THE PRIVATE FINANCE INITIATIVE SECTOR IS BOOMING. BUT HOW DO YOU GO ABOUT RATING SUCH PROJECTS? **CRAIG JAMIESON** OF STANDARD & POOR'S EXPLAINS.

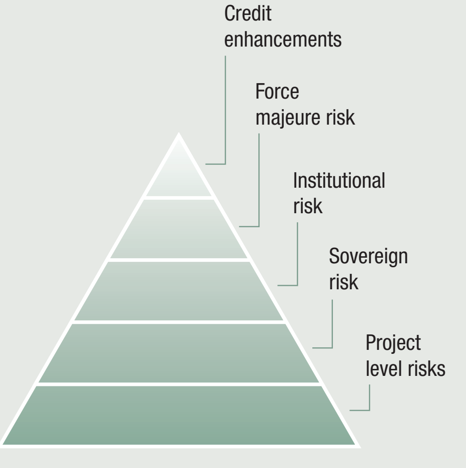
RATING PFI IN THE UK

Since the launch of the private finance initiative (PFI) model in 1992, more than 450 projects have been constructed and are operational; the majority on time and to budget. Their combined capital value is about £40bn. A diverse range of assets has successfully used PFI techniques, but they have largely followed the UK government's priorities, such as healthcare and education. Significant periods of under-investment in public assets, together with an ageing public sector infrastructure, have resulted in a backlog of maintenance and asset delivery. PFI has emerged as an accepted technique for leveraging private sector finance to assist in the delivery of public sector infrastructure.

DEFINITION OF PROJECT FINANCE. PFI is a sub-set of project finance, and Standard & Poor's uses the same methodology and rating criteria to assess PFI project risks (see *Figure 1*) as it would for other forms of project finance. In our view, project finance is a collection of contracts and, in PFI, the key contract is most often a concession contract or project agreement between a special purpose entity (SPE) and a government department or entity (generally 'the authority'). The SPE is generally a highly-leveraged entity – debt-to-equity ratios are typically 90% debt to 10% equity – and is often owned by a combination of subcontractors and financial investors (the project sponsors).

The obligations to design, build, finance and operate the asset for the period of the concession are written into the project agreement. Risks of cost overruns and delays (except for delays outside the SPE's control, such as *force majeure*) are passed from the authority to the SPE under a date-specific, fixed-price contract. The SPE has little flexibility so it needs to ensure that the risks passed to it under the concession contract are adequately transferred to the subcontractors responsible for the execution of the construction, services and lifecycle contracts.

FIGURE 1
FRAMEWORK OF PROJECT ANALYSIS.



- **Project-level risks.** Standard & Poor's assesses project, operational and financing contracts that, along with the project's physical plant, serve as the basis of the enterprise. The technology, construction and operations of the project are then reviewed, together with an analysis of the project's competitive position in its market. Other risks include an evaluation of project counterparties, legal structure, cashflow and financials.
- **Sovereign risk.** Projects are generally constrained by the foreign currency rating of the country in which the project is located. This is not a constraining factor for UK PFI projects because the sovereign rating on the UK is 'AAA/Stable/A-1+'.
- **Institutional risk.** Although not usually relevant to UK PFIs, certain country-specific risks will require more detailed analysis to ensure lenders have appropriate remedies to protect their interests.
- ***Force majeure*.** If not properly compensated for, *force majeure* events (unpredictable events outside the control of the contracting parties that are not attributable to any act or failure to act by the party concerned) can quickly lead to a project default. In UK PFI projects, this risk is most often shared between the public and private sector.
- **Credit enhancements:** In UK PFI, these have generally taken the form of monoline insurer guarantees, but multilateral agencies may offer insurance programmes to cover political and commercial risks.

PFI IS A SUB-SET OF PROJECT FINANCE, BUT HAS UNIQUE CHARACTERISTICS. Overleaf are some of the characteristics that are unique to PFIs.

- **Strategic importance and essentiality of asset:** Public sector assets, such as the General Communications Headquarters project and many defence assets, are often unique and difficult to replace or replicate. Strong features are often incorporated into a project contract to ensure it can survive robust downside scenarios before defaulting.
- **Purchaser credit strength:** Not all UK public sector bodies are equated with the AAA-rated UK sovereign rating. NHS trusts and universities, as project counterparties, generally have investment-grade ratings but may have lower ratings than the project and therefore constrain the project rating. Direct government departments, such as the Ministry of Defence and the Home Office, are considered to have the same credit quality as the UK government.
- **Limited construction exposure:** Construction risk is often somewhat mitigated by the use of tried-and-tested building techniques with proven technology and suitably qualified contractors. Construction contracts are mostly fixed-price, date-specific turnkey contracts with realistic budgets and schedules. Credit enhancements, such as letters of credit and surety bonds, provide further support, particularly where construction is complex or there is reliance on a weak contractor. The ability to replace a failing contractor without causing interruption to project cashflow is also important.
- **Availability-based revenues:** Most healthcare, defence and accommodation UK PFIs receive revenues from the government counterparty, regardless of asset usage. Making a facility available for use is generally the trigger for the unitary charge to be paid to the SPE, although this can be reduced for unavailability or poor performance. The relatively stable and predictable project cashflows and the lack of market risk are key strengths of UK PFI projects. Risks, such as change in law and unavailability of insurance, are generally shared between the parties.
- **Operations and services:** Services can range from simple, such as grounds maintenance and cleaning, to complex, such as sterile services and managed equipment, and protections such as resetting a subcontract price on a regular basis (benchmarking or market testing) are positive features. Lifecycle maintenance risks over the life of the project have yet to be fully tested, as most projects have not yet reached this phase.
- **Legal and financial features:** Most projects have weak debt protection measures, such as high leverage, low interest cover ratios and equity distribution lock-up mechanisms. Most also provide lenders the protection of a fixed and floating charge over the contracts, together with step-in rights.

TRENDS IN FUNDING PFI PROJECTS. PFI funding in the UK has been dominated by the bank market in terms of number of transactions. In the past few years, however, the number and size of debt issues have increased substantially. Coventry and Rugby Hospital Co PLC has £407m of senior debt, for example, while RMPA Service Plc at Colchester Garrison has £680m of senior debt. Larger amounts of debt to underwrite mean that the capital markets can often provide a price and term advantage over traditional bank funding. Publicly traded PFI debt has typically been limited to index-linked bonds that attempt to match an index-linked revenue stream with a debt profile with similar characteristics, while others have been fixed-rate bonds. The index-linked market is not as liquid as the fixed-rate market and can constrain the amount of index-linked debt to be issued.

‘FUNDING COMPETITIONS, ESPECIALLY FOR LARGER TRANSACTIONS, ARE INCREASINGLY COMMONPLACE AS THE PUBLIC SECTOR SEEKS TO MAXIMISE VALUE FOR MONEY’

Furthermore, the public bond market is dominated by the monoline insurance companies, which provide financial guarantees of full and timely payment of interest and principal. The monoline’s guarantee is sufficient to equate the project debt rating with that on the monoline. All of the monolines wrapping PFI debt in the UK are currently AAA-rated. SPEs’ savings through issuing AAA-rated debt are greater than the cost of the monoline insurance premium. Funding competitions, especially for larger transactions, are increasingly commonplace as the public sector seeks to maximise value for money.

Standard & Poor’s is involved at all stages of a project’s life cycle, from pre-bid evaluations to final ratings. An investment-grade credit rating is considered necessary by many sponsors, monolines and investors, and there is an increasing trend for sponsors and funders to seek an indicative credit rating as part of the normal commercial negotiation process.

THE EMERGENCE OF A SECONDARY MARKET AND GROWTH IN REFINANCING. After more than 10 years, the PFI market appears to be maturing in several respects. Many projects have performed, or are considering, a refinancing of initial debt, often replacing bank debt with capital markets debt after construction completion. The completion of construction does not remove all risk from a project, and refinancing often increases a project’s level of financial risk because of weaker post-refinancing debt protection measures.

The emergence of a secondary market for PFI is likely to broaden the number of sponsors, lenders and investors participating in PFI. This secondary market for project debt and equity has been slow to develop, however. This is partly because of the lack of homogeneity among projects and the time required to evaluate and price inherent risks, and partly a result of the concentration of sponsors, funders and investors. We believe that transparency and information sharing is essential for the creation of a meaningful secondary market. We will continue to publish underlying project ratings, presales and commentary on the sector.

ALTERNATIVE GOVERNMENT FUNDING OPTIONS. Her Majesty’s Treasury (HMT) has also considered alternative funding for PFI projects. The most significant is the intended issue of government gilts to fund some projects. By this means, HMT hopes to achieve greater value for money by eliminating the funding premium incurred through the cost to the private sector of accessing the financial markets and minimising the negative carry associated with an upfront debt issue. By acting as senior lender to a project, HMT would transfer project risk to the private sector by way of a credit guarantee from a suitable private sector credit provider.

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