consequently, European Union (EU) member governments have been reminded that they do not have a blank cheque for coping with the present at the risk of neglecting to plan for the future.

#### ***The negative effect***

The negative effect has been the serious reduction in the availability of credit. This crunch has also been reinforced by the overall economic downturn, which has increased the risk profile of private investments, consequently making it more difficult to access credit due to increased financial costs and requested covenants.

This could particularly affect PPP/PFI projects as it is a distinctive feature of these financial-legal structures to achieve the highest gearing level in order to more easily obtain targeted levels of return on equity/return on investment ratios. This situation is also leading to lower competition which, on top of higher weighted average cost of capital requirements (WACC), is making PPPs more expensive. As an example, in Spain we have seen a decrease in the number of bidders from an average of 10-15 to a maximum of two or three per project.

Furthermore, increasing resource to promoters' balance sheets is erasing from the actors' scene a lot of previously active developers, which are currently struggling to reduce their very high debt levels. Those whose financial statements show relative strength are, nevertheless, acting more cautiously and have become much more selective in the number and type of projects they assess and take part in. They are also requesting, as a starting point, a greater level of minimum return.

To summarise, there is greater demand for private investment but less on offer, and the 'product' is now much more expensive for the public sector. As a consequence, it seems to be more necessary than ever before to consider the efficiency that PPP procurement might provide, and any changes in PPP structuring parameters that might allow the achievement of value for money so crucial in the use of public funds.

#### **Market overview**

The *European PPP Infrastructure Forum*, organised by Infra-News and held in London on 28-29 April 2009, was attended by representatives from most of the leading industry players across Europe. They confirmed that PPP/PFI deal flow, despite being impacted by the crisis, had proved more resilient than other sectors. This is largely down to governments needing to boost economic activity through productive investments. Consequently, the PPP/PFI project pipeline remains, although it is moving more slowly.

As previously stated, the number of PPP/PFI deals that reached financial close during the first half of 2009 was down just 6% from the prior year. This indicates that most European governments are determined to keep the PPP deal flow going, or at least with regard to projects that were already nearing completion. These, in most cases, have been helped by the provision of public funds and/or guarantees that filled the gap created by the credit crunch.

Despite the prominence of some governments in acting as co-lenders or providing state guarantees to help reduce projects' perceived risk profiles, governments are not there to replace private financing entities in the role they were playing prior to the crisis outbreak. In essence, the governments aim to restore confidence, as well as acting as catalysts/facilitators for access to funding.

A good example of this is the UK government's creation of a PFI lending unit within the treasury – the Infrastructure Finance Unit – that lends to PFI projects struggling to raise sufficient debt finance on acceptable terms. It was clearly stated that this unit's activity would be a temporary and reversible solution to prevent public infrastructure investment from stalling, and it was designed to complement bank/capital market funds, with the treasury's loans mirroring commercial lenders' loans. Once capital market conditions improve, this unit will immediately sell its loans to the private sector. Another example is the initiative by the Spanish government to support PPP transport projects through public financial guarantees.

Due to the constraints cited above, the PPP market has been forced to consider 're-sizing' projects. This is because the multi-billion Euro projects have been those where governments have been forced to intervene in order to avoid them being scrapped or put on hold, whereas low- to medium-budget projects have achieved financial close more easily because the provision of state guarantees has satisfied lenders.

Another outcome of the situation, which is particularly disappointing for emerging European countries, is that international infrastructure promoters/developers (which in fact are mostly European) have reduced the resources reserved for opportunities in these economies which are so badly in need of public infrastructure.

On a more positive note, this problem has been swiftly recognised. The European Investment Bank (EIB) and European Bank for Reconstruction and Development (EBRD) have carried out an assessment of its likely impact on prospective growth. As a result, they have reinforced their teams and announced that more funds are now available for infrastructure financing through PPP/PFI schemes that create value for money.

Regarding project financiers, despite the fact that some of the financial institutions that dominated the PPP/PFI market previously have significantly reduced or limited their project finance activity, others have reinforced theirs. This way, the financiers' message to other PPP stakeholders is that they are still here and they still have an appetite for well-structured projects – but not as many or as cheaply as in the recent past.

#### **European PPP opportunities coming up**

Regarding short- to medium-term prospects in key European markets:

- The UK government has publicly emphasised its aim to continue resourcing PPP/PFI schemes mainly for transport, waste, education and housing infrastructure projects. Its PFI pipeline amounts to around €31bn – 63% of which is currently at the tender stage – and deals worth approximately €11bn are planned to close in 2009/10.

- Despite the difficult public accounts situation in Ireland and its government's decision to cut the budget's capital programme, existing transport projects in procurement – such as the upgrade of Dublin's Metro network – are going ahead. Education (Irish Schools Bundle 3 has just issued an OJEU notice) and road projects at the structuring or tender stages are also expected to progress, although presumably at a slower pace.
- The Spanish government, despite its fast-growing public deficit, has stressed that it plans to place its national transport infrastructure plan (PEIT) at the centre of its efforts to kick-start the economy. Twenty percent of a total €250bn of investment (mainly in national roads and new high-speed railway lines) is expected to be financed by the private sector. In terms of private development, two road PPPs worth €500m are expected to hit the market in the next few weeks; tenders for design-build-finance-operate-maintain projects for bus lanes in Madrid are on the horizon; as are several rail projects.

Regional and local authorities, which have been largely responsible for making the Spanish PPP market one of the most dynamic in Europe, seem to be committed to continue using PPPs for many of their planned infrastructure projects. For example, 10 light-rail transit/tram projects have been announced and are intended to hit the market in the next few months (with predicted investment of €2bn), and at least 10 regional roads are currently at the PPP structuring stage.

- The Portuguese and French governments have both committed themselves to significant multi-billion Euro high-speed rail programmes, as well as more modest investments in other transport and social infrastructure projects. However, while the €12bn French programme is going ahead (three tranches are currently in procurement), the €9bn Portuguese programme has been delayed pending the outcome of the country's elections in September. Nevertheless, cautious optimism remains at developers' headquarters.

- Serious constraints affecting financial markets in Eastern Europe are casting a shadow over the future of PPP projects in the region. The fact that many of them are multi-billion Euro projects is making it difficult to get them through to completion. Good examples of this include the R1 and D1 in Slovakia, the D3 and R3 in the Czech Republic, the Bar-Boljare motorway in Montenegro and the A3 in Romania. These projects are in tender or have recently been awarded, and private promoters are struggling to get final arrangements for their financing structures in place. However, governments do not seem to be giving up and a project pipeline remains. To avoid any potential delay, the re-sizing and revision of previously designed PPP structures will allow many projects to hit the market in the coming months. Government guarantees will likely be required for the closure of any successful deals.

#### **A need for a fresh approach**

There are several proactive measures that can be taken to encourage the continuation of a reasonable pace of procurement for crucial infrastructure projects all over Europe via PPP/PFI structures.

In essence, what public administrations must cope with in the short- to medium-term is that the 'product' – the PPP/PFI scheme – has become more expensive, not only because of more costly financing conditions but also because of reduced competition.

In order to reduce costs to more manageable levels, the first thing that governments should do is emphasise their role in financing projects, giving a clear and reassuring message that will contribute to a recovery of confidence.

Also, public administrations should devote the necessary effort to providing effective regulation regarding the assignment of risks, and adopt a firm and consistent position when assessing risk impact and transferring it to the area that is best prepared to deal with it. It is worth noting that under current conditions, some risks are no longer transferable or are very expensive to transfer, because risk premiums have sharply increased. As a direct consequence of this, it is fundamental to thoroughly review the structure of PPPs – particularly in terms of size and risk transfer.

Finally, governments should also implement measures that will help to lessen the financial risks. The provision of state guarantees has already emerged as a helpful resource in this sense. However, another approach should be for public administrations to directly provide financial resources – by means of capital grants or loans – so as to reduce the need for recourse to commercial debt and/or equity injections. This would increase the price requested for private participation and speed up financial closure.