Summary of the 6th Annual Network Meeting of Senior PPP officials, Paris, 15-16 April 2013[1]

Increasing level of attendees

The Network meeting was well attended by 80 delegates from 24 countries and the IMF, World Bank, EIB, AfDB, IADB, Standards and Poor's HSBC, Maquarie Bank, Oxford University and others. *There was an increase in the seniority of the officials and private sector representatives attending.* The chief officials for PPP/concession policy in Ministries of Finance from the UK, France, Germany and Turkey attended as well as the CEO of PPP Canada, and the new head of the PPP Unit in Portugal. Key countries such as US (Treasury) and Russia (Ministry for Economic Development, National Development Bank) were represented at head of division level. Below is a summation of the key points discussed.

Developments in the PPP market: decreasing volume, increase in the use of export credit, shadow banking and public sector initiatives to lower the cost of finance.

The current PPP market is characterised by a general decline in deal volumes. The total PPP deal volume fell from around USD 58 billion in 2011 to USD 44 billion in 2012 according to PwC. In Europe 2012 saw the lowest volume and number of deals for a decade and a sharp decline year on year (from EUR 17.9 billion to EUR 11.7 billion) according to the EIB. The main reason for the decline is that debt markets are struggling in the light of weak sovereign ratings, Basel III capital requirements, general de-leveraging and risk aversion. The general policy environment is uncertain at this point which has held back investors.

Transport remains the most active sector for PPPs. It has exhibited relatively little decline since 2010 whereas the social sectors have declined sharply. Looking at project finance volumes, *of which PPPs are a sub-set*, the biggest sectors in 2012 were project finance power (USD 66.3 billion), project finance oil and gas (USD 60.2 billion) and project finance transport (USD 40.5 billion) according to PwC. All three sectors have exhibited marked volume growth since 2009.

The needs for PPPs in transport are certainly there in both developing and developed countries. For instance, Europe faces enormous infrastructure investments to meet the Europe 2020 Strategy. Standard and Poor's estimates the need to be between EUR 1.5 trillion to EUR 2 trillion. In Asia the needs are even greater. According to the Asian Development Bank Asia requires USD 750 billion in infrastructure investment annually. However, traditional lenders are under severe economic pressure and the market is struggling to find a structure that meets both equity sponsors' requirement and investors' demand for low-risk bonds.

A number of developments were highlighted in response to this. First, *export credit agencies are becoming a major source of lowering the cost of PPP finance*. This is increasingly effective for Japanese, Korean and Chinese contractors and has lead to some concern on market concentration. Second, *there is a rise of alternative 'shadow banking[2]' financing in infrastructure*. New investors

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[1] For more information see: www.oecd.org/gov/budget/ppp.

[2] Standard and Poor's defines shadow banking as the system of finance that exists outside regulated depositories, commercial banks, and publicly traded bonds. Typically, shadow banking participants differ from traditional banks in three important ways: they do not usually operate under bank regulatory supervision; they do not normally benefit from capital support; and they do not benefit from the liquidity support available to regulated banks, such as the ability to borrow from central banks. Shadow banking is a potential source of long-term committed capital; may help to reduce the cost of borrowing for projects and introduces financial innovation into the marketplace. On the other hand the opaque nature of the shadow banking system could lead to a build-up of systemic risks; there is a lack of established and tested funding mechanisms in shadow banking; and a dearth of performance data for new and growing industry sectors acting as barriers to growth.

have entered the marketplace (for instance Blackrock) or stated their interest in doing so. For instance, in the U.S., a quarter of all project lending last year came directly from alternative sources. MENA and Asia Pacific, follows a similar pattern. In 2012 over USD 20 billion in infrastructure debt involved alternative funding sources and the trend is set to continue. Macquarie Bank is in the process of building a large source of funding servicing the global infrastructure market with bank-like lending products funded by a club of large long-term investors. Third, *various initiatives have been put in place by the public sector in order to make PPP financing more available for new projects*. The EIB has launched a new project bond initiative. The EU is contributing €230 million in capital for the pilot phase of the bond initiative which means at least €4.6 billion of senior debt could be made available. The UK is set to re-introduce its guarantee and financing scheme as well as the public sector taking equity stakes in the projects companies (see below). While government and market innovations can shift project financing from bank to capital markets, this in itself would not be sufficient to improve the credit quality of a project with weak fundamentals. Likewise, better financing opportunities should not deflect attention from the public sector's constant attention to budget/user affordability, value for money and the transparent treatment of PPP liabilities.

The UK and France are updating their PPP framework in light of concerns from stakeholders and recent experiences.
The UK government has identified a number of concerns with the PFI/PPP framework. In some cases the return to private equity has been too high. Off-balance sheet classification has meant that there have been budgetary incentives for departments to use PPPs. As the majority of PPP projects are excluded from Public Sector Net Debt there has been a lack of transparency of future liabilities to the taxpayer. Other issues include that long-term contracts for certain services can be too inflexible given the changing needs of the public sector and there have been questions about value for money from fixed price lifecycle maintenance contracting over 25-30 years. Certain risks transferred to the private sector may not have provided value for money in that they resulted in higher risk premiums, inefficient capital structure and/or capital reserves being maintained. Finally, the PPP procurement process has often been lengthy and costly for both the public and the private sector. In response the government launched a new approach to PPPs (PF2) in December 2012. *The new approach includes the Introduction of public sector equity in the SPV to enable a better partnerships between public and private sector; improving transparency; certain risks previously transferred to the private sector will now be retained by the public sector; projects will be structured to facilitate access to capital markets or other sources of long term debt finance; procurement will be faster and less expensive.* The private sector will be required to provide actual and forecast equity IRR information which will be published. Another notable initiative is that the UK will once again start to provide financing in the form of guarantees in order to unplug the pipeline and lack of interest from banks.

Since 2004, when **France** changed its legal framework, PPPs have been on a strong trajectory. Over 500 PPP projects have been launched from 2004-2012 representing an aggregate amount of investment in excess of EUR 16 billion. However, this still represents less than 5% of total investment. *While 90% of projects have been delivered on time and budget it is still too early to assess the operating performance*. Challenges for PPPs in France come from decreasing fiscal space in procuring authorities, the drying up of traditional financing sources and a perceived political opposition to PPPs. There have been increasing concerns regarding the long term adaptability and sustainability of PPPs. PPP deals are complex to assess, conduct, structure and control. *There may be a lack of competition in the French market characterised by an absence of foreign bidders.* The EUR 320 million Evry Hospital project is currently failing and bringing all these issues to the forefront. The recent Gallois report emphasized the need for more selectivity required upstream in launching new projects. This is mirrored in the new budget sustainability study that has been required for projects since December 2012. On the financing side several domestic banks are exiting the market and big-ticket PPP projects have only managed to close in 2010/11 thanks to state guarantees and similar efforts. In 2012 the MoF conducted a review of PPP procedures which resulted in proposals to reinforce VfM studies and strengthen the public interest in the procurement process. The use of PPPs is still expanding, but financing will remain a key issue and public sector participation of some sort, either directly or via development banks, will be important.

New financing sources – 2013 the year of the project bond?
HSBC is working with the UK Department of Education to develop **project bonds for PPP financing** to take up the slack left from the retreat of bank lending. In order to create volume many projects will be combined into a single bond. With the purpose of making at least senior debt attractive for institutional investors, the bonds will be credit enhanced and the financing volume aggregated via the use of state guarantees/direct lending. Project bonds supported by the EIB and other market inventions *could mean that 2013 could be the year that sees PPP project bonds emerge as a significant financing method.* HSBC also outlined *four pillars that are being used by finance companies in assessing whether to enter a particular PPP market*: a) suitability of the sector, in terms of providing a well understood model of PPP financing; b) an investor base, facilitated by clear legal and other foundation blocks provided by the sovereign; c) a well selected project pipeline; and d) performance of the bonds. A specific case of a well functioning PPP bond market is Canada which was illustrated in a case study at the meeting by PPP Canada.

How to integrate traditional capital budgeting and PPPs
If used correctly PPPs deliver value for money through lower cost, better outcomes and/or cost recovery. Research conducted by the OECD in 2012[3] indicates that in the opinion of most countries (that use PPPs) *this procurement method outperforms traditional infrastructure procurement on timeliness, construction cost and quality, but transaction costs are higher.* The same research also indicated that countries feel that there is *not enough data* to judge whether the same applies with regards to realised operating costs. There is *no clear answer* as to whether one of the procurement methods consistently outperforms the other when calculated over the whole life of the asset. This probably depends on the specific project. According to member countries *a key element in attaining value is that the procurement, budgeting and accounting of infrastructure via PPP or traditionally is integrated* and continuously compared. This can only be ensured if an integrated capital budgeting process is created and enforced. The paper summarises the lessons from best practice countries in how to build such an integrated approach.

***Re-negotiation** is considered to be a tool that strategic bidders can use to undermine value for money after being awarded the contract*. By timing re-negotiation to take place at key decision points – e.g. just before construction of the asset is set to begin – some research shows that the private party is able to extract excess rent from the public side. *Recent research from the Sorbonne Graduate Business School indicates that the picture is more complex.* Renegotiation shortly after contract award decreases surplus for the public sector. It also decreases the likelihood that the public sector renews the contract with that particular private party. However, renegotiating on several dimensions favours win-win interactions and renegotiation in itself is not detrimental to public sector surplus. The recommendation from this research is that contracts should target equilibrium between rigidity (commitment) and flexibility (adaptation) since the situation will invariably change during long contract periods. For renegotiation to work it is a necessary condition that the public sector's threat not to renew contracts (or engage in others with this particular bidder) is credible. There must be competition in the market. Past experience with bidders and their general reputation should be included in the award criteria. This will enable the detection of strategic bidders. The legal framework should give the procuring agency discretionary power to award as well as require a maximum of transparency. Lessons from Germany, Korea, Mexico illustrated the importance of designing an appropriate legal framework for renegotiation.

[3] Working Paper by I. Hawkesworth & P. Burger 'Capital budgeting and procurement practices' Presented at the OECD Annual Network Meeting of Senior Public-Private Partnership Officials 15-16 April 2013. It will be published in the OECD Journal on Budgeting.

OECD research indicates that despite the theoretical fit between institutional investors and PPPs, infrastructure as an asset class is relatively limited.
Of the USD 71 trillion assets under management (2011) only about 0.7% was found to be devoted to Infrastructure in the OECD Large Pension Funds Survey 2011. The OECD and the long term investors club is trying to create new models and strategies for long term investors to access infrastructure both in terms of holding debt paper and equity. The OECD gathers data and is in the process of developing the Principles on Long-Term Investment by Institutional Investors that is to be approved in September 2013[4]. It is clear that the investor appetite is there, but the product must be created at a sufficient volume and quality for institutional investors to get involved. The IMF pointed to the fact that in many countries the basic enabling policy framework and investment climate had to be improved for institutional investors to get involved.

Conclusions and next steps
On the basis of the discussions the Chairman summarised that the traditional 'financing gap' is now replaced with a 'structuring gap'. The public sector could consider reshaping the policy environment to facilitate the large latent demand for various types of financing. Addressing this issue could possibly be a productive avenue for future work in this area. The upcoming PPP project in Tunisia was presented by the Secretariat as well as a possible effort to develop a book of case studies based on the best presentations from the annual PPP network meetings. The Secretariat is in the process of expanding the PPP Principles into a template for assessment of a national PPP and capital budgeting program. It is envisioned that the case studies will mainly be drawn from the group of best practice countries.

[4] For the draft principles see: http://www.oecd.org/daf/fin/HL-Principles-LTI-Public-Consultation-May-2013.pdf