risk management
COMPLEX PROCUREMENTS

Making a contribution

Executive summary

- Public authorities are increasingly open to using complex commercial structures in their relationships with suppliers.
- The delivery vehicle for most PFI contracts is a special purpose company with two key financial risks: interest rates and inflation.
- Evaluation of public-sector procurement decisions revolves around value for money and affordability.

JONATHAN CLARKE EXAMINES THE MANAGEMENT OF FINANCIAL RISKS IN COMPLEX PROCUREMENTS.

Public authorities have become increasingly open to using complex commercial structures in their relationships with suppliers. A key example is the Private Finance Initiative (PFI), but there are others including various types of Public Private Partnership (PPP), long-term service contracts, and vehicles for regenerating disadvantaged areas. At the same time, relationships between public bodies are being put on a more commercial footing, with a search for competitive tension without privatisation.

The government recognises that private-sector methods can contribute to the delivery of public services. The key driver is value for money. This demands careful thought about what is required and what the incentives should be.

There is a range of issues associated with these developments, but this article focuses on financial risks and the use of derivatives. Much of it relates most directly to PFI projects, because PFI is a standard model to reflect the strong market of over 600 signed projects. But the principles apply more widely. See *Figure 1* for a typical structure.

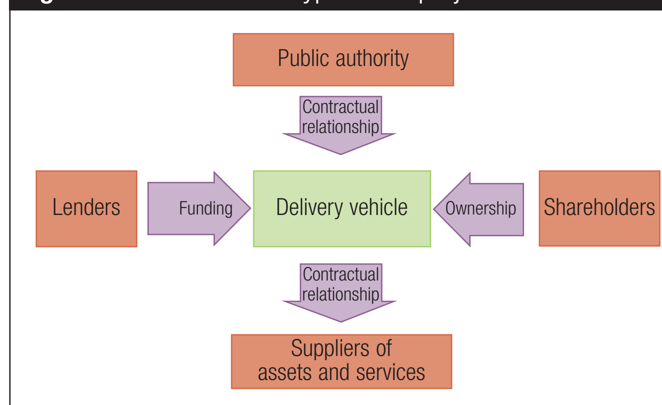
In PFI, the relationships in *Figure 1* are governed by a detailed contract between the delivery vehicle and the procuring authority, complemented by other agreements between the various parties. The PFI concept does not require a particular financial structure but given the capital investment and the existence of a robust, long-term payment stream, limited-recourse project finance is most common, with a 90:10 split between senior funding from banks or the capital markets and equity from sponsors. Outside of mainstream PFI, the public service objectives of the enterprise may be managed through some other route, such as the ownership stake taken by the public sector in the Building Schools for the Future programme.

The commercial sector has seen a significant increase in the range and volume of financial instruments for hedging and managing commercial risks. These instruments can also add financial stability to long-term relationships with government.

While a public authority would not expect to sign a derivative contract directly (they would normally be part of the funding package), their presence can still affect an authority's financial position. For example, flexibility is an increasingly important concept in public procurement; where interest-rate or inflation derivatives are used within the funding package, the flexibility of the financial arrangements also needs to be evaluated. Where the price of a funding proposal is considered, the pricing of any derivatives involved will affect the competitiveness of the price overall.

WHAT FINANCIAL RISKS ARE RELEVANT? Most PFI contracts are for the delivery of services supported by a specified capital asset or group of assets, such as a hospital or group of schools, for 25 years or thereabouts. The delivery vehicle is usually a special purpose company, the funding requirements are based on the fixed price of a turnkey construction contract, and a detailed financial model determines the price to the authority as a monthly performance-based charge. There will normally then be two key financial risks facing the special purpose company: interest-rate risk, should the funding be floating-rate; and inflation risk, where there is a mismatch between the sensitivity of costs to inflation and the sensitivity of revenue. The treatment of inflation also often involves commercial arrangements

Figure 1: Structure of a typical PFI project



such as regular benchmarking or market testing of some costs.

Interest-rate or inflation swaps are commonly proposed to mitigate these exposures. It is sometimes argued that as the government has deep pockets it should take all such non-project-specific risks. But individual parts of government may have shallower pockets and shorter arms (to mix metaphors), and it is the private sector which has developed expertise in managing financial risks.

VALUE FOR MONEY, NOT LEAST COST Derivatives allocate risk, for a price. While the market in interest-rate swaps is one of the deepest and most liquid, the same cannot be said for more complex interest-rate products or inflation products. The most well-established approach is not always the best, and there are a variety of issues to be considered. The most obvious is pricing.

Pricing The interest-rate swap for a PFI contract commonly attracts a credit margin of 8-12 basis points, compared with the margin on the underlying debt of 50-80bp, so it is a not insignificant part of the overall package. There is also the bid-offer spread to consider. All of these costs will be reflected in the price paid by the procuring public authority, and they need to be clear that some downwards price pressure has been applied.

There are a range of ways to apply competitive tension to get the best price, from seeking a clear narrative from bidders about the competitive process they have used to develop their funding solutions, to running separate competitions for funding after selection of a preferred bidder, to requiring the use of particular structures and products. HM Treasury has suggested using a fronting bank structure to separate the pricing of the underlying swap from the pricing of the swap credit margin, which has potential benefits over the more standard benchmarking of the underlying price.

Contractual relationship The most common interest-rate product used in PFI is the simple Libor vs fixed-rate swap, but other products such as interest-rate caps have been used in PPP projects – where there is uncertainty about the future cashflow profile they can help ensure financial robustness while also giving flexibility.

There are further alternatives. Authorities might accept some exposure to interest-rate movements if the risks are difficult or expensive to hedge, or the overall funding package might be designed to allow greater robustness without hedging – for example, in terms of the gearing. Lower gearing allows more flexibility in terms of commercial risks generally, to the extent that corporate sponsors take a different view to third-party lenders. Inflation risk is perhaps a more familiar commercial risk for equity or an authority to take.

Recent PFI/PPP innovations include fixed-price authority break points within a long-term contract, variants on the use of corporate rather than limited-recourse finance, embedded refinancings (where the initial funding is on a corporate basis but external funding is anticipated subsequently). Most of these require a clear picture of how derivatives are executed and priced. Financial innovation can be used by bidders to generate competitive advantage, and this is likely to require in-house treasury skills as well as skilled advisers.

PUBLIC-SECTOR EVALUATION Evaluation of public-sector procurement decisions revolves around value for money and affordability. Value for money evaluation normally revolves around the calculation of net present costs comparing the proposed deal to other investment and procurement options. Key to value for money appraisal is HM Treasury's Green Book discount rate, of 3.5% real, which tends to be combined with an inflation assumption of 2.5% to give a discount rate of just over 6% nominal. The 3.5% rate is likely to differ from the cost of funding and the discount rates used to price derivative contracts. In principle, authorities also seek to monetise non-cash items (such as flexibility) in the evaluation. Financial engineering for its own sake is unlikely to contribute to value for money, but bidders still need to appreciate that the ability to move cashflows backwards and forwards in time can have an impact.

Affordability is more linked to budgets and accounting presentation; value for money assessment is largely carried out in terms of cashflows. Although decisions should be based on value for money and not engineered purely to meet affordability objectives, it is only those projects that are affordable that are deliverable. Affordability in the public sector is a complex issue, but most authorities will have budget available under a variety of headings and based on discrete years or periods. The main categories of budget are normally distinct capital and revenue budgets. Public-sector organisations normally have to recognise a cost of capital charge against their revenue budgets, to reflect their use of public capital.

COMPLEXITY The relationships between different parts of the public and private sector (and the voluntary sector for that matter) are growing more complex. Improved efficiency and effectiveness in public service delivery will remain high priorities for all tiers of government, with great emphasis placed on a proper evaluation of value for money. Achieving value for money starts with a clear statement of requirements by contracting authorities but requires two-way communication.

The complexity of derivative instruments used to manage financial risks presents challenges to all parties. For the private sector, the onus is on achieving full transparency and matching proposals to the needs of their client.

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