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InfraRead

Riding on the crest of a wave

ashurst

An overview of this issue

I am delighted to introduce the first issue of **Infra**Read for 2013, in which we examine a range of topics relevant to the infrastructure sector, from our offices across the globe. In this issue, we will be looking at:

EUROPEAN INFRASTRUCTURE M&A Nick Rainsford and Eavan Saunders Cole highlight the key trends appearing in the infrastructure M&A market and discuss the reasons why the market appears to be defying the global slowdown.

ITALIAN PROJECT BONDS The financial crises of the last five years have greatly affected the availability of funding for infrastructure projects across the globe and particularly in southern Europe. Carloandrea Meacci and Nicola Toscano examine the promising development of project bonds in Italy and the impact that such improvements will make to the Italian infrastructure market.

JAPANESE INFRASTRUCTURE INVESTMENT Harvey Weaver, Matthew Bubb, Giles Ashman and Matthew Rickards discuss the reasons why Japanese sponsors and lenders have identified infrastructure as a key area of investment and outline the main areas of infrastructure that can expect to benefit.

THE FRENCH PPP MARKET Despite numerous questions and extensive criticism regarding the use of PPP for procuring projects, the French PPP market overtook the UK in 2012 as the number one global PPP market. Michel Lequien and Jacques Dabreteau explain the significant impact that recent legal and tax constraints will have on the French PPP market and predict that the market will have a difficult 2013.

AUSTRALIAN PROPERTY-BASED PPPs As the Australian PPP market continues to develop, projects involving a large real estate component continue to be particularly challenging and prone to difficulties. Chris Mitchell and Melinda Harris examine the procedures that have been put in place to promote a new generation of property-based PPP opportunities in Australia.

THE PF2 PROGRAMME Last year, the UK Treasury released guidance on its new approach, known as PF2, for the development of private finance investment in infrastructure projects in the United Kingdom. Cameron Smith and Philip Vernon assess the potential impact of the changes proposed by the Treasury and debate whether the increased role of the public sector in privately-financed deals will be a help or a hindrance to private sector parties.

PROJECT BANK ACCOUNTS IN CONSTRUCTION Nicholas Hilder and Barbara Walshe examine the increased use of project bank accounts by public sector construction procurers and explain the potential benefits that they could provide to the UK construction industry.

I hope that you find **Infra**Read useful and that you enjoy reading this issue. Please let us know if you have any feedback and if there are any topics that you would like us to cover in future editions.

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EUROPEAN INFRASTRUCTURE M&A

Defying the trend

by Nick Rainsford and Eavan Saunders Cole

While its more established relative, private equity, struggles in a sea of failed or elongated fundraising processes, a general malaise and mistrust over the asset class and mixed availability of debt, European infrastructure M&A seems to be riding on the crest of a wave.

In this article we look at some of the reasons why the infrastructure M&A market appears to be defying the global slowdown and some of the trends appearing in the market.

Dry powder and new money

Estimates put the amount of "dry powder" that unlisted infrastructure funds are sitting on at in excess of €80bn globally (approx. €30bn in Europe) on an unleveraged basis. For Europe in particular, global interest in the jurisdiction is making for extremely competitive auction processes. The last 12 months has also seen an increase in direct investment by pension funds and institutions who had traditionally invested through infrastructure funds.

This is music to the ears of sellers and it seems that buyers are not shy of paying full value for the perceived safe harbour of GDP-linked, inflation-linked regulated infrastructure assets.

Global Infrastructure Partners paid 16.7 times EBITDA for Edinburgh Airport in May last year safe in the knowledge that it had already reached second close (€4.3bn) on its second infra fund, GIP II. GIP II went on to reach a final close with €6.3bn in commitments raised in October 2012, the largest infrastructure fundraising ever.

The Manchester Airports Group and IFM consortium bought Stansted Airport for £1.5bn in January (15.6 times EBITDA) notwithstanding heavy reliance by the airport on Ryanair for its traffic.

It is not just airports that are attracting investors in the UK. In February of this year, Sumitomo Corporation raised eyebrows when it agreed to buy Sutton and East Surrey Water at a 35 per cent to 40 per cent premium to its regulated capital value. Since February, Alinda has sold South Staffordshire Water to KKR; Citi Infrastructure Partners and Infracapital are rumoured to be preparing to divest certain interests in Yorkshire Water; and Severn Trent has received a takeover approach from Borealis Infrastructure and Kuwait Investment Office.

With a surfeit of cash available for acquisitions, the relatively low return on investment requirements of certain infra funds and a debt market which remains open, you might think prices would increase across the board. It seems, however, that infrastructure M&A investment professionals have learnt from their private equity cousins and appear more circumspect about certain assets coming to market, particularly around valuation.

Both the Hochtief sale of its airport divisions and Alinda's proposed auction sale of South Staffordshire Water seemed to be stalling earlier this year through lack of interest. In the case of South Staffordshire Water it appears that certain elements of a traditional auction process (e.g. vendor due diligence in respect of the regulated business) are believed to have been sidelined in favour of getting to market quickly). According to press reports, the unregulated part of the South Staffordshire Water business accounted for approximately 40 per cent of the business. Hochtief had assets which were individually attractive (Hamburg and Dusseldorf) and this was the third attempt to offload the portfolio. None of the respective challenges proved insurmountable as both divestment

processes have now concluded, but it is likely that internal expectations in terms of valuation were heavily managed.

Some infra funds are also coming to market with seasoned assets in search of a return and to show an investment track record. In a move which may well be linked to its attempts to raise a €2bn to €3.5bn infrastructure fund in conjunction with China Development Bank, Terra Firma is preparing both Infinis (the UK-based renewable energy company) and Phoenix (Northern Irish gas distribution group) for sale processes, with some reports suggesting likely combined sale proceeds in excess of £1bn.

In short, despite some caution, there continues to be healthy competition for quality infra assets because of the amount of firepower in the market and a willingness for funds and direct investors to settle for returns of between 8 per cent and 12 per cent.

Divestment of non-core assets and reduction of debt

As governments across Europe try to kick start growth with domestic infrastructure initiatives, so we see energy and construction companies trying to recycle capital or simply restore their balance sheet. Governments have tended to focus on greenfield development to stimulate economies, but the UK Green Investment Bank (which was set up in 2012 with approximately £3bn funds at its disposal and a three-year investment period) appears to be willing to consider investment in equity and debt in brownfield projects. This approach, it is hoped, will also stimulate funding and construction for greenfield projects.

Divestment of non-core activities by European utilities also continues to be a strong theme across Europe:

- **Veolia** – made some headway through the sale in the UK of its water business to a consortium including Infracapital Partners and Morgan Stanley Infrastructure Partners for €1.6bn. It remains focused on a divestment process to reduce its debt burden.
- **E.ON** – raised €3.2bn on the sale of Open Grid Europe in an auction process to a Macquarie-led consortium in May 2012.
- **Total** – sold French gas storage and transport company TIGF to a consortium comprising SNAM, GIC and EDF for €2.4bn.
- **RWE** – agreed to sell its Czech gas transmission business, Net4Gas, to an Allianz-Borealis consortium for €1.6bn.

The pipeline of divestments also appears strong:

- **Fortum** – the Finnish energy giant is understood to be gearing up for a sale process in respect of its electricity networks and distribution business which reports state could lead to several sale processes and attract sale proceeds of approximately €5bn.
- **FCC** – the Spanish developer has announced a divestment process to sell assets with a value of around €2.2bn between now and 2015.

Consortium bids

As evidenced by the list of transactions described above, the past year has seen a number of consortium bids for European assets. Many of the other potential buyers for these assets were also part of consortia. One of the main reasons for forming a consortium is to de-risk exposure to a particular asset – this is partly a function of the size of the purchase price paid for the asset. Consortia are also allowing pension funds and investors to deploy capital directly into an asset and leverage off other consortium members' deal team and related expertise. This initial funding step may well be a segue to establishing a more permanent presence in Europe (a move some Canadian funds have already made).

There are, however, some risks associated with being part of a consortium:

- **Flexibility in bid process** – it is imperative that agreement is reached very early in the process as to how the consortium will conduct its bid. Liability for costs, the ability to introduce new consortium parties, withdrawing from the consortium and possible non-compete following withdrawal should all be addressed. Most importantly, the consortium needs to be able to act swiftly and decisively so that it can compete effectively in an auction process.
- **Investment liquidity** – for some investors, buy and hold is their preferred investment approach and they will not require liquidity for their proportion of shares in the investment vehicle. For other investors, it may well be important that they are able to transfer their shares. The pre-emption process can be a cause of tension in consortium negotiations. The "devil is in the detail" and concerns have been justifiably raised that a right of first refusal is a deterrent to the market: is a third party really going to carry out full diligence and is it possible to truly test the market if potential bidders for your stake know there is a chance that co-shareholders may be able to pre-empt? Getting anything other than an indicative price is very difficult unless you are willing to underwrite costs. A right of first offer is objectionable to the remaining shareholders as there is no true way of settling a market value without going out to the market.
- **New money and dilution** – many of the infrastructure assets that funds and investors are acquiring will need substantial capex over the next 10 to 20 years. Understanding how this capex might affect the internal rate of return is important and negotiations are likely to focus on whether there is a requirement for co-shareholders to "follow their money" if a certain level of IRR is achieved. Whether the sanction for not "following your investment" is simply dilution and whether this constitutes a rather draconian event of default requiring the defaulting shareholder to offer to sell its shares to

the remaining shareholders or another sanction is a key debate.

- **Reserved matters** – understanding what reserved matters each party wants (and may need for internal risk management purposes) and at what level of shareholding any such rights will apply is important. Consortium members also need to consider the effect of dilution and transfers.
- **Drag along and tag along rights** – the agreed position will depend on the bargaining powers of the respective parties but it is not unusual to have a threshold for a drag along right allowing shareholders to force a sale of an entire asset. Similarly, "piggy back" protection would not be unusual if a significant disposal of shares (e.g. above 50 per cent) was in contemplation.

Strategic interest from the Far East

There has been continued interest from China in UK assets following the buyout of the remaining shareholders in Wales & West by Cheung Kong Infrastructure. China's Beijing Water Authority is understood to have submitted a bid for Sutton and East Surrey Water before it was purchased by the Japanese trading house, Sumitomo, and it is reported as having been involved in the South Staffordshire Water process but declined to submit a bid.

In further evidence of Chinese determination to get a foothold in Europe, State Grid Corporation of China has opened an office in Frankfurt. In 2012 it purchased a 25 per cent interest in the Portuguese national energy network Redes Energeticas Nacionais from the Portuguese Government. There is a strong belief that Chinese state-owned power and utilities companies will continue to be active in their search for power utility and transmission assets across Europe.

An article by Harvey Weaver, Matthew Bubb, Giles Ashman and Matthew Rickards later in this magazine expands on the growing appetite for global infrastructure by Japanese investors.

Outlook

Greenfield and related construction risk still remains, for the most part, unattractive to institutional investors. The same investors are, however, willing to buy assets in sectors where large capex spend will be required. Protection against this capex is often built into the licensing and price control regimes but there is still some potential exposure. In jurisdictions with better developed regulatory regimes, investors have historically felt more comfortable with this risk. There are, however, undercurrents of sponsor concern about the increasing willingness of regulators to intervene in jurisdictions with more mature regulatory regimes where the perceived safe haven of the regulatory regime is outweighing the risk associated with the investment. In the UK, OFWAT, the water regulator, has taken water companies to task in an attempt to try to increase regulation over price increases, as well as creating greater market competition. At the time of writing, amendments to this regime are in a period of consultation.

In Norway, less than 12 months after financial investors purchased an interest of approximately 25 per cent in Gassled, the Norwegian gas networks, from the Norwegian Government, the Ministry of Petroleum and Energy announced in early 2013 that it was submitting for consultation a proposal to reduce tariffs for new gas contracts entered into in relation to gas from the Norwegian shelf. The effect of the proposals are understood to mean that returns to investors will fall from a credible 7 per cent to 4 per cent.

Regulators and governments do need to exercise caution. Estimates of the required infrastructure spending for the next 20 years cannot be serviced by governments alone and the sector needs private investment. Investors have started to consider regulatory change and intervention as a real risk and there may well be a trend towards "pricing" this risk. When the infra M&A deal drivers are taken as a whole, the optimistic among us believe that the limited regulatory intervention to date will have a negligible effect on transaction volumes. Regulators: meddle too much at your peril (and ours)!


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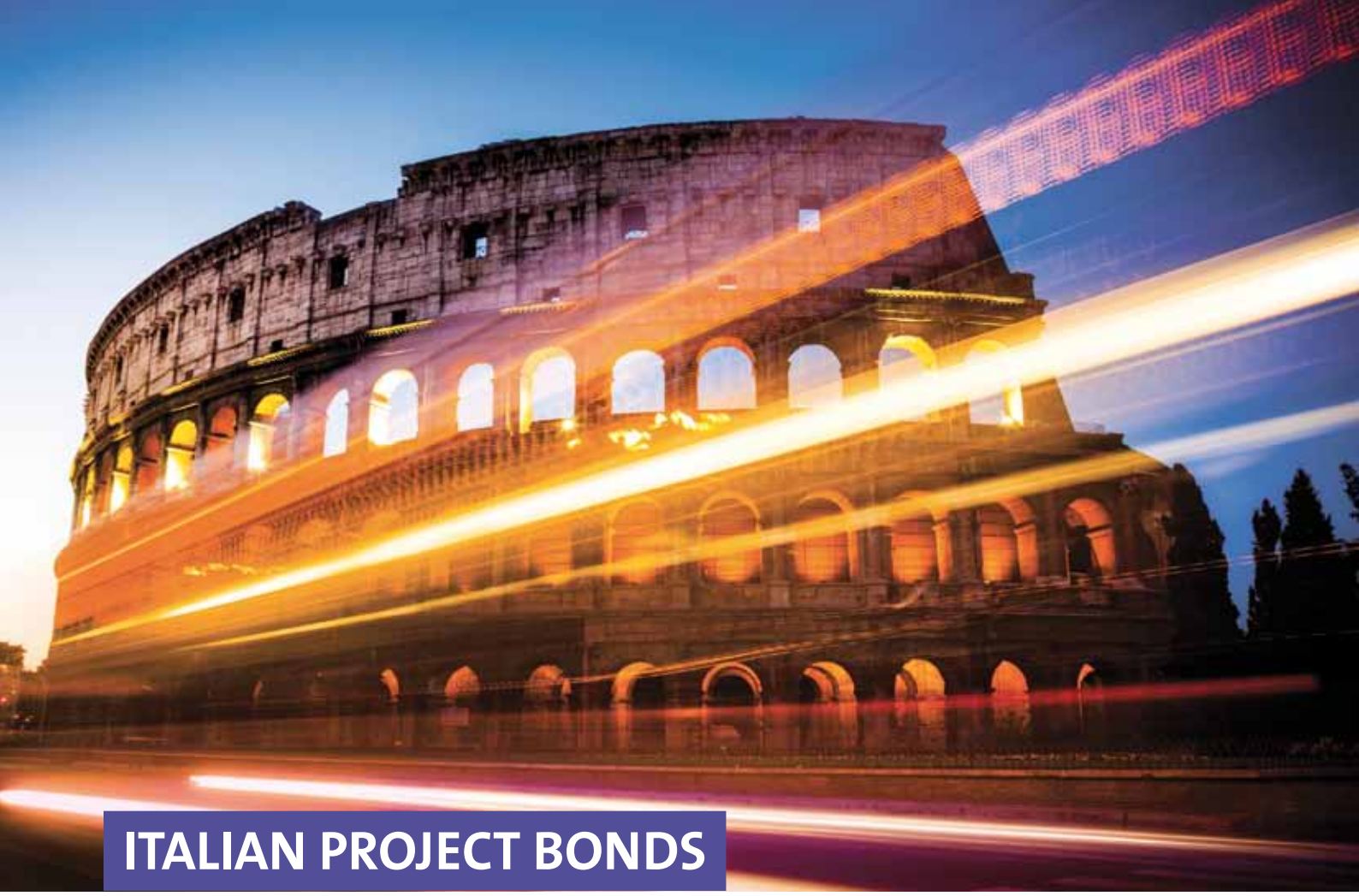


ITALIAN PROJECT BONDS

A new era for infrastructure financing

by Carloandrea Meacci and Nicola Toscano

"A number of laws have been recently approved in Italy, introducing a more modern regime for bonds, both in comparison to the previous Italian regime and, even more surprisingly, in comparison to other European countries."

It is no secret that five years of financial crises of all sorts (from the 2008 Lehmans collapse to the 2011/2012 risk of a Euro break-up) have rattled the financial markets, particularly in southern Europe.

Coupled with the new Basel III requirements, which have made long-term bank financings very expensive, the availability of bank finance for energy and infrastructure projects has been materially affected. As a result, bank loans have either not been available or have been available only on very expensive terms.

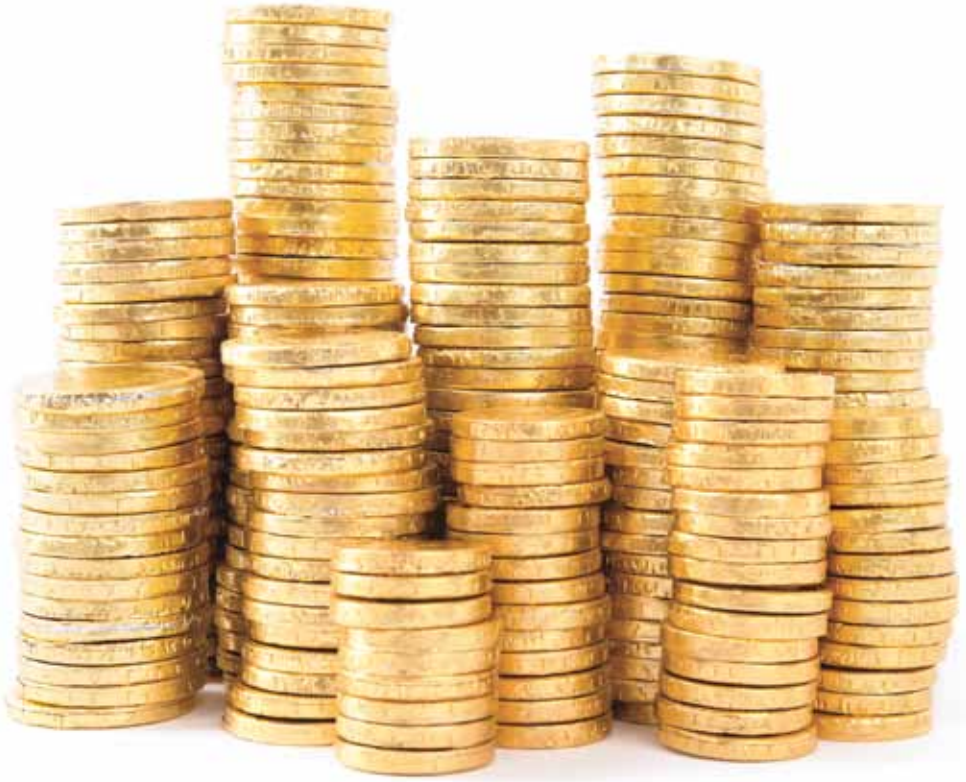
Against this background, the Italian Government acknowledged that the Italian financing market was too dependent on bank loans (upwards of 80 per cent) and that a new legal and tax regime was required to facilitate access to non-bank sources of finance, and the capital markets in particular. This is in line with more mature markets such as the USA where the majority of financing transactions are not bank loans but capital markets deals.

Traditionally, capital markets transactions in Italy – i.e. bond issuances – have been a sensible alternative to bank loans only if the issuer/borrower was a listed company, which is usually not the case for project-financed energy and infrastructure deals. Indeed, obsolete and unhelpful legal and tax rules prevented non-listed companies from issuing bonds exceeding a 2:1 debt (i.e. the amount of the bond) to equity ratio unless a mortgage was granted to the bondholders, as well as levying a hefty withholding tax on interest payable thereunder and preventing the deduction of interest payable by the issuer in certain circumstances.

In order to address the above issues, a number of new laws[1] have been recently approved, introducing a more modern regime for bonds, both in comparison to the previous Italian regime and, even more surprisingly, in comparison to other European countries.

1 See decree no. 1/2012 (converted into law no. 27/2012) also known as the "Liberalisation Decree", decree no. 83/2012 (converted into law no. 134/2012) also known as the "First Growth and Development Decree", and decree no. 179/2012 (amended and converted into law no. 221/2012) also known as the "Second Growth and Development Decree".

Under the new regime, a fundamental distinction is made between: (i) bonds denominated as "project bonds", which are issued to finance core infrastructure projects (Project Bonds); and (ii) other bonds, originally denominated as "mini bonds", which are issued for any other purpose (Other Bonds).



Project Bonds

In order for a bond to qualify as a Project Bond, it must meet the following requirements:

- it must be issued to finance or refinance a core infrastructure project;
- it must be placed and transferred only among "qualified investors";
- it must meet certain formal requirements; and
- if it is subscribed by an insurance company which wants to take advantage of an ad hoc 3 per cent basket of its technical reserves, the [construction] risk must be guaranteed by a financial institution and the issuer's financial statements must be audited.

Each of these requirements is described in more detail below.

If a bond qualifies as a Project Bond, then a favourable legal and tax regime applies whereby, among other things[2]:

- the old 2:1 debt-to-equity ratio described above is no longer applicable nor is the requirement for a mortgage to exceed such limit, so the issuer can issue Project Bonds in the amount it considers appropriate;
- no withholding tax is applicable on the interest payable to the bondholders (excluding retail and a few residual categories of bondholders) provided that the Project Bond is issued by 25 June 2015 and the bondholder is resident in a white-list country for tax purposes;[3] and
- the security package securing the Project Bond (which would otherwise be subject to registration taxes which could be as high as 2 per cent of the bond issuance) is virtually tax-free (i.e. subject only to a €168 registration tax).

In terms of the requirements for a bond to qualify as a Project Bond, the following details should be noted:

- The core infrastructure projects in relation to which Project Bonds can be issued are limited to the following categories: BOT concessions (e.g. toll roads, undergrounds and hospitals),[4] PPP projects,[5] LNG receiving terminals, national electricity distribution grids, gas distribution grids (both national and local), gas storage facilities, local public services, electronic communication grids and public telecommunications.
- The "qualified investors" among which Project Bonds must be placed include banks, investment companies, certain registered financial intermediaries, insurance companies, SGR, SICAV, pension funds and "large companies" as defined by the Italian stock market regulator Consob[6].
- The formal requirements that Project Bonds must meet include a requirement that the bond must specify the name of the bondholder (*titoli nominativi*) and the documentation relating to their offer must warn about the high risk profile.
- The [construction][7] guarantee required for insurance companies to take advantage of the ad hoc basket of technical reserves can be provided by banks, certain registered financial intermediaries, insurance companies, Cassa Depositi e Prestiti, SACE, EIB, banking foundations and private equity funds. These guarantees must, among other things, be irrevocable and unconditional. The unconditional nature of such guarantees could make them quite difficult to obtain, and

2 Other positive aspects of the new regime include that, in case of termination of a PPP concession due to the awarding authority's default or revocation of the concession for public interest, the priority of the lenders over the termination payments has been extended to holders of Project Bonds.

3 Therefore, this withholding tax regime is even more attractive than the regime for bank loans which are subject to withholding if the lender does not have a branch in Italy.

4 SPVs established pursuant to Art. 156 of the Public Procurement Code.

5 SPVs holding contracts of public private partnership under Art. 3, paragraph 15 – ter of the Public Procurement Code.

6 These are companies that meet at least two of the following conditions: (i) annual total balance sheet equal to €20m; (ii) annual net turnover equal to €40m; and (iii) equity equal to €2m.

7 Whether the guarantee should cover only the construction risk and not the operational risk is a matter of interpretation of the insurance regulation on technical reserves (IVASS regulation no. 36 of 31 January 2011 as amended on 18 July 2012). On the one hand, the regulation makes reference to Project Bonds backed by the guarantee issued under Article 157, paragraph 3 of the Public Procurement Code which makes reference only to a guarantee during the construction phase, to be detailed by a ministerial decree. However, this ministerial decree, when it was eventually issued, provided that the guarantee may also cover the operational phase. Although there are reasonable arguments to believe that the guarantee required by IVASS was intended to cover only the construction risk, we would strongly recommend checking this point with IVASS before any actual transaction is structured. Furthermore, the IVASS regulation could be interpreted to mean that, if no guarantee is provided, an insurance company could potentially still invest its technical reserves in Project Bonds provided that it meets the general requirements for investments of technical reserves in bonds. Interestingly, compared with these requirements the 3 per cent new ad hoc basket for Project Bonds described above seems to represent an actual advantage mainly/only if the Project Bond is not listed.

we understand that lobbying efforts are under way to seek to soften this requirement. Similarly, there are a number of technical and practical glitches affecting the rules governing the application of the ad hoc basket which we understand market operators are trying to address with the Italian insurance regulator IVASS (formely ISVAP).

Interestingly, a Project Bond does not need to be listed.

Other Bonds

As noted above, bonds issued to finance projects other than the core infrastructure projects indicated above do not qualify as Project Bonds and therefore the favourable legal and tax regime described above does not apply. This is material, considering that so many projects do not fall within the core infrastructure projects, e.g. many energy projects, including all renewable energy projects.

However, new rules have also been introduced in relation to these Other Bonds, which have been issued to finance projects which are not core infrastructure projects.

Under these new rules, Other Bonds also benefit from:

- the cancellation of the old 2:1 debt-to-equity ratio described above and the requirement of the mortgage to exceed such limit; and
- the non-application of withholding tax on the interest payable to the bondholders (excluding retail and a few residual categories of bondholders).[8] In addition, a special limitation on the deductibility of interest payable for bonds issued by non-listed companies does not apply.

This favourable regime is subject to the following requirements: (i) the Other Bonds must be listed in an EU or Norway regulated market or multilateral trading system (MTF); (ii) the bondholder must be resident in a white-list country for tax purposes; and (iii) the issuer must be a *società per azioni* (limited liability company). These requirements do not seem particularly difficult or expensive to meet.

Unfortunately, unlike for Project Bonds, the security package for Other Bonds is subject to the ordinary tax treatment, i.e. registration taxes equal to 2 per cent (for the mortgage) or 0.5 per cent (for the other notarial security documents) of the amount of the bond[9] apply.[10] However, we are structuring a number of transactions where these issues are sought to be partially mitigated through, for example, intercreditor agreements where there is a parallel bank loan and/or a security structure whereby the secured amount is just a fraction of the bond with the right of the bondholders to increase the secured amount upon breach, for example, of the distribution ratios. Non-notarial security documents can be structured as exchange of correspondence and essentially be tax-free except in very remote circumstances.

8 Other positive aspects introduced by the new rules on Other Bonds include the possibility for certain Other Bonds to introduce a subordination clause (whereby the bondholders agree to be subordinated to other creditors of the issuer, which may be relevant for mezzanine funds) and/or a participation clause (whereby the amount payable to the bondholder is proportional to the profits of the issuer within certain limits, which may be useful in a restructuring scenario).

9 To be precise, the registration tax is, in most cases, levied on the secured amount rather than the amount of the bond, but usually the security document secures at least 100 per cent of the principal bond amount.

10 To be precise, the registration tax can be reduced to €168 per notarial security document (except for the mortgage and the assignment of receivables by way of security) if the grantor of the security secures its own indebtedness (which is usually the case when the issuer is also the owner of the asset and is therefore not the case when the bond is issued by a holding company in the context of a portfolio financing).

Conclusions

We are seeing a huge interest in Project Bonds and Other Bonds from a wide variety of players ranging from issuers (who need a new source of financing), banks (who need to satisfy the debt appetite of their clients without using their balance sheet), insurance companies (who need or wish to cover their technical reserves) and even from bondholders themselves (who need to find new remunerative ways to deploy their funds). In this respect, it is interesting to see that many private equity funds, which traditionally invested only in equity, are now setting up large funds to invest in debt: Project Bonds and Other Bonds are an ideal instrument to match all these different needs.

Another reason why we are seeing so much interest in this product is that it is competitive vis-à-vis a traditional bank loan in terms of both cost and maturities. In terms of maturities, long tenors are available from many investors who wish to achieve the so-called "matching of assets and liabilities" (e.g. insurance companies), while banks prefer short term loans due to Basel III. In terms of costs, the remuneration of a Project Bond or Other Bond for an Italian energy or infrastructure project is usually linked to Italian government bonds (usually 1 or 2 per cent above ten-year government bonds). The combination of the cost of government bonds continuing to decrease in recent months (from a peak of more than 6 per cent in June 2012 to just above 4 per cent in January 2013) and the cost of bank loans (including the hedging costs, which are not applicable to bonds) remaining high (6-7 per cent all-in) explains the interest in this product.

Clearly, not everything is positive. In particular, the real appetite of bondholders to invest in a new product, coupled with the initial transaction costs (higher than for a normal debt transaction) and the risk of investing in Italy which is still perceived by some investors, are the biggest challenges.

However, based on the hundreds of conversations that we have been having with various industry players, we are optimistic that we are on the cusp of a new era for infrastructure financing in Italy.

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JAPANESE INVESTORS

A growing appetite for global infrastructure assets

by Harvey Weaver, Matthew Bubb, Giles Ashman and Matthew Rickards

Japan has long been renowned for the quality of its domestic infrastructure.

It is no surprise that in preparation for the introduction of HS2 in the UK, the UK Department for Transport recently sent a fact-finding delegation to Japan to learn about the latest bullet train technology. Many of the companies which developed this world-class infrastructure are now expanding their activities in overseas markets.

Given its lack of natural resources, Japan has been a major investor in international projects in the oil, gas and mineral resource sectors for many decades. We are now also seeing significant investment by leading Japanese companies and banks in other infrastructure sectors, in particular renewable energy, water, rail, airports and nuclear.

Investment drivers

A number of factors have contributed to this trend:

- **Technological edge:** Across a number of sectors – wind, solar, water, rail, nuclear – Japanese companies are among the global leaders in infrastructure technology. The Japanese trading companies are able to utilise their relationships with the key equipment manufacturers to create strong consortia to bid for infrastructure projects.
- **Strength of the Yen:** Although there has been some depreciation in the Yen over recent months, by historic standards it remains strong against other major currencies. This is encouraging Japanese companies with significant Yen cash reserves to invest overseas.
- **Energy policy:** In the wake of the crisis at the Fukushima No. 1 nuclear power plant in 2011, there has been a shift in government energy policy in favour of renewable energy. In certain sectors – for example, solar and wind – this will likely lead to significant growth in the domestic market, but is also encouraging Japanese firms to invest in renewables projects overseas to gain know-how from other developed renewables markets, coupled with a desire to invest in more green energy.
- **Growth markets:** Notwithstanding the boost for renewable energy over the short to mid term, the major Japanese infrastructure companies recognise that over the long term, domestic demand will likely weaken due to low growth rates and a shrinking population. Simultaneously, there has been a huge increase in demand for infrastructure around the world and, in particular, in the fast-growing Asia-Pacific region where Japanese companies are well placed to invest.
- **Financial sector strength:** Compared to many of their European and US rivals, the major Japanese commercial banks emerged relatively unscathed from

the 2008 financial crisis. Since then, given their relatively healthy balance sheets and continued willingness to lend over long tenors, the share of the big three Japanese banks in the global project finance market has increased significantly (see below).

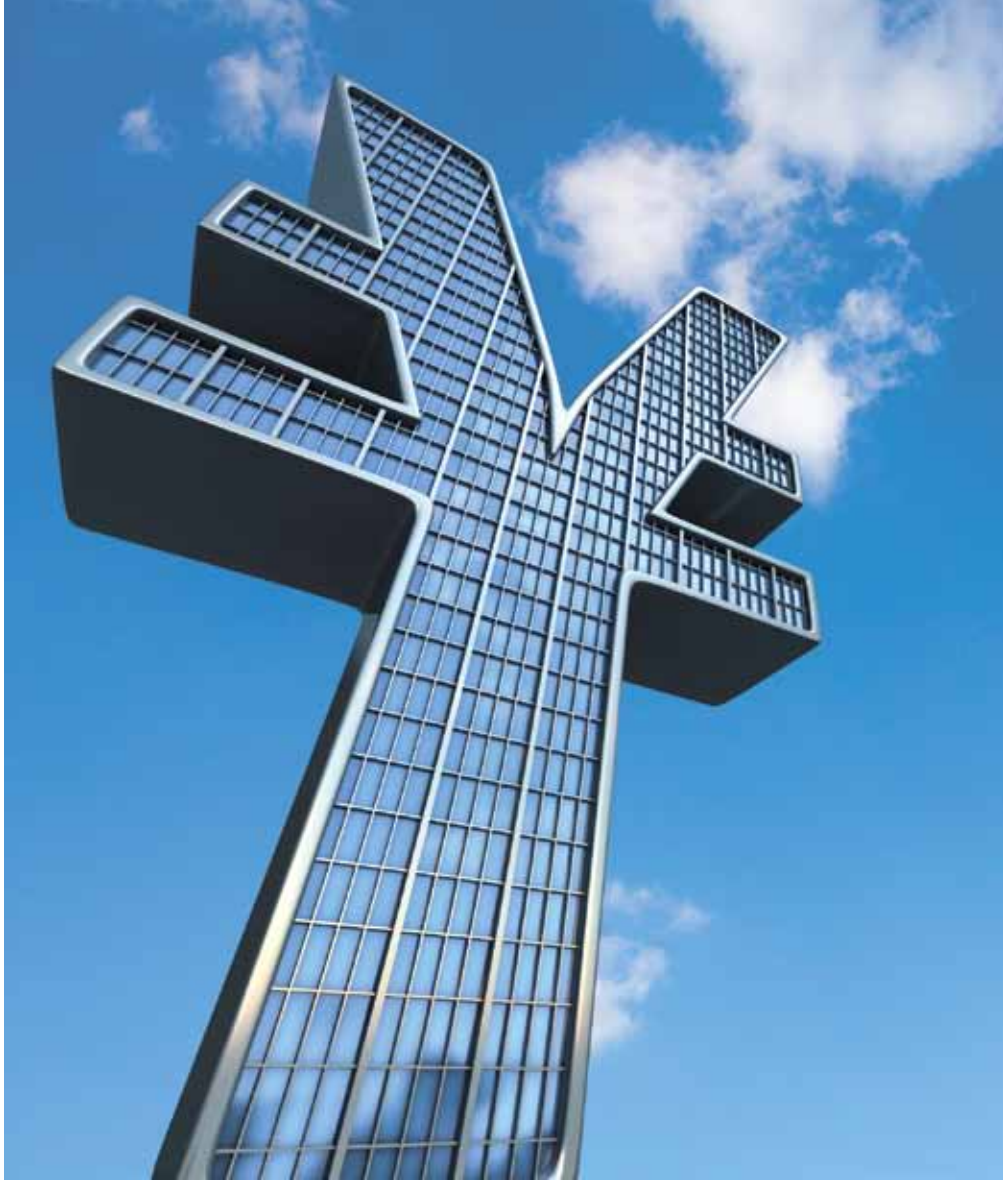
- **Government support:** As well as having the support of a strong private financial sector, for certain major infrastructure projects Japanese sponsors may also benefit from the significant support provided by government institutions, in particular the Japan Bank for International Cooperation (JBIC) and Nippon Export and Investment Insurance (NEXI).

The '*Sogo Shosha*'

The Japanese general trading companies (*Sogo Shosha*) are at the centre of much of the country's overseas trade. The five largest – Mitsubishi Corporation, Mitsui & Co., Ltd., Sumitomo Corporation, Marubeni Corporation and Itochu Corporation – each have annual revenues in excess of US$40bn[1]. One of their principal functions is to implement complex transactions by managing relationships with contractors, lenders and government entities and by providing financial support with the strength of their balance sheets. This makes them ideally suited for project finance transactions.

The trading companies have been investors in oil, gas and mineral resource assets for many years. Although these sectors will remain as core activities, there is a recognition that the trading companies need to diversify if they are to avoid being over-exposed to a downturn in the commodities markets. A key part of that diversification is focusing on infrastructure. By way of example, in its latest mid-term corporate strategy[2] Mitsubishi Corporation (the largest of the *Sogo Shosha*) identified just two of its business areas as "strategic domains" – these were Infrastructure and Global Environmental. It has set aside a significant capital allocation for investing in these sectors.

Among major Japanese corporations it is not only the *Sogo Shosha* that are increasing their investments in overseas infrastructure. The largest Japanese equipment manufacturers – for example, Hitachi, Toshiba and Mitsubishi Heavy Industries – also have the financial strength to act as lead sponsors on major infrastructure projects.



Rank	Company	Total (US$m)	Transactions	Market share (%)
1	Bank of Tokyo-Mitsubishi UFJ	8,536.55	81	8.62
2	SMBC	6,349.52	60	6.41
3	HSBC	4,085.61	39	4.13
4	Mizuho Financial Group	3,481.75	31	3.52
5	Commonwealth Bank of Australia	2,831.86	15	2.86

Robust financial sector

In the years before the 2008 financial crisis, the major European banks dominated the international project finance market. During that period, the major Japanese banks were continuing the process of clearing up bad loans and strengthening their balance sheets following Japan's economic difficulties during the 1990s. As other banks around the world struggle with the combined impact of the banking crisis and Eurozone sovereign debt crisis, Japan has been left with some of the strongest financial institutions in the world.

It is no surprise, then, that the three major Japanese commercial banks in the project finance market – the Bank of Tokyo Mitsubishi UFJ (BTMU), the Sumitomo Mitsui Banking Corporation (SMBC) and Mizuho – have been steadily increasing their market share over the last few years. For the 2012 financial year they dominated the rankings for project finance lending, taking first, second and fourth place respectively with a combined market share of around 19 per cent of total lending[3].

All of the Japanese trading companies and major manufacturers have longstanding relationships with one or more of these major banks and are able to

1 See Fortune Global 500, 2012.
2 See Mitsubishi Corporation Mid-term Corporate Strategy 2012 (dated 15 July 2010).
3 See Infrastructure Journal 2012 FY League Tables.

CASE STUDY: UK INTERCITY EXPRESS PROGRAMME

An excellent example of the private and public sector entities described above combining to deliver a major project financing is the UK's Intercity Express Programme. The project is for the replacement of the intercity trains on the UK rail network and is the largest privately-financed rolling stock deal in history. The senior debt required for Phase 1 (West Coast Main Line) was £2.2bn with a tenor of approximately 30 years. The senior debt was made up of the following tranches:

- £1bn JBIC facility;
- £235m EIB facility;
- £150m NEXI covered commercial bank facility; and
- £850m uncovered commercial bank facility.

The group of seven commercial banks included five from Japan. In addition, the Development Bank of Japan participated in the equity bridge facility.

Financial close for Phase 1 was reached in July 2012 and the support of Japanese lenders was critical to achieving this milestone in spite of the challenging financial markets at the time.

utilise these relationships to support their investments overseas. Those investments may also be eligible for support from the Japanese Government through the various public sector institutions:

- **JBIC:** The Japan Bank for International Cooperation is a policy-based financial institution wholly owned by the Japanese Government. It has a number of defined functions, but two of these are "*maintaining and improving the international competitiveness of Japanese industries*" and "*promoting the overseas business having the purpose of preserving the global environment, such as preventing global warming*". JBIC supports suitable overseas infrastructure projects by supplementing the financing being provided by private sector financial institutions and providing project finance expertise. In a paper delivered in October 2012, the Director General of JBIC's Power and Water Finance Department emphasised the opportunities for Japanese investors in infrastructure and confirmed that JBIC's approach would be to promote the acceleration of infrastructure development through the PPP model[4].
- **NEXI:** Nippon Export and Investment Insurance is an independent administrative institution which provides trade insurance in respect of certain risks relating to overseas transactions carried out by Japanese businesses. For example, insurance may be available for certain political risks. The insurance provided by NEXI is reinsured by the Japanese Government.

Recent investments – water and renewables

The factors outlined above are encouraging Japanese investors (both of equity and debt) to look at infrastructure assets around the world. Over time, the fast-growing economies across the Asia-Pacific region will likely provide enormous opportunities for Japanese investors, but in recent years much of the investment activity in the infrastructure sectors has been in more developed markets. This in part reflects the more reliable deal flows in those markets, but it can also be explained by the fact that, frequently, the Japanese companies are looking to learn from best practice developed in other established markets. Also, many Japanese investors look to invest in lower risk assets and are often reluctant to participate in untested markets.

Sectors in which Japanese investors are currently very active are water, wind and solar. The last 12 months alone have seen the completion of a number of significant investments. The examples below focus on the European market; the picture for the North American and other developed markets is similar.

4 Infrastructure Finance – Global Opportunities for Japanese Entities.

Water

As developing countries rush to upgrade their water infrastructure to cope with an increase in demand, rapid growth is anticipated in the global water market. Japanese companies have leading-edge technology in this sector, but historically the manufacturers and service providers have been relatively fragmented and have struggled to compete in overseas markets.

A number of the trading houses have identified water as a strategically important business area and are seeking to boost their capabilities by investing in full service companies in developed markets.

Wind

The Japanese Government's energy policy has shifted towards renewables in the wake of the crisis at the Fukushima No. 1 nuclear power plant. It has set a goal of reaching 19,000 MW of renewables capacity by 2030 (compared to only 2,960 MW in 2010).

The Environment Ministry recently released estimates that as much as 1,600 MW could potentially be produced from offshore wind farms around the country. Japanese companies have been keen to invest in established offshore wind markets, particularly in northern Europe, which is seen as the market leader in this field.

Solar

The shift in energy policy towards renewables has also provided a boost for Japanese companies in the solar industry. Japanese companies are seeking to expand market share and gain operational know-how through the acquisition of existing solar assets in developed markets such as southern Europe.

Outlook for Japanese investors

Japanese sponsors and lenders have identified investment in infrastructure as a key growth area to offset weakening domestic demand over the long term and achieve more diversified business models. With a strong Yen, robust support from the Japanese Government and the ability to involve contractors with leading technologies, we expect to see a continued and growing interest in overseas infrastructure assets.

Water

Japanese investor	Investment	Value	Date
Sumitomo Corporation	Sutton and East Surrey Water plc (acquiring 100 per cent of the shares)	Investment value: £305m	February 2013
Itochu Corporation	Acquisition of a 20 per cent interest in Bristol Water	Investment value: £43.5m	May 2012

Wind

Japanese investor	Investment	Value	Date
Mitsubishi Corporation	49 per cent interest in the DolWin 2 and HelWin 2 offshore transmission cable projects, Germany	Project value: €1.7bn	January 2013
Mitsubishi Corporation	50 per cent interest in the Luchterduinen 120 MW offshore wind farm, Netherlands	Project value: €380m	January 2013
Marubeni Corporation **Innovation Network Corporation of Japan** (a government-backed investment fund)	Acquisition of Seajacks International Limited (offshore wind power service provider), UK	Investment value: US$850m	March 2012

Solar

Japanese investor	Investment	Value	Date
Mitsubishi Corporation (50 per cent) **Innovation Network Corporation of Japan** (35 per cent)	85 per cent interest in Solar Holding (operator of 42 MW of PV plants, Italy)	Investment value: €40m	March 2013
Mitsubishi Corporation	50 per cent interest in 55 MW Toul-Rosières solar power plant tranche 1, France	Project value: €200m	January 2013

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THE FRENCH PPP MARKET

What does the future hold?

by Michel Lequien and Jacques Dabreteau

The current French public private partnership (PPP) market is marked by a paradox: 2012 saw France overtake the UK as the number one global PPP market in terms of total value of closed PPP projects, and yet this comes at a time when questions and political criticism over the use of PPP for procuring projects[1] have never been so pronounced.

The national elections which took place in May and June 2012 certainly encouraged debate on the use of PPP compared to other public procurement tools, particularly in an environment characterised by strong budgetary constraints and a lack (or a significant reduction) of long-term debt financing.

Although the use of PPP cannot be said to have dried up since then, it is likely that the scepticism of the new Government over its use is playing a role in the slowdown of projects and opportunities since 2012.

Indeed, France has embarked on a reassessment of its relatively new PPP model with an in-depth review of major PPP programmes launched by the previous right of centre government. In addition, the new political majority has also sponsored the adoption of legal and tax constraints which will make it ever more difficult to use PPP.

In-depth review of major PPP programmes and key findings

Last summer, following the elections, the new Government ordered administrative and financial reviews to be undertaken on the major PPP programmes launched by its predecessor, i.e. those in higher education (known as the "Campus Plan"), prisons and courthouses.

These sector reviews were combined with a general audit of PPP projects led by the *Inspection générale des finances* (the department of the Ministry of Finance responsible for auditing public bodies).

These reviews have had a significant effect on proposed PPP projects, in particular on French university PPPs which were frozen during the review.

The key findings of these reports were released during the last quarter of 2012.

As regards French universities, the report issued in October 2012 by the national evaluation commission on the progress of the Campus Plan (*mission nationale d'évaluation de l'opération Campus*) chaired by a high-ranking official (*conseiller d'Etat*), M. Peylet, questioned: (i) the financial sustainability of the Campus Plan as a whole; (ii) the systematic reliance on PPPs for the implementation of this plan; and (iii) the higher-than-anticipated costs encountered on several projects.

As a consequence, PPPs have been cancelled for projects which were at pre-launch stage, whereas PPP projects for which the procurement process was sufficiently advanced have been confirmed (for example, the Condorcet Campus near Paris, the project for Aix-Marseille University's oceanography department, and the Toulouse II Le Mirail PPP).

As regards prisons, the Minister of Justice has also criticised the systematic use of PPP for new prisons and ordered a review of a number of projects.

The previous government had planned a programme of 24,000 new prison places to be built between 2012 and 2017 – with the intention that a number of new prisons would be procured under PPP.

1 I.e. projects implemented through partnership contracts (*contrats de partenariat*) pursuant to Ordinance No 2004-559 of 17 June 2004 (*ordonnance no. 2004-559 du 17 juin 2004 sur les contrats de partenariat)*, as amended.

However, given the criticism of the systematic use of PPP and in light of the reform of the penal system aimed at reducing the number of inmates in France's overcrowded prisons, only a handful of projects have been implemented or are to be implemented through PPP: Lot A relating to prisons at Valence, Riom and Lutterbach, and Lot B relating to a prison at Beauvais, which reached financial close in January 2013, and Prison de la Santé for which final offers are expected at the end of the first half of 2013. To our knowledge, a number of other projects have been abandoned in favour of a traditional procurement approach.

To a lesser extent, courthouse PPP projects that have been launched (such as that in Perpignan) or that were expected to be launched (such as that in Lille) have now been scrapped, and it is understood that they will be procured using traditional public procurement methods instead.

In addition, although it has not yet been disclosed to the public, the PPP report issued by the *Inspection générale des finances* in December 2012 is understood to be critical of PPP procurement schemes. According to press releases, the report points out serious failures in the use of PPP. It also criticises the use of PPP as a way for public authorities to circumvent budgetary constraints by transferring the debt to the next generation. In this respect, PPP encourages public authorities to invest beyond their budgeting capabilities.

However, as a counterpoint, President Hollande has not definitively discarded the use of PPP as a means of procuring public infrastructure. In a speech delivered on 10 January 2013 on challenges and priorities of investment in France (*discours sur les défis et priorités de l'investissement en France*), he stated that PPP was one of the procurement tools available for use in carrying out public investments, provided it was the best solution. It is also worth noting that, according to recent press releases, fewer university PPPs than expected are effectively being cancelled[2].

New legal and tax constraints applicable to PPP

During the course of 2012, the French legal framework applicable to PPP was modified in a manner which has adversely affected the use of PPP.

Legal constraints

A decree dated 27 September 2012[3] has imposed a new condition on the use of PPP, by requiring the State and national public entities (*établissements publics de l'Etat*) to carry out a study (*étude*) prior to using a PPP. The purpose of this study is to assess the project's effects on public finances and on the availability of public funds, as well as its consistency with the real estate management policy of the relevant procuring authority.

A similar study must be carried out for projects to be procured by public hospitals (*établissements publics de santé*) and similar institutions (*structure de coopération sanitaire dotée de la personnalité morale publique*).

This study must be carried out before the start of the procurement process, alongside the preliminary "value for money" assessment of the project (*évaluation préalable*) provided for in the ordinance of 17 June 2004 on partnership contracts.

The study must also be submitted to both the authority in charge of financing control (*autorité chargée du contrôle financier*), the Minister in charge of the budget and the Minister in charge of the economy, as well as to the expert advisory body responsible for delivering a notice on the preliminary assessment (the *Mission d'appui aux partenariats public privé – MAPPP*[4]).

The study must be updated if requested by the Minister responsible for the budget, or where significant changes affect the project.

Given that the Ministries of economy and budgeting are known to be rather averse to the use of PPP, going forward these provisions will make the use of PPPs more difficult – but not impossible – for major projects procured by the French State and national public authorities, given that such PPPs cannot be executed without the prior approval of both the Minister in charge of the budget and the Minister in charge of the economy.

Tax constraints

Before the introduction of the finance law for 2013[5], under French tax law, interest expenses were generally tax deductible without any limitation, subject to certain measures regarding specific interest expenses (e.g. thin capitalisation rules, etc.).

The finance law for 2013 has introduced a new limitation on interest deductions for companies subject to corporate tax in France: only 85 per cent of the interest incurred in fiscal years 2012 and 2013 is deductible, and 75 per cent of the interest incurred in fiscal year 2014 and thereafter. In other words, by virtue of the finance law, 15 per cent (25 per cent for fiscal years beginning on 1 January 2014 and thereafter) of the interest expenses will be disallowed.

As a general measure, the disallowance applies only if the total amount of the net interest expenses exceeds €3m. Once this threshold is exceeded, 15 per cent of the

2 It is expected that at least six university PPPs will progress to preferred bidder stage in 2013 (*Grenoble 2/Pilsi, Clermont-Ferrand, Lille, Lorraine/Metz, Université européenne de Bretagne and Montpellier*).

3 Decree No 2012-1093 of 27 September 2012, supplementing the provisions relating to the procurement of certain public contracts.

4 http://www.economie.gouv.fr/ppp/accueil.

5 See article 23 of finance law no. 2012-1509 of 29 December 2012 for 2013.

net expenses must be added back. In other words, under the new limit, 15 per cent of the net finance expenses of a company subject to French corporate tax will not be deductible. Also, the 15 per cent add-back applies on the net interest expenses less interest added back under other measures (for instance, thin capitalisation rules).

An exception applies for loans that have been entered into for the financing of PPPs (defined widely, and including not only partnership contracts, but also public works and/or public services concessions, etc.), as well as for loans entered into by a company whose sole purpose is to hold shares in an operating company that holds a concession or a partnership contract.

However, this exemption applies only for loans entered into prior to the date of promulgation of the finance law (i.e. prior to 29 December 2012).

Thus, for PPP projects closed after this date it is expected that the new tax constraint will increase the total cost of the project, as bidders are unlikely to agree to bear the additional cost resulting from the new limitation on interest deductions.

The above factors clearly demonstrate that the prospects for the French PPP market remain bleak in the short to medium term. However, the hope is that a better environment for PPPs will return once budgetary constraints are removed.

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PROPERTY-BASED PPPs IN AUSTRALIA

Factors in success and failure

by Chris Mitchell and Melinda Harris

Like most countries, Australia has had its share of successful public private partnership (PPP) projects and a number of failures. Projects involving a large real estate component have proved the most challenging.

What is a property-based PPP?

Those working in the PPP sector will be familiar with economic and social PPP projects, and the types of infrastructure which are commonly delivered through PPP structures. The usual elements include the design and construction of facilities, and their operation and maintenance over the life of a concession. The concept of provision of output specified services will also be familiar.

But the inclusion of a real estate element, through the provision of private sector development opportunities, is less common. Development rights can be provided as the result of the conversion of project land into private residential, commercial or retail buildings which are incorporated into the infrastructure. A typical example is the development of residential apartment towers above railway stations, toll road interchanges or other intermodal connection points.

Governments have long lamented the fact that the development of transport and services infrastructure, at taxpayer cost, creates a value uplift in surrounding land. Where that land is owned by private interests, it is the private sector which benefits from the value uplift. Australian governments have become, in recent years, focused on "value capture" as part of major infrastructure projects.

In a property-based PPP, the Government's requirements for the project often include the delivery of hard infrastructure and some soft services. Examples include the construction of rail or transport infrastructure and ongoing operation and maintenance requirements for that infrastructure. This aspect resembles a traditional PPP, involving the design and construction of infrastructure which is maintained and operated by the private sector. Development rights are included as a perceived bonus for the private sector, allowing the successful bidder to deliver infrastructure more cheaply. One recent Australian example – the Chatswood Interchange PPP – involved the delivery of a major new passenger-heavy rail station, bus interchange and associated public areas, together with the duplication of rail lines and bridges. The resulting podium structure also incorporated an 8,000 m² retail precinct and three pad sites for the construction of three residential apartment towers housing approximately 600 apartments. The development opportunities were created by the completion of the infrastructure and its accompanying podium structure, and were made available to the private sector via a series of call options which allowed on-sale.

The combined physical features of the project and the commercial and legal structure permitted the project to obtain integrated planning approval for

both the public infrastructure and the private components, while allowing the development to be undertaken in a staged manner. The integrated planning consent for both elements was seen as a means of "de-risking" the development component.

What can go wrong?

With the provision of development opportunities defraying infrastructure costs and the benefit of an integrated planning consent, it might seem that the property-based PPP is a winning combination. However, the Australian experience has demonstrated that financing risks, delivery risks and market risks can still create substantial instability in property-based PPPs. While failure can arise from any one of these factors, it is usually a combination of all three which has led to insolvency and other problems.

Financing risk

One major cause of this instability is the differing financing profiles which PPP projects and real estate projects generate. Particularly where a PPP involves social infrastructure, financiers are accustomed to the benefit of government availability payments. Provided that the project company successfully delivers the infrastructure and then meets operation phase KPIs, there is a guarantee that government availability payments will be received throughout the term of the concession. Real estate project financing transactions, by contrast, base their structure on the promise of development proceeds – from the successful sale of completed apartments, commercial office towers or other facilities – being received in a relatively lumpy fashion towards the end of the project.

The fact that the infrastructure component and the real estate component have often been offered by the Government under a single project deed means that financiers have struggled to accommodate financing for both components under a single loan facility or, alternatively, through multiple collateral facilities. This has increased the complexity of the finance structures and added various potential default triggers which are unfamiliar in PPP transactions. One such mechanism is the inclusion of borrower covenants in relation to loan-to-value ratios (LVR). LVR covenants are traditionally used in real estate financing to ensure that the financier is able to recover at least the value of the loan in the event of borrower insolvency. By either requiring the borrower to obtain valuations of the relevant real estate asset on a periodic basis, or allowing the financier to trigger such a valuation, the financier is able to monitor whether the value of the real estate has fallen below a critical level at which the financier's debt may be lost or compromised in the event of sale.

Property-based PPP projects have difficulty with LVR covenants because the real estate asset does not yet exist – it is often only created when the public infrastructure is completed and the development opportunity can be activated. At the start of the project, valuers producing the initial valuation for loan purposes are faced with the difficulty of estimating the end value of the completed asset. The end value is, in turn, often partially dependent upon the strength of a takeout covenant by an investor or purchaser of the completed asset. If the takeout party fails during construction, or the value of the real estate asset drops between financial close and the completion of the commercial component of the project, a finance breach will occur and the project financiers will be prompted to step in.

Such problems have, in recent years, been successfully avoided by governments through the division of projects into an infrastructure component and a real estate component, which are made the subject of a combined market call process but which are contracted under two separate project deeds. By allowing the successful consortium to back down real estate risk to separate debt and equity participants to those involved in the PPP component, recent property-based PPP projects appear to have accommodated both aspects more successfully. The New South Wales Government's recently closed Sydney International Convention and Exhibition Centre PPP has attempted to separate real estate and PPP dimensions in this way.

Infrastructure priority over private sector development

A further issue with property-based PPP projects is the natural priority which infrastructure delivery has over private sector development. Using the example of the Chatswood Transport Interchange, the development of the rail component created rail interface issues which impeded the development of the real estate component. A similar risk materialised in relation to an earlier rail PPP in Victoria, which also involved the construction of a major passenger rail station over an operating rail system. In both projects, the need to maintain live rail operations while construction proceeded caused substantial delays to completion. This is not to say that the Government approached either project in an incorrect manner: the need to maintain safe and continuous rail operations should always be the priority when delivering projects of this nature. However, the inevitable effect of obtaining additional approvals, delays in obtaining rail possessions and safety issues was to create substantial delays in completion and additional cost to the project.

In the New South Wales Government's Schools 1 and 2 projects, a successful delivery of private development and public infrastructure was achieved through the development of various primary schools which included childcare centres. The childcare centres were delivered (in a construction sense) by the same consortium as had developed the adjoining primary school. Ownership and operation of the completed daycare centres was then delivered to a private operator. The success of this combination was probably due to the complementary nature of the public and private development, and the absence of competing infrastructure requirements.

Learning from mistakes

While the past decade has seen several major property-based PPP projects come and go, the willingness of governments around Australia to adapt and create flexible contract structures has promoted a new generation of property-based PPP opportunities. The willingness to include commercial development opportunities in PPP projects continues, and the separation of real estate from infrastructure in project deeds and other arrangements is assisting the private sector in selling down different components of projects to appropriate participants.

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SON OF PFI

New approach to private funding for UK infrastructure investment

by Cameron Smith and Philip Vernon

Last December, the UK Treasury released guidance on its new approach – known as PF2 – for involving private finance in the delivery of public infrastructure and services, as part of a widespread package of measures to kick-start the UK economy.

PF2 replaces the private finance initiative (PFI) which had been the form of public private partnership (PPP) used most frequently in the United Kingdom. Alongside its policy document, entitled "*A new approach to public private partnerships*", HM Treasury also released a draft version of its "Standardisation of PF2 Contracts", otherwise known as SOPF2.

The hope is that SOPF2 will herald a new wave of privately-funded UK infrastructure development. Ashurst is at the forefront of developments in the process of rolling out PF2, as legal advisers to the Education Funding Agency in its forthcoming programme of privately-funded school development projects, as part of the Priority School Building Programme.

SOPF2 is an updated version of SOPC4, the standard form project agreement used for PFI projects, and incorporates a number of major changes since SOPC4 was released in 2007. At the heart of SOPF2 is the Government's attempt to address those features of PFI projects which had come in for particular criticism in recent years, and in particular:

- the protracted procurement process;
- the inflexibility of PFI contracts during the operational phase;
- the lack of transparency on future liabilities;
- the allocation of inappropriate risk to the private sector; and
- the perception of private investors making excessive profits.

This article gives an overview of the key structural and contractual changes introduced by PF2, which are now required to be implemented in accordance with SOPF2.

Structural changes to PF2 deals

Equity finance

From a sponsor's perspective, the most significant change proposed is the investment of public sector capital in project vehicles.

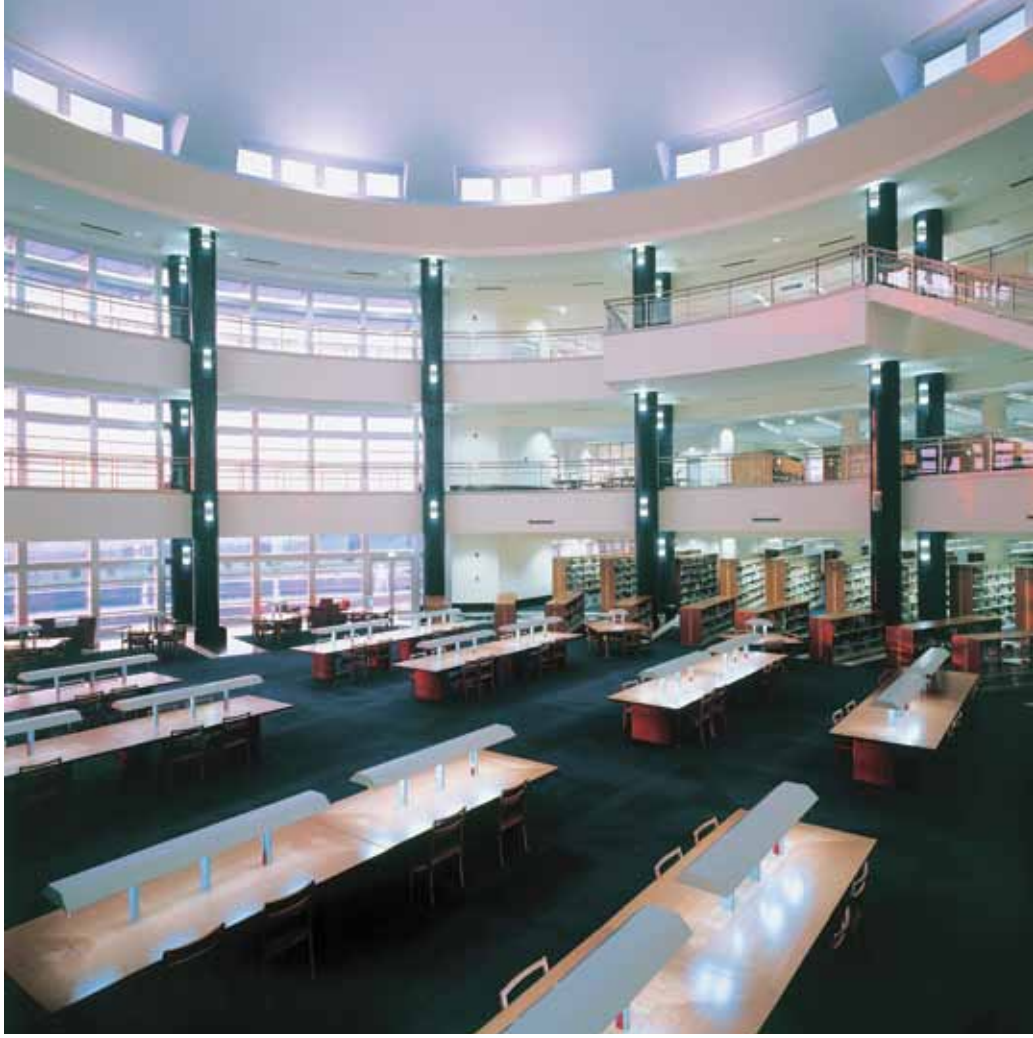
SOPF2 anticipates that:

- an equity investment (of between 30 and 49 per cent of all shareholder capital) will be made by a new Central Government Unit (CGU) situated within

HM Treasury and independent of the procuring authority;

- the CGU investments will be priced at market rates and will attract the same rights as any other shares in the project;
- each project company will hold an equity funding competition after appointment as preferred bidder, in order to attract longer term equity investors, such as pension funds; and
- all investors (the CGU, the development sponsors and the institutional equity investors) will invest a proportionate amount of subordinated debt in each project.

Much criticism has been levelled at these proposals, since their combined effect is likely to further delays to procurement timetables and increase development costs for sponsors. The proposed shareholding structure will also significantly reduce the shares which can be held by the original sponsors, reducing the financial attractiveness of such infrastructure projects for many sponsors. Ultimately, private equity investors will have to become more adept at squeezing significant equity returns from a reduced shareholding.



Shareholder rights

HM Treasury is currently carrying out pre-consultation discussions on the development of a standardised shareholders' agreement, to be used on all PF2 projects. In brief, SOPF2 proposes:

- three separate classes of shares held respectively by the CGU, the developer sponsors and third party equity investors;
- six directors comprising the SPV's board, two from each class of equity investor;
- tag-along rights for the benefit of the CGU;
- limited reserved matters for the protection of the CGU; and
- the appointment of an observer, appointed by the CGU, with no speaking or voting rights (*it is suggested that this observer will be a representative of the procuring authority or a local representative*).

It is this final requirement which we believe could prove difficult to manage, particularly where a project is under-performing or is in default. The list of reserved matters is also likely to prove contentious, unless the list of such matters is confined only to a narrow list of the key matters over which CGU requires control.

PF2 contractual developments

Risk allocation

SOPF2 addresses concerns that the public sector had been requiring private sector sponsors and subcontractors to absorb inappropriate risk, leading to increased project costs without any real benefit to the public sector.

SOPF2 seeks to reverse this trend, providing that procuring authorities should:

- warrant title to sites provided, make available all site surveys and ensure bidders are provided with collateral warranties in respect of the survey results;
- share both latent defect risk and ground conditions risk relating to the relevant site;
- bear a greater proportion of any increased insurance costs during the operational phase; and
- take all risks relating to general changes in law requiring capital expenditure during the operational phase.

This revised approach to risk allocation should lead to a general reduction in operating costs and improved affordability. On the flipside, the absorption of these risks by the public sector may reduce the ability for well-managed contractors and developers to profit from careful management of such project risk in the future.

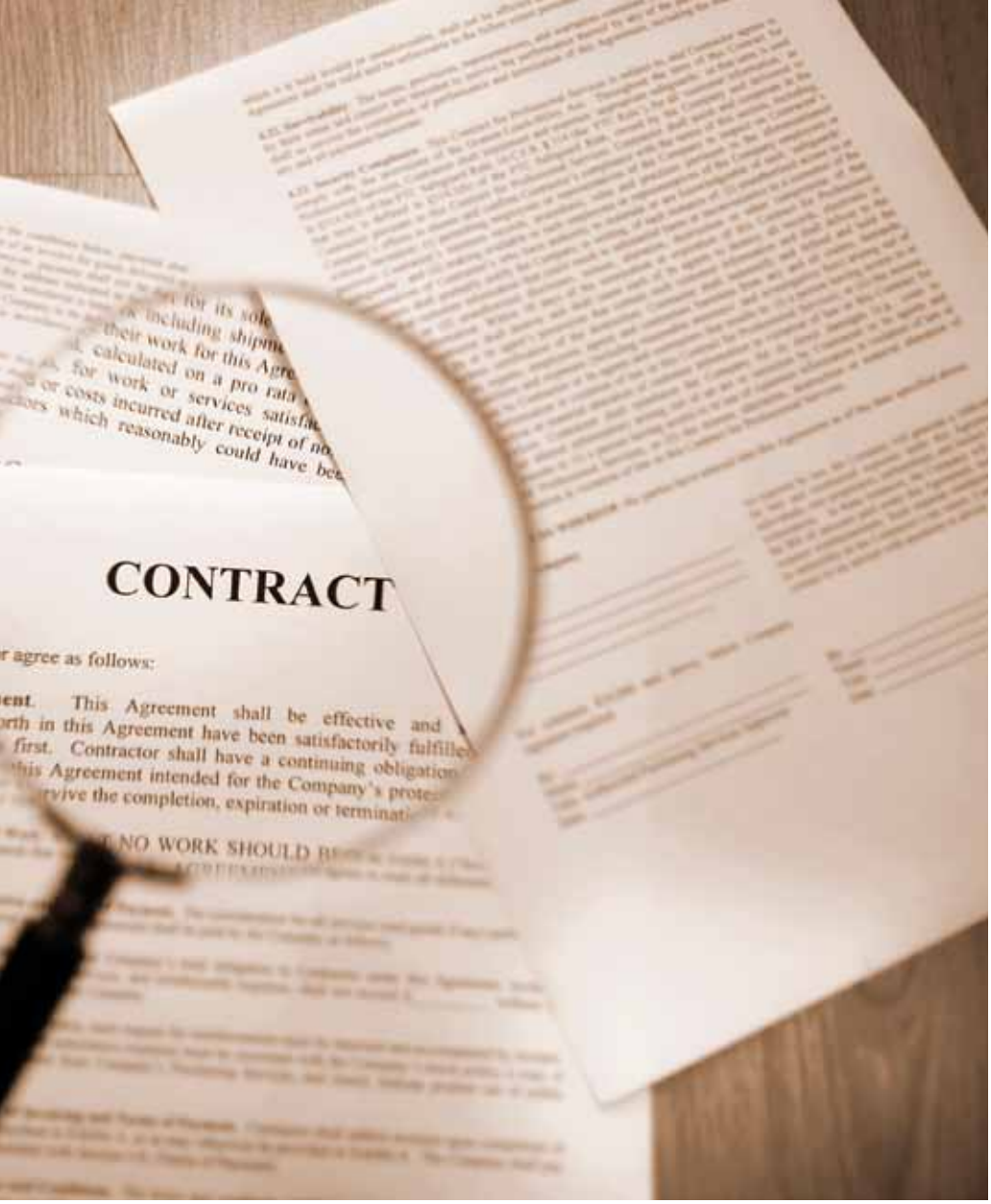
HM Treasury also anticipates releasing a standardised output specification and standardised payment mechanism for use on future PF2 projects.

Soft services

Another significant change made by SOPF2 is that "soft services", such as catering, cleaning and security, are likely to be excluded from projects in future (with the limited exception being the custodial sector) and, instead, will be provided by the procuring authority itself. The aim is to increase project flexibility and enable authorities to reduce project costs by contracting for soft services on a more short-term basis. The authority will need to provide these soft services in accordance with an "interface protocol" and will need to bear all responsibility for the risks associated with their provision.

Transparency and control

SOPF2 contains a number of wide-ranging control and information rights in favour of the authority. These increased authority powers may be of concern since the increased obligation on sponsors to disclose



commercially-sensitive information will reduce the competitive edge for the leading PPP developers and will impose a significant administrative burden on contracting parties and their shareholders.

Sponsors should be particularly aware of the following:

- there are greater disclosure obligations on contractors with respect to share ownership and share transfers;
- there is a duty to report semi-annually on actual and forecast levels of equity IRR for the project company and each shareholder;
- sponsors and contractors will also have far more onerous reporting obligations, including the need to produce regular updates on the performance of the project, and a failure to provide these reports will result in payment deductions;
- sponsors will be required to produce a detailed "transaction guide" to each project within 20 business days of financial close;
- sponsors will be required to carry out efficiency reviews every two to three years, with the majority share of any savings achieved being payable to the authority;
- subcontractors will be required to adhere to an agreed planned maintenance schedule and the authority will have new rights to accelerate or defer maintenance obligations;
- the authority will exercise greater scrutiny over lifecycle management and will be entitled to a share of any savings in lifecycle spend at the end of the contract term; and
- the authority will have more extensive step-in rights than has previously been seen on most accommodation-style deals.

Not only will these additional obligations place a significant administrative burden on project participants, but it is also expected that contractors will need to employ additional resources in order to manage the information flow from PF2 projects. Going forward, procuring authorities will be expected to play a greater role in the running of operational projects and cannot simply sit back and take a hands-off approach until payments are due.

The future of PF2

The Government's view is that the introduction of a comprehensive suite of standardised documentation, alongside a strengthened public sector procurement team and a commitment that the procurement process will take no longer than 18 months (except where an exemption is granted by the Chief Secretary), will put paid to drawn-out procurement timetables. However, it is far more likely that, at least in the short term, the unintended consequence of this raft of changes will extend, rather than truncate, the procurement process.

In terms of the substantive changes proposed, our view is that many of the reforms relating to risk allocation are long overdue and are a refreshing change to the way in which UK PPP deals had previously been structured. However, some of the changes on reporting and transparency, which have been made in response to the perceived excesses of the past few years, seem more onerous than may have been strictly necessary.

Arguably, it is the development sponsors, third party equity investors and contractors who will shoulder the greatest impact of these PF2 reforms. SOPF2 will undoubtedly force their hand, changing the way in which the private sector approaches, and structures investments in, privately-financed projects of the future. As to whether the increased role of the public sector in privately-financed deals will act as a force for good and ultimately lead to a more efficient and competitive private finance market, only time will tell.

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PROMPT PAYMENT IN CONSTRUCTION CONTRACTS

Project bank accounts in construction projects

by Nicholas Hilder and Barbara Walshe

Hailed by some as a pioneering way of ensuring prompt payment of supply chain members on construction projects and criticised by others as an unnecessary burden on those tasked with their administration, the increased use of project bank accounts (PBAs) by public sector construction procurers is being driven by UK government policy.

The UK Government's commitment to deliver £4bn of construction work through PBAs by 2014 means that, whatever the construction industry may think about their use, the PBA is set to become a more common feature on construction projects procured by the public sector, including projects using private finance. This article explores some of the key features of PBAs and provides an overview of the pros and cons of implementing a PBA arrangement.

What is a PBA and how does it operate?

A PBA is a ring-fenced bank account from which payments are made to the contractor and members of its supply chain.

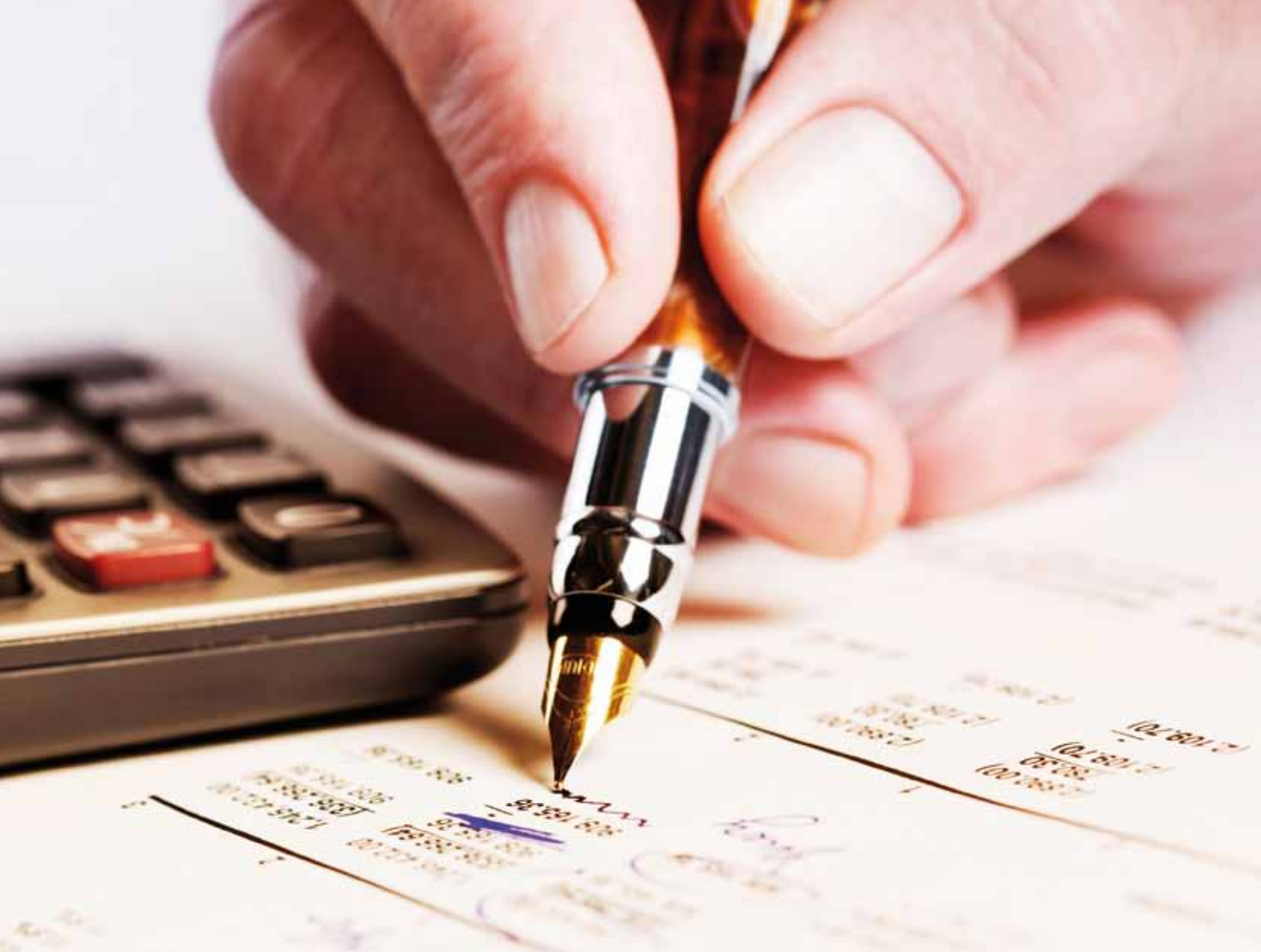
In terms of operational reality, the building contract will include a mechanism for calculating the sum that the employer should pay into the PBA in time for payments to be made to the supply chain. The employer makes a payment into the PBA, or ensures that payments of certified sums are made over time so that the balance is above an agreed minimum level, and payments to the beneficiaries (i.e. subcontractors) are made directly and simultaneously from the PBA without the need for payment to trickle down through various tiers of subcontractors. PBAs are therefore seen as a means of achieving security of payment and improving certainty of payment to the supply chain.

PBAs are usually put in place by way of a trust deed and are administered by a bank under a mandate. The trustee of a PBA is usually the employer but the employer and the contractor may also act as joint trustees. The subcontractors need to be joined to the trust deed to receive the benefit of the PBA.

The documentation for PBAs is usually agreed as part of the main contractual documentation and modifications to the contracts at each level will be required to accommodate the use of the PBA. JCT and NEC have both produced amendments to their standard forms to provide for PBAs, and Cabinet Office guidance includes basic model forms of the documentation used to establish a PBA.[1]

While the trust deed will regulate the operation of the PBA, it does not of itself cut across contractual provisions governing the preparation, submission or certification of interim payments nor does it undermine the lead contractor's responsibility for selecting and managing the supply chain.

1 A guide to the implementation of Project Bank Accounts (PBAs) in construction for government clients - (Cabinet Office, 3 July 2012) (Cabinet Office PBA Guidance).



Why are PBAs important?

The Cabinet Office PBA Guidance reiterated the Government's position that:

"The use of PBAs ensures compliance with the Government Construction Board's (GCB) agreement for the use of Fair Payment Terms on central government construction contracts. The GCB agreed that PBAs should be used wherever possible; there should only be a very small number of projects where PBAs cannot be used."

Various government departments have stated their commitment to using PBAs. For example, Highways Agency policy is that PBAs will be used on all contracts awarded post-October 2011 across all directorates unless there is a compelling reason not to do so. Although PBAs were rejected by the Olympic Delivery Authority for the main venues of the 2012 games, they have been adopted by Crossrail on all its major contracts and the Northern Ireland Assembly is the first national administration to mandate the use of PBAs on all centrally procured construction contracts.

The increased level of commitment by the public sector to the use of PBAs means that they are set to become more prevalent in the future.

Are PBAs necessary?

The construction industry has long been criticised for adopting poor payment practices. Difficult economic conditions have made achieving security of payment under construction contracts even more challenging. Any mechanism such as PBAs that could improve the financial health of the construction industry by speeding up payment and reducing the risk of cash flow problems should, on the face of it, be a welcome development.

However, as with any change to long-established procedures, there has been resistance to the introduction of PBAs from some quarters. The Cabinet Office PBA Guidance therefore contains a list of arguments against using PBAs that may be put forward by contractors at each level of the supply chain, along with suggested rebuttals to those. While some of this resistance can be attributed to a reluctance to adopt new working practices, PBAs are not a panacea for all the construction industry's woes, and there are arguments both for and against adopting PBA arrangements. Indeed, even some of the arguments in favour of PBAs must be treated with caution, as the benefits may not be as great as they first appear. Four of the main issues raised are as follows:

Security of funds in the event of insolvency?

Funds paid into the PBA are to be held on trust for the contractor and the participating subcontractors, and the protection of funds in the PBA on an insolvency is often cited as one of the key benefits of the PBA.

Although the issue is yet to be tested by the courts, the prevailing view is that, if a properly drafted trust deed has created a trust in favour of the contractor and the subcontractors, an administrator should

be prevented from seizing the proceeds of the account if the employer or the main contractor becomes insolvent. However, identifying whether a valid trust has been created in respect of the balance of a bank account of an insolvent company can prove complex as it requires an examination of the documents establishing a trust and a review of how the account was operated. For example, in an account not jointly held by the employer and contractor, mixing the employer's funds with the PBA funds would cause the trust to fail. Some commentators have expressed concern that, for example, the JCT PBA amendments are not sufficient to create a valid trust. The trust mechanism for a PBA is therefore a key area where legal advice should be sought.

Also, it should be noted that the PBA does not protect the whole project in the event of insolvency of the employer (as opposed to the contractor) as the amount paid into the bank account will only be the amount already certified as due, or at a pre-agreed level, and not the entire contract sum. However, if an employer is the subject of insolvency proceedings, and an administrator elects to continue work on the project, they may welcome the existence of a PBA as it will assist in funding the ongoing work.

Cost savings?

The Guide to best 'Fair Payment' Practices (the "Guide")[2] suggests that public sector procurers can achieve savings of up to 2.5 per cent on projects through the use of fair payment practices facilitated by a PBA. This potential saving comes from subcontractors not having to incur financing costs associated with lengthy credit periods/ overdraft facilities or bear the cost of chasing payments. This research appears to suggest that the supply chain will reduce prices due to the use of a PBA, but does not seem to consider whether the supply chain might add a premium due to an increased administrative burden (particularly where a party is unfamiliar with PBAs).

The Cabinet Office PBA Guidance acknowledges that lead contractors may have to increase their prices due to the impact on maintaining profitability through the retention of cash. However, it is precisely this kind of payment practice that the PBA is seeking to guard against and, although public sector parties will not welcome arguments in this vein, it goes some way to explaining resistance within the construction industry.

Over time, once PBA arrangements have become familiar and are widely used, it is likely that cost savings will be achievable as the negative impact on profitability at contractor level is balanced by the potential savings through prompt payment to the supply chain. It is important that the requirement for a PBA is established at the outset of a project, otherwise supply chain contracts may have already been let, and pricing agreed, only to have to be re-opened to accommodate a PBA which would decrease the potential benefit from cost savings. It is probably fair to acknowledge that, in the shorter term, as the construction industry adapts to the use of PBAs, the cost savings may not be as significant as the Government suggests.

Fewer disputes?

While PBAs ensure that payment for certified works is made on time, they cannot prevent parties disputing the value of any sums retained by the employer by virtue of a "pay less" notice. Furthermore, a PBA will not prevent disputes between a contractor and subcontractor where a contractor rejects the subcontractor's claim and refuses to make payment. In such a case, the subcontractor would only have an unsecured claim.

Taking a more holistic view, PBAs are intended to complement collaborative working and partnering. Greater transparency on payment flows allows the employer to understand how subcontractors are engaged, evaluated and managed which may ultimately have a positive effect on relationships throughout the supply chain, and decrease the risk of disputes.

Suitability?

The Government Construction Board (GCB) requires PBAs to be used to at least tier three on projects and for at least 80 per cent of the value of the work subcontracted. However, not all members of the supply chain will participate in the PBA arrangements either through choice or due to a *de minimis* threshold for low value spend or a payment cycle that does not align with the mechanics of the PBA arrangements. It will be important to ensure that policy does not force impractical arrangements that create an unnecessary administrative burden. PBAs will only be accepted by the construction industry more widely if they are used where they can bring a real benefit rather than being imposed on projects.

The Cabinet Office PBA Guidance suggests that project bank accounts are no more difficult to set up than a normal bank account and, while this may be true, the additional documentation, the processes required and ensuring that the payment provisions in all relevant contracts are dovetailed with the PBA arrangements may add further complexity and strain to time-pressured projects.

One of the main arguments for the use of PBAs is, as noted above, that a properly constituted PBA should provide protection on an insolvency. However, in the context of PFI/PPP projects, it is worth considering whether this provides a genuine added benefit to subcontractors, given all the controls that will already exist in relation to the solvency of the project company in both the project documents and the finance documents.

In the context of project finance, establishing a project bank account at the project company level can be problematic given the requirements of the funder security package and the issue of control over project company bank accounts. Where it is required in order to satisfy government policy objectives, it may be more straightforward to set up the PBA at top subcontract level so that the project company is not a trustee of the PBA and the funds flow from the public sector through the project company to the PBA.

The future for PBAs

Whatever the construction industry may think of PBAs, given the UK Government's commitment to their use, contractors and the supply chain will need to ensure that they understand the operation of PBAs, and have efficient and robust PBA arrangements in place. Although there are some challenges, PBAs are set to become a feature of the construction industry and, if implemented correctly and where appropriate, should provide benefits.

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2 Guide to best 'Fair Payment' practices, OGC, 1 August 2007 http://www.b-es.org/files/6813/1055/2142/fairpayment.pdf.

STOP PRESS

Ashurst promotes three partners in the global infrastructure team

On 1 May 2013, Manuél Lopez, Nikhil Markanday and Nick Rainsford were promoted to partner.

Manuél is based in Ashurst's Madrid office and his practice focuses on advising funders in relation to energy and infrastructure projects, with particular emphasis on the transport sector.

Nikhil and Nick are both based in Ashurst's London office. Nikhil specialises in the project development and financing of energy, transport and infrastructure projects with particular experience in multi-sourced financings. Nikhil has also spent time on secondment to the European Investment Bank where he worked in the legal directorate.

Nick specialises in infrastructure M&A, private equity and consortium deals/joint ventures in the transport and infrastructure sectors.

Infrastructure CPD Day – watch this space

As the end of the CPD year approaches in October, we will be running an infrastructure training day which will help to meet your CPD requirements for the year.

The training day includes sessions run by a mix of internal speakers on infrastructure M&A, procurement, PF2 and a range of other topics.

And of course, if you are not a UK lawyer and don't need CPD hours, you are still more than welcome to participate in this training.

We will be providing you with more detailed information in due course.

Ashurst opens new office in Beijing

We are delighted to announce that we have expanded our Asian offering with the launch of an office in Beijing. The Beijing office will be led by Patrick Phua, who joined Ashurst in March 2012. Patrick is a banking and finance partner, with particular expertise in derivatives transactions and regulatory matters. Ashurst Beijing will focus primarily on banking and finance work, as well as assisting PRC corporates in relation to outbound investment, working in conjunction with Ashurst Shanghai and Ashurst Hong Kong.

Patrick Phua commented:

"I am very pleased with the progress we have made in building relationships with key PRC clients since I joined Ashurst 12 months ago. A licensed Beijing office will enable us to provide even greater support to those clients, forge new relationships and reinforce the Ashurst brand in China."

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