

# **PFI Refinancing Conference**

## **PFI Funding Competitions**

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# PFI Funding competitions

- ◆ Project sponsors often call for competitive funding bids:
  - at bid stage
  - at BAFO stage
  - at preferred bidder stage
  - on contract award
- ◆ Sponsors may also change the original funders because they have become uncompetitive or, *e.g.* switch from banks to bonds
- ◆ PFI funding competitions are similar but:
  - carried out in conjunction with the Authority
  - sharing of risks / returns with the Authority

# Documentation

- National Audit Office: “Innovation in PFI Financing: The Treasury Building Project” (December 2001) [*NAO GOGGS Report*]
  
- House of Commons Committee of Public Accounts: “The Use of Funding Competitions in PFI Projects: The Treasury Building” (June 2002) [*PAC GOGGS Report*]
  
- Office for Government Commerce: “OGC Guidance on Certain Financing Issues in PFI Contracts” (July 2002), Section 1: “Ensuring Competition in the Financing of Contracts”

# Treasury Building (1): Timetable

- ◆ Sep 96: Exchequer Partnership (Bovis / Stanhope / Chestertons) appointed as preferred bidder
- ◆ 1997: Negotiations suspended after general election, while a general spending review was undertaken
- ◆ Oct 98: Negotiation resumed provided a funding competition was held. (Construction and maintenance costs were also benchmarked.)
- ◆ Aug 99: 37 year Project Agreement signed for refurbishment and management of the building
- ◆ Aug 99-Jan 00: Funding competition (N.B.: not critical path)
- ◆ May 00: Financial close (governed by planning)

# Treasury Building (2): Objectives / Risks

- ◆ First significant Authority-mandated competition for PFI project funding
- ◆ Aimed at:
  - Obtaining demonstrable best value in the financing market, after the long delay since BAFO
  - Acceptance of TTF Standardised PFI Contract
- ◆ Division of risk:
  - Availability of funding - Contractor
  - Movement in finance terms *vs.* Base Case - HMT (subject to a Unitary Charge cap, and pre-assumed base rates)
- ◆ N.B.: Movements in base interest rates also HMT risk

## Treasury Building (3): Structure

- ◆ Competition run by the Contractor (advised by SocGen), because the Contractor
  - has the obligation to obtain finance
  - has the long-term relationship with lenders
  - is responsible for due diligence
- ◆ But with active HMT involvement (advised by DrKB)
- ◆ Competitive bidding for:
  - bank vs bond debt
  - monoline insurance
  - senior debt ratio, maturity, cover ratios, margins, *etc.*
  - provision of mezzanine debt
  - separate competitions for:
    - due diligence legal advisers
    - redeposit of bond proceeds (GIC) / agent functions

## Treasury Building (4): Results

- ◆ 28 potential funders received ITB - 19 initial bidders (banks, bond arrangers, monolines) - whittled down to 4 banks, 2 monoline insurers and 2 bond arrangers
- ◆ 2nd round between monolines - won by UBS Warburg [WDR] / Ambac
- ◆ Final funding: £128m bond; £6m mezzanine; £7m equity
- ◆ 7% saving to HMT, *via* Unitary Charge adjustment, derived from
  - RPI indexation
  - Lower cover ratios / more aggressive repayment
  - Savings in monoline fees and other front-end costs
- ◆ Acceptance of TTF Standard Contract by a wide range of bidders in the market

# NAO Recommendations

- ◆ Option to hold a competition should always be left open
- ◆ To be balanced against risks:
  - delay to overall closing timetable
  - costs outweigh benefits
  - uncompetitive bids
- ◆ Project documentation should be complete / well-presented
- ◆ Actual use of a funding competition governed by:
  - complexity of project
  - size of funding requirement, and capital spend ratio
  - delays since BAFO / competitive tension
  - qualification of advisers and capability of Authority
- ◆ In any case, Authorities should be aware of Contractors' financing arrangements, and ensure they are competitive, *e.g.* by benchmarking

# PAC Recommendations

- ◆ Funding competitions should always be considered in future PFI projects
- ◆ Therefore Authorities should make it clear to bidders that they reserve the right to hold a funding competition
- ◆ Even if an Authority decides not to hold a funding competition it should scrutinize the bidder's financing arrangements to ensure they offer good value for money

# OGC Guidance (1) Use of Competitions

- ◆ Funding competition may offer better value for money:
  - more competitive terms to a preferred bidder
  - issues less likely to be raised on the Project Agreement
- ◆ Authorities may require a competition in the ITN, or may reserve the right to require one
- ◆ Reserving the right may produce adequate competitive pressure to make a competition unnecessary
- ◆ Competition can be applied to both senior and 3rd party mezzanine debt
- ◆ In general funding competitions should be the exception rather than the rule

## OGC Guidance (2) Suitability of Projects

- ◆ Projects for which competition may be suitable:
  - large projects with significant capital investment (if necessary with partially underwritten bids)
  - new types of project where the views of market players may vary
  - projects with few bidders (where these cannot be re-competed)
  - existing lenders are asking for unnecessary changes in the Project Contract
  - significant delay after BAFO
- ◆ Hence a “standard” project does not need to use a funding competition?

## OGC Guidance (3) Risks

- ◆ Lack of market interest, especially if funding is excluded until after BAFO
- ◆ Banks unwilling to carry out due diligence at BAFO stage, thus resulting in unsuitable Project Agreements
- ◆ Final bids not affordable, or otherwise unacceptable
- ◆ Higher advisory fees because of the extra work
- ◆ Higher advisory fees where the adviser would have been the arranger
- ◆ Delays - but not if competition is well organised and timed
- ◆ Bidder has less incentive to get the best terms, and the Authority ends up negotiating finance

## OGC Guidance (4) Division of Benefits

- ◆ If the Authority is taking all the risk of adverse movements in financing terms since BAFO, the benefit of the competition should also go to the Authority
- ◆ But if the Contractor is, *e.g.*, providing a guarantee that the terms will be no worse than BAFO, a split of the net benefits between the parties may be appropriate
- ◆ Advisers' costs should be borne by the each party and included in the bid costs (? only if a competition is specified in ITN)

# Issues

- ◆ The original bid has to include competitive funding anyway so why make it more complicated?
- ◆ Will funders provide bid support?
- ◆ Will other funders be willing to bid later?
- ◆ Threat or reality? - Controlling deal creep
- ◆ Rôle of the Authority
- ◆ Bid evaluation criteria - financial costs *vs* contract / sub-contract terms
- ◆ Variant bids
- ◆ Division of benefits - Contractor's incentive to undertake the extra work?

# Competitive Funding

- ◆ NAO GOGGS Report also discussed whether the bond was placed at a competitive price - Deutsche Bank analysis concluded that it was (@ gilts + 1.63% = swapped LIBOR + 0.3%)
- ◆ Raises an issue not dealt with in the NAO GOGGS Report or OGC Guidance - how to ensure a competitive base interest rate at Financial Close, the risk of which is on the Authority
- ◆ Draft OGC Guidance on Interest Rate Risk & Hedging published in December 2001 as part of the SoPC package, but consultation deferred
- ◆ Watch this space...