BOYADJIAN & ASSOCIATES

PROJECT FINANCE & MANAGEMENT CONSULTANTS

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Financial Issues for PPPs

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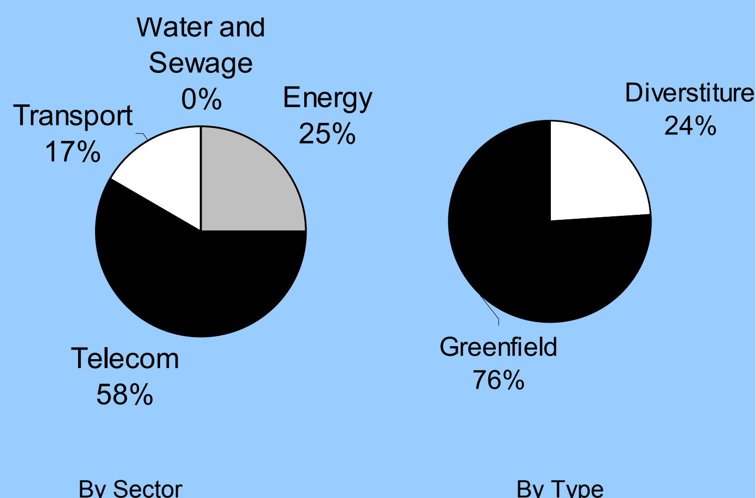
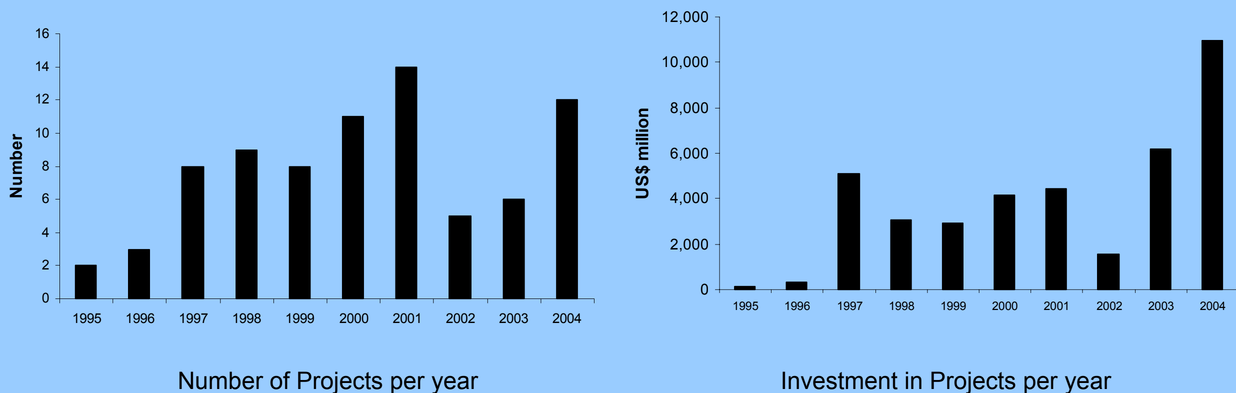
With better public services at the heart of Government agendas, the need for private sector involvement in their delivery and management has intensified. The pioneering role of the Private Finance Initiative (PFI) brought the private sector into asset financing, procurement and management, while Public Private Partnerships (PPP) have brought the private sector into areas of public sector business where more service provision and greater flexibility is required.



MENA PPP Projects: Growing Number and Increasing Investments



Number of Projects per year

Investment in Projects per year

Source: The World Bank Group

Partnering transactions require finance but this is likely to come from a broader range of sources than traditional PFI limited recourse debt. The source of funding remains a critical consideration in structuring a partnered deal. But with partnering it is less a question of scoping a project that fits the single project finance lending source, as understanding the needs and the resources of the funders.

Private Sector Finance

Private sector sources of funding are usually a feature of PPPs. This reflects the fact that, by providing the finance, the private sector is able to optimise the mix of initial and through-life spending and will also engage in rigorous risk management procedures. An important step is to develop the contractual and risk sharing framework that will allow the private sector to finance the capital investment underpinning the service delivery.

Critical questions that must be asked in designing this framework include:

- What assets will the partnership be required to finance in order to meet the service requirement?
- Will the public sector require the assets to be returned at expiry of the partnering arrangements or upon termination of the partnership?
- Do the assets have an alternative use or user from which value could be extracted?

Such questions will begin to determine how far the partnership must rely upon contractual arrangements with the public sector in order to raise finance, and how closely the partnership might mirror a more conventional private sector business. If, as will more often be the case, the partnership will, to some degree, be relying upon public sector contractual support, then the types and level of risk that are transferred to the partnership must be clearly defined and well understood. In addition, the scope for the partnership to manage risk needs to be understood. Where the contractual arrangements can be made to help risk management, this should be factored into the project structure. For example, if different project activities have differential risk profiles, then these can be placed in separate subcontracts and delivery vehicles to promote their efficient management and competitive financing.

A variety of funding methods has been used across the public-private spectrum. For privatisations, where entire undertakings are transferred to the private sector, funding has generally come from the balance sheet of the new shareholders. Part of their consideration for the shares may be investment into

the privatised entity. Where the business plans are credible, the entity may raise debt in its own right, secured on its own, or its shareholders' assets.

In contrast, the most common form of funding to date for PFI, and similar infrastructure projects, has been via bank debt loaned to the private sector project company, and combined with a small element of risk capital from the sponsors or other shareholders. The key to raising significant proportions (up to 90% being common) of the finance as debt has been the existence of comprehensive and clear allocations of risk between each of the parties and, in particular, away from the debt and asset-holding vehicle. These limit the risk to the project cash-flows and make borrowing on the back of them feasible, with associated financing cost savings.

As public-private deals move into areas where greater flexibility is needed and the public and private sector are jointly involved in projects, there is less clear definition up-front of each party's risk and responsibility. In order for a true partnership to fulfil its aspirations and objectives, it is likely to require a significant degree of operational and financing flexibility. Without this flexibility, it will be difficult for the partnership to adapt to changing circumstances; fund projects if they differ from those originally conceived and integrate services as seamlessly as may be desired.

At a simple level, a degree of financing flexibility can be achieved by keeping banking lines of credit committed and available for future use. Keeping committed lines of credit is only going to be achievable and represent value for money if there is a high degree of certainty with regards to the size, timing and use of the future funding need.

Other departures from standard PFI financing arrangements must therefore be considered if the partnership is to achieve the flexibility to respond to new funding requirements and operational demands. This may take the form of capital structures that involve higher levels of shareholder-provided finance. Another solution is to require the partner vehicle to retain earnings in reserve to fund certain types of expenditure. Finally, the project can simply provide for subsequent fundraising on the terms provided in the financial markets at the time.

Number of PPP MENA Projects by Type:

Financial Closure Year	Concession	Divestiture	Greenfield Project	Management and Lease Contract	Total
1990	1	0	0	0	**1**
1991	0	0	0	0	**0**
1992	0	0	0	1	**1**
1993	0	0	2	0	**2**
1994	0	0	4	0	**4**
1995	0	0	2	0	**2**
1996	1	0	1	1	**3**
1997	3	0	4	1	**8**
1998	1	1	7	0	**9**
1999	3	0	3	2	**8**
2000	1	2	8	0	**11**
2001	6	0	8	0	**14**
2002	1	0	2	2	**5**
2003	0	1	5	0	**6**
2004	0	0	7	5	**12**
Total	**17**	**4**	**53**	**12**	**86**

Source: The World Bank Group

Where provision of assets of a similar nature under a consistent risk allocation framework is a feature of an overall capital programme, framework funding structures may be used. These allow individual projects to access a pool of funding which is available for the programme as a whole. Such framework finding structures, which have been used in the past in housing and oil and gas, increase certainty and reduce complexity for fundraising in PPP programmes.

It is likely, therefore, that the partnership will be funded not simply by debt but by a mixture of debt and other funding sources. This will, in turn, have an impact on cost, as such funding is typically more expensive than debt. It also reduces the availability of funding. As an alternative, the public sector may choose to finance part of the partnering.

Public Sector Equity

One common model for partnership involves the public sector client co-investing directly with the private sector contractor in a newly formed limited company. In order to protect this investment, there will frequently be public sector representation on the company's board of directors. This representative will nonetheless have a fiduciary duty to protect the interests of all shareholders.

Where there is an exact alignment of public and private sector objectives, for example in a joint venture to exploit a piece of development land for maximum value, the interests of all shareholders will be consistent. However, where the public sector is the client of a company in which it also takes a role as shareholder, the issues will be more complex. As shareholder, and commonly with the associated right to appoint Directors, the public sector will have greater access to information about the PPP's performance and will be more closely integrated into its governance. However the issue of fiduciary duties become more important.

An example of such a situation would be in the future pricing of a new investment or service that the public sector wishes to deliver via the partnership. In its capacity as client, the public sector will be seeking to transfer as much risk at the cheapest price possible to the partnership. In its capacity as shareholder, its expected investment return will be maximised by a completely opposing set of conditions – minimum risk transfer for maximum price.

This dual client/shareholder role has the potential to result in conflicts of interest that, from the perspective of the private sector, could manifest itself in public sector behavioural uncertainty. Such uncertainty may be considered a risk by private sector equity investors and debt funders and they may incorporate pricing premiums in their returns as compensation. It is therefore in all parties' interests to take a keen interest in understanding and structuring the partnering relationship in such a way that will allow as much clarity as possible as to how the partnering vehicle is to be governed.

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