

# Partnerships Victoria financing options

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## Guidance

### 1. Purpose

This guidance outlines:

- the use of modified financing options;
- the use of State contributions (as a commonly used modified financing option); and
- the refinancing process, including allocating refinancing gains.

This guidance note is publicly available and may be amended from time to time.

### 2. Policy requirement

The *Partnerships Victoria Requirements* state:

Modified financing structures should be considered for specific projects where project outcomes can be improved. Typically public private partnership (PPP) projects are entirely privately financed and effectively repaid over the term of the PPP contract. In certain special circumstances where there exists unusual risks to be mitigated or opportunities to improve project outcomes without materially compromising the fundamental PPP risk allocation, modified financing structures should be considered. An alternative to private financing is partial State contributions either during the Development Phase, upon Commercial Acceptance, or at scheduled refinancings during the Operational Phase of the project.

In consultation with the Department of Treasury and Finance (DTF), procuring agencies should consider State contributions where there are liquidity constraints in the project financing market or where project costs could be reduced by decreasing the level of private capital at risk during the operations phase without materially impacting the integrity of the risk allocation underpinning the contract. It is important to maintain sufficient private sector capital at risk to absorb the remaining risks the private party is taking and to incentivise performance.

The following criteria will be used to assess modified financing structures against a standard PPP financing approach:

- a) risk allocation;
- b) cost and complexity;

- c) preservation of the benefits of private finance;
- d) competitive tension;
- e) alignment of the tenor of finance with the project's risk profile; and
- f) potential for innovation.

## 3. Financing options

### 3.1 State contributions

There is potential for the State to achieve greater value for money, without compromising the performance, outcomes and risk allocation of the particular project, via the use of a State contribution(s). Depending on the nature of the project, contributions may be made during or at the end of the Development Phase or via an early pay down of private sector debt during the Operational Phase of the contract (particularly where contracts are structured such that a significant level of private sector debt remains in the structure during the term).

Procuring agencies should consult DTF regarding the potential for, and optimal quantum and timing of, any State contributions. Options to provide a contribution should be written into the procurement documents upfront, i.e. during the Request for Proposal (RFP) phase, so that respondents can fully consider and incorporate the requirement into their capital structures.

Government may make a partial contribution through:

- milestone payments during the Development Phase, for example where private capital cannot be raised to fully fund a very large project;
- a lump sum payment upon Commercial Acceptance in order to achieve greater value; and/or
- a lump sum payment at a refinancing event during the Operational Phase of the project to achieve greater value.

### 3.2 Funding sources

#### 3.2.1 Bank debt

Bank debt products are the most common source of financing for PPP projects. As banks have the greatest experience in financing infrastructure projects, bank debt solutions are financially efficient and banks can ensure projects are financed within tight procurement timeframes.

##### *Advantages*

- Banks are comfortable financing projects through development and operational phases; and
- Banks have a high level of maturity within the Australian public private partnerships market and understand the process and risks involved with projects.

##### *Disadvantages*

- Typically banks will only offer short to medium term tenors of 4 to 10 years, with the State bearing the risk of changes in interest rates from the first refinancing.

### 3.2.2 Bond financing

Further diversification of financing sources for PPPs may be achieved through bond financing (acknowledging that since the global financial crisis (GFC) the Australian bond market has been very limited).

#### 3.2.2.1 United States Private Placement (USPP) issues

The USPP bond market has exhibited increasing appetite in financing Victorian PPPs. The Western Suburbs Roads Package PPP was financed upfront via a hybrid USPP / bank debt structure. PPP refinancing transactions including the Victorian Desalination Plant, Southern Cross Station and Victorian Comprehensive Cancer Centre have been partly refinanced with USPP bonds.

##### *Advantages*

- USPP bonds are available at long tenor, usually 10 to 25 years, which reduces the private sector's refinancing risk (indirectly benefitting the State); and
- Through increased use of alternative financing sources (such as bonds), and increased competition between bond investors and banks, the banks may be incentivised to provide longer tenor with respect to both in the initial financing of PPPs and at refinancing, as well as improved margins.

##### *Disadvantages*

- USPP bonds typically require a make-whole provision in the event of early repayment of the bonds (upon termination for convenience or Force Majeure). This can potentially be softened during negotiations, and/or avoided through requiring novation of the bonds to the State under the relevant early termination scenarios; and
- USPP bonds tend to favour financing brown field/operating assets and place high premiums on risks associated with green field projects.

#### 3.2.2.2 Inflation indexed bonds

Capital market financing solutions and particularly index linked products were commonly featured in Australian PPPs prior to the GFC. Their popularity was attributable in part to government's preference for a fully indexed service payment over the term, as well as the relatively low cost of bonds compared to other forms of debt at the time.

### 3.3 Debt competitions

Debt funding competitions have historically worked well in markets with standardised underlying documentation and balanced risk allocation. DTF has published standardised Project Deeds (for social and linear PPPs), however projects still have bespoke risk allocations that cannot be predicted by financial providers.

In a typical PPP procurement, debt providers align with a bidding consortium during the RFP process and assist in developing the proposal including technical and financial due diligence of project requirements and associated risks, as well as assessment of subcontractor counterparties, parent company guarantees and the overall financial security arrangements. Through this detailed due diligence process, risk allocation is considered and refined with the debt providers gaining a firm understanding of the bidder's proposal and its construction (delivery/development) and operating plans.

DTF will continue to monitor market development and reception of the standardised Project Deed to identify suitable opportunities for debt competitions.

Market-led proposals present good opportunities to consider various forms of debt competitions that are likely to provide value for money for the State. Depending on the nature of proposals and to enable the realisation of benefits the financiers bring to projects, a front ended debt competition (akin to a normal PPP bid process) that allows for an iterative and parallel approach to raising finance whilst developing the proposal may be optimal.

### 3.4 Base interest rate risk

The State requires the base or reference interest rate under the private party's debt financing arrangements to be fixed from Financial Close to the date of the first refinancing. The private party may elect to implement appropriate hedging arrangements (or fund the Project with fixed interest rate financing instruments) to achieve this outcome. The State will retain the long term risk of variations in the base interest rate after the first refinancing.

In order to encourage the private party to consider alternative base interest rate risk allocation (such as fixed longer tenor financing solutions) or hedging strategies that would deliver greater value for money benefits to the State, the State requires bidders to add a notional risk margin to the base interest rate assumed in the bid financial model after the first refinancing for bid evaluation purposes.

Under this approach the risk margin would be set at a proxy private sector base interest rate swap credit margin (often based on recent PPP transactions and prevailing market pricing). This approach is intended to imply that the State is broadly indifferent with respect to who manages floating interest rate risk at the project level. It reduces the embedded incentive for bidders to pursue short term debt (even if there were no margin difference between a shorter and longer term debt solution), as all things being equal, the earlier the floating rate component (FRC) of the service payment commences, the lower the respondent's total modelled net present cost.

This margin is for evaluation purposes only (to be removed at or before financial close). Procuring agencies should consult with DTF regarding the appropriate risk margin prior to finalising the RFP.

## 4. Refinancing and allocating refinancing gains

### 4.1 Refinancing process

Under PPP contracts, the State's consent must be sought for all proposed refinancings. Management of refinancing consent is centralised in DTF where the subject matter expertise resides.

Refinancing is a financing exercise, with no or very little impact on the actual performance of the PPP asset. The majority of issues arising out of a refinancing are matters for DTF to consider such as refinancing/insolvency risk and State exposure to compensation and termination payments. In order to ensure a rigorous assessment, DTF works closely with the relevant Contract Administrator and procuring agency in assessing a proposed refinancing. Consideration will be given to operational performance matters or contractual disputes that may impact the terms and conditions of the proposed refinancing.

## 4.2 Refinancing gain/loss

A refinancing event can result in either a refinancing gain or refinancing loss. Refinancing gains arise from an improvement in debt margins or debt terms particularly when the project is in steady-state operations. Generally for each project, after the first refinancing the State takes the risk of movements in base interest rates, whereas the private party takes the risk of either a worse or improved debt financing margin. In the event of a refinancing gain, a fifty per cent share of the benefit is returned to the State. Prior refinancing losses suffered by the private party may be recouped from subsequent refinancing gains before gains are shared with the State.

Consistent with existing practice, and at the State's discretion, the State's share in a PPP refinancing gain is to be returned to the Consolidated Fund either as a lump sum or through a reduction to the ongoing service payments, and the procuring agency's financial estimates adjusted accordingly.