REFINANCINGS – A PFI SUCCESS STORY

BUILDING ON MANY 2014/15 DISCUSSIONS ABOUT REFINANCINGS, THE PRIVATE FINANCE INITIATIVE (PFI) INDUSTRY AND THE PUBLIC SECTOR IN 2016 ARE NOW ALIGNED AND WORKING DILIGENTLY TO REFINANCE THE 2009–2013 PROJECTS THAT WERE DONE AT THE MARGIN HIGH-POINT OF THE RECENT CREDIT CYCLE.

BY MATTHEW HOUSELEY, PARTNER, NEWBRIDGE ADVISORS LLP.

This work is releasing many millions of pounds to share with the public sector and is generating genuine savings through partnership. This is a success story that the PFI industry should be shouting about. Senior debt lending margins for 25 to 30-year projects were contracted at 2%–3% during the recession whereas current rates are more in the region of 1.5%. The potential to unlock value is obvious.

Current examples of success stories include Kirklees Social Housing, Cambridge Building Schools for the Future, Stoke and Staffordshire Fire & Rescue and North Staffs LIFT. Plus, outside of PFI project financings, OFTOs, Thameslink Rolling Stock and a few other non-PFI rail projects. Newbridge is working on a further five (four UK) and is aware of at least 20 others being progressed, including the much talked about Sheffield Highways Maintenance and M25 – the latter of which is rumoured to be stationary with multiple complications.

Newbridge advised the John Laing Infrastructure Fund on the recent Kirklees Social Housing PFI refinancing, successfully completed in March 2016. This involved replacing a Nord LB and Nationwide senior debt finance package closed in 2011 with a Nord LB and Bank of Tokyo-Mitsubishi UFJ financing at a materially lower margin.

Breakage and transaction costs were funded with increased senior debt but this was more than made up for by the margin decrease and the public sector has secured a significant saving from the refinancing. Improving the efficiency of a housing joint venture is clearly a current political hot topic.

Newbridge have been asked in this article to address the technicalities of UK PFI refinancings but most of the points apply to some degree to all sectors and jurisdictions. Below, we talk about technicalities, swaps and refinancing sharing but the bottom line is that there are clear upsides to be released in the projects signed in the 2009–13 period and it is in the PFI industry's interests to work hard to release and share them.

Refinancing drafting and guidance are complicated and are shaping the viability of refinancings. Each takes months of negotiation and, while the window of opportunity is open to deliver the refinancing savings, Newbridge recommends that guidance is not amended!

Technicalities

Whereas historic precedents such as Fazakerley Prison and Norfolk & Norwich Hospital were about gearing up and exploiting long debt tails, current refinancings are largely about margin reductions and as such are relatively simple. Apart from a few rather dry technicalities, including:

- Whether to include any other project agreement changes in the refinancing, such as amending changes in law and insurance risk to latest guidance. The general view is that this is not material and leads to delays.
- Any disputes that need to be resolved, obviously.
- Whether there is a debt service reserve account that can be converted into a reserve facility. This is a material issue and can increase the refinancing gain significantly.
- Increasing debt does increase compensation on termination and this is the most material issue for the public sector, apart from ensuring that they receive a fair share of any gains. Increases to pay for swap terminations is an amount that would be payable anyway and so is readily justifiable. Increases to pay transaction costs are marginal. But gearing up to further increase refinancing gains can be material and they need to be justified against gain sharing.
- Accounting for swap break costs, arranging fees and transactions costs are critical to maximising refinancing gains given that all of these have the potential to impact distributable reserves.

Swaps

The next question is then which of the existing lending banks wish to remain involved and on what basis, and which need to be replaced and

Increasing debt does increase compensation on termination and this is the most material issue for the public sector

with whom. The crucial issue here is which banks hold the interest rate swaps, and how out of the money they are. And if there are RPI swaps in place with a bank that does not want to remain in the project. The impact of swap break costs has eliminated the benefit of a number of refinancings. At a minimum swap break costs depress refinancing gains by reducing distributable reserves.

Current long-term interest rates are at an all-time low so swap breakage costs are at an all-time high. Paying break costs and putting in place a new low rate swap should be relatively neutral but paying the credit spread on the new swap and the margin on the debt used to fund the break costs is not.

Novation of swaps to new banks has been discussed as a solution to embedded swap problems. However, novation involves behind the scenes inter-bank swaps and inter-bank credit risk is expensive. Newbridge is yet to find that long-term novations provide value.

These costs and embedded risk positions are also the reason why capital markets solutions and aggregators have not been an efficient solution for PFI refinancings. There is no avoiding the fact that minimum changes and maximising simplicity drives best value where every change involves triggering material sunk costs.

Refinancing sharing

Once the most efficient refinancing route has been established, the sharing of the refinancing gain needs to be settled. Some interpretation is required here and there is much confusion in the industry across the varying advice that has been discussed, but the refinancing sharing calculation under UK standard form PFI project agreements and guidance can be summarised as follows:

- First, the notional lump-sum refinancing benefit is calculated as a theoretical number as the net present value (NPV) of shareholder payments in the post-refinancing model, net of the shareholder payments in the pre-refinancing model, all discounted at the threshold equity IRR (which is the financial close equity IRR).

This is an iterative calculation because the benefits of the tax deductibility of the authority's refinancing share need to be taken into account (this point is not generally drafted in the project agreement but is well known and included in HM Treasury guidance).

- The notional lump sum is shared with the authority 50% for the first £1m, 60% for the next £2m and 70% thereafter. This was changed to 90% in 2012 and any contracts with such a high sharing are obviously unlikely to be refinanced. Prior to 2009, the sharing was 50:50 with the code of conduct applying prior to 2002.
- The timing of when the benefit is paid out is then to be determined. If the shareholders choose to have an element paid out in a lump sum up-front, then the authority can choose to match this. However, given that the gains largely arise over time (through margin reductions), it makes sense for gains to be paid to all parties over time.
- Where the authority is paid over time their share is a deduction from the unitary charge, so it is fixed in nominal terms, sculpted annually, and is senior even to operating costs and debt service – ie, it is paid before operating costs. 2007 guidance states that because their payment is lower risk the deemed interest earned on this deferred payment should be at the long-dated swap rate "plus [x]%".

Partnership

We have set out above the practicalities of refinancing PFI projects. However, it is vital to realise that it is virtually impossible to execute a refinancing at a reasonable cost without all parties agreeing to it. This includes all shareholders, the authority project agreement counter-party and the banks, and often even the sub-contractors. Given that a refinancing tends to be a diversion for most parties, the larger the project and the more complex the refinancing, the less chance there is of success. Refinancings have to be a genuine partnership between all parties.

The PFI industry has worked hard to establish a firm but fair delivery framework for refinancings that achieves a positive result for all involved. And importantly achieves a success story for PFI, delivering material partnership benefits for the UK. We should shout about it. ■

© Alex Nevin-Tylee - https://commons.wikimedia.org/wiki - A Thameslink train