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Preserving the Integrity of the PPP Model in Victoria, Australia, during the Global Financial Crisis

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The state of Victoria, Australia, under the Partnerships Victoria policy, uses public-private partnerships (PPPs) as an important mechanism for meeting public service delivery needs in many social and economic infrastructure sectors. Since 2000, 21 PPPs have reached financial close, representing some $A10.5 billion of investment—about10 percent of Victoria's total public investment program. Typically, the private sector designs, builds, finances, and maintains or operates the infrastructure and receives revenue consisting of service payments made by the government that are linked to the project company's performance and the availability of the infrastructure.

As in many markets, in Australia the global financial crisis substantially affected the cost and availability of financing for PPPs. Monoline guarantors, who had played a key role in many projects, were early casualties of the crisis, and their exit required new projects to raise debt from banks. Although the Australian banking sector was not affected by the crisis as substantially as in some countries, short-term funding costs and financing availability were significantly altered by a dramatic fall in liquidity.

As the crisis unfolded, Victoria sought to maintain the integrity of its well-developed PPP model while meeting the changing situation in the financial markets. This approach required limited and carefully considered changes in the way a small number of finance-related risks were allocated and managed in PPP projects.

The Partnerships Victoria in Schools Project

The first Partnerships Victoria project to reach financial close after the start of the global financial crisis was the $A255 million Partnerships Victoria in Schools project. The winning bidder, Axiom Education Victoria, reached financial close in December 2008. Although long-term interest rate swaps were available, long-term debt funding was not. Axiom Education Victoria issued three- and four-year debt and took on the risk created by the need to refinance the debt during the project's life. The state agreed to a variation on its standard position regarding sharing of refinancing gains. The standard position is that the state is entitled to a 50 percent share of any refinancing gains, other than those for scheduled refinancings that have already been priced into the service payments to be received by the project company. In the Partnerships Victoria in Schools Project, the state is entitled to only a 50 percent share of gains earned by Axiom Education Victoria from refinancings following financial close that (a) increase the amount of debt beyond the level assumed in the financial model as at financial close or (b) occur after Axiom Education Victoria has secured long-term debt finance.

The Biosciences Research Centre Project: Continuing Viability of PPPs with Minor changes in Risk Allocation

The next PPP project to reach financial close in Victoria was the $A287 million Biosciences Research Centre Project. The successful bidder, Plenary Research, raised $A225 million in debt from three of Australia's four major banks and fixed its base interest rate for the project's life through interest rate swaps. However, to ensure that the project was bankable, the state and the equity providers agreed to share in market disruption risk, allowing the banks to increase

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their debt pricing in limited circumstances if two or more banks' cost of funds is materially greater than the relevant reference rate. This project was the first Australian PPP in which the state agreed to share market disruption risk (box 1). The state also agreed to share scheduled refinancing gains and losses with Plenary Research.

The Victorian Desalination Project: The Government's Goal of Full Private Finance through a Temporary Syndication Guarantee

An ongoing drought in Victoria has highlighted the importance of water to the economy, community, and environment. The Victorian Desalination Project, with an estimated capital cost of $A3.5 billion, will be the largest desalination plant in Australia, supplying 150 gigaliters of water per year. In 2009, the project was the largest PPP project in the world.

During the bidding process, interaction with bidders and the financial markets indicated that liquidity constraints in the Australian market were likely to prevent a bidder from securing the full amount of finance required for a project of this size. The project's capital cost was more than 10 times the capital cost of the Partnerships Victoria in Schools and the Biosciences Research Centre projects. Because the desalination project had to be delivered within tight timelines to secure Melbourne's water supply, it could not be delayed by the bidders' process of obtaining finance.

In view of these project-specific features, the project team and the bidders recommended—and the state supported—the syndication of bank debt through a form of temporary guarantee at commercial rates. The bidders' lead bank arrangers would provide the project's

Box 1: Market Disruption Risk

Market disruption clauses aim to provide scope and flexibility for lenders to address any misalignment between the base rate that would apply to a loan and the lender's own cost of funds. Historically, lenders in Australia did not include market disruption clauses in their Australian dollar loan agreements because the market originally involved domestic banks lending out of their own (Australian dollar) funding base.

However, as a result of the onset of the global financial crisis, lenders in Australia began insisting on including market disruption clauses in all of their loan documentation, including project finance facilities. In PPP projects, a lender's ability to pass on an increase in its cost of funds is constrained by the cash flow available to the project company. The project company's equity providers may be able to absorb a modest increase in the lender's cost of funds. However, more significant increases may result in a breach (in particular, the required debt service cover ratio) of the project company's loan covenants. Thus, banks and sponsors bidding for PPP projects in Australia during the crisis sought to pass the market disruption risk back to Victoria by asking it to agree to increase the PPP service payments to reflect the project company's increased loan service costs if a market disruption event occurred.

The Partnerships Victoria Unit within Victoria's Department of Treasury and Finance took the view that lenders may be able to mitigate the risk through prudent management of funding sources, and the project company may be able to mitigate the risk by refinancing if one of its lenders is affected by market disruption. However, the unit also recognized that it may be prudent for the state to share the risk if the sharing mechanism met the following criteria:

1. *Market disruption* should be narrowly defined to ensure that the market disruption mechanism is invoked only where genuine market disruption occurs—not, for example, where a bank's cost of funds has risen for other reasons, such as concerns about the bank's financial position.
2. If market disruption occurs, the project company must be obliged first to seek to replace the offending bank, typically through refinancing.
3. If the offending bank cannot be replaced, the project company should bear the initial cost increase under the lender's market disruption clause.
4. If necessary, the government will meet the increased cost above an agreed threshold, but it will require a right to be reimbursed by the project company (for example, from future free cash flow that would otherwise be available for equity distributions or as a priority share of any future refinancing gains).

remaining debt for a specified term. The state would guarantee the part of the debt that was to be syndicated (slightly under half the senior debt) and would act as a lender of last resort if the debt were not completely sold down within a specified period. Because Victoria has a AAA domestic credit rating, provision of the syndication guarantee was expected to enable bidders to access significantly greater volumes of funds than would be the case without the guarantee (see box 2).

The government chose to use a syndication guarantee rather than other forms of state support for these reasons:

- The support was temporary in nature, with the guarantee in place for only the initial three years of the project.
- The support ensured that the project was fully privately financed at financial close, albeit with assistance of a partial government guarantee, and it provided a strong incentive for the winning bidder to secure full private finance with no guarantee for the longer-term debt.
- The syndication guarantee allowed (a) financiers from the losing bidder to join the winning bidder's team and (b) new investors to participate in the project once the successful proponent—and proposal—were announced.
- If the state did have to act as the lender of last resort, it would be able to exit that role by selling down the debt when market conditions improved.

With the support of the syndication guarantee, bidders for the Victorian Desalination Project could obtain committed finance to meet the full cost of the project. On July 30, 2009, the AquaSure consortium was announced as the winning bidder. It reached financial close on September 2, 2009. More than half of the required debt was committed by 12 debt providers without state support. The remaining $A1.7 billion was provided by banks with support of the three-year syndication guarantee. Following an international road show, 22 new debt providers committed 50 percent more syndicated debt than required for the project. The state's syndication guarantee ended on November 16, 2009, just over two months after financial close. As a result, the project is now completely privately financed for the longer term, and the state syndication guarantee is no longer required.

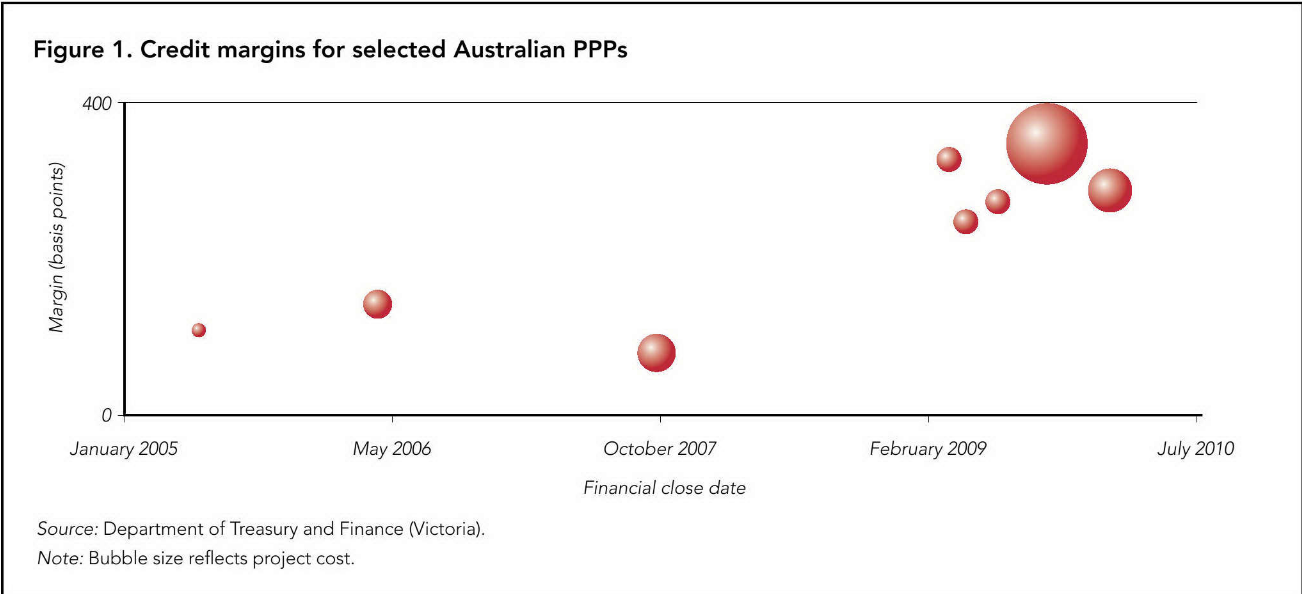
As was the case with the Biosciences Research Centre Project, the state has elected to share in refinancing gains and losses and market disruption risk under limited circumstances associated with the Victorian Desalination Project.

Box 2: How Does a Syndication Guarantee Work?

The onset of the global financial crisis led to a reduction in banks' risk appetites and, hence, their hold positions. Some foreign banks exited the Australian market, and great uncertainty arose as to how financial market conditions would evolve in the short to medium term. In view of these factors, banks were no longer willing to underwrite loans on the assumption that they would be able to syndicate the loans following financial close. The risk that they would be unable to syndicate was too great for them to accept. For smaller projects, bidding consortia were still able to secure committed finance through a "club" of banks, each agreeing to provide a proportion of the required debt that was within their long-term hold limit. However, for larger projects, even forming a sufficiently large club of banks could be difficult, if not impossible.

A *syndication guarantee* is a means by which a government with a strong credit rating can secure committed finance for a PPP when the required debt is not available on a club basis before financial close but is expected to be available after financial close in the syndication market if the risk to the syndicating bank is mitigated. The government agrees to guarantee the part of the debt that is earmarked for syndication, but only while it is held by the initial lender. As a result, the initial lender will treat this portion of the loan as a credit exposure to the government, rather than as an exposure to the project company. Hence, the lender's "hold" limit for its exposure to the project company will not apply to this portion of the loan. Commercial incentives are put in place to encourage the initial lender to syndicate the debt. Once syndication occurs, the government guarantee falls away. If the initial lender is not successful in syndicating the debt within an agreed period, the government steps in as a lender of last resort on commercial terms (but only for that part of the debt intended for syndication).

Figure 1. Credit margins for selected Australian PPPs



Source: Department of Treasury and Finance (Victoria).
Note: Bubble size reflects project cost.

The Peninsula Link Project: Movement Back to Precrisis Risk Allocation

The successful financing of the Victorian Desalination Project has led to improvement in the financial market appetite for future Partnerships Victoria projects. This improved appetite was first seen in the Peninsula Link Project, a $A849 million road project being delivered under an availability payment model.

On January 15, 2010, Victoria awarded the Peninsula Link contract to the Southern Way consortium, with financial close occurring less than one month later. Although market disruption risk is still shared by the state in limited circumstances, refinancing losses will be borne entirely by Southern Way. Victoria shares in any refinancing gains, except to the extent that refinancing has already been assumed in calculating the availability payments to be made by the state. This approach represented a movement of risk allocation back to precrisis arrangements.

Although risk allocation is moving toward precrisis principles, the cost of finance remains significantly higher than before the crisis, presenting challenges for bidders seeking to provide value for money to the state. As figure 1 shows, credit margins are considerably higher than precrisis margins.

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