GIF BRIEFINGS

Contractual Considerations for Bond and Corporate Financing in PPPs

The Global Infrastructure Facility (GIF) supports the standardization and development of infrastructure as an asset class through its knowledge program. As part of these efforts, the GIF commissioned guidance on the contractual provisions to facilitate bond financing and corporate financing in PPPs. This guidance aims to fill the gap in existing knowledge resources available on alternative financing arrangements for Public-Private Partnerships (PPP)s.

The guidance commissioned by the GIF is part of a larger World Bank Group report, “Guidance on PPP Contractual Provisions, 2017” (the Guidance). The objective of the Guidance is to provide contracting authorities, particularly in emerging markets, with an understanding of standard international market practice, to assist them in attracting private sector investment and procuring PPP projects successfully and efficiently where PPP is their chosen procurement route. It contextualizes and further develops guidance on eight recommended contractual provisions in PPP projects.

This GIF Briefing provides a brief overview of the Guidance and summarises the GIF-funded sections on bond financing and corporate financing. These sections examine the legal and commercial considerations for bond financing and corporate financing of infrastructure.

Contractual Considerations for Bond and Corporate Financing in PPPs

1

INTRODUCTION & OBJECTIVES

With an estimated USD3.3 trillion in investment needed for global infrastructure to 2030[1] according to McKinsey Global Institute analysis in 2013, the financial challenge facing governments is immense. Private sector finance is an essential part of addressing this challenge, but it is not unlimited. Regulatory constraints since the financial crisis have reduced the level of commercial bank lending for infrastructure projects and changed the terms on which it is provided. Alternative financing sources are becoming increasingly important and non-bank investors are becoming increasingly interested in infrastructure investment.

PPP is one method available to governments to procure infrastructure using private finance. The complexity and sophistication of PPP transactions, and the fact that they are often heavily negotiated to reflect their individual characteristics, means that considerable time and expense is invested in preparing PPP contracts and financing arrangements.

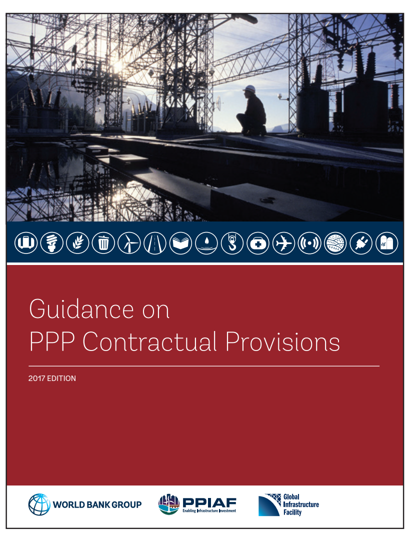
Even with well-structured projects, the supply of capital into emerging markets and developing economies (EMDE) infrastructure projects can be constrained by the lack of footprint and managerial capacity of international financiers in these markets, as well as the lack of credit experience of domestic investors. An important way of overcoming these constraints is to present projects to the market in an increasingly standard way, so that investors (international and domestic) are not facing fundamentally different investment propositions each time they consider projects and can more easily assess the projects that are presented. Standardized approaches are particularly important for governments that are trying to launch PPP programmes and those that are trying to attract institutional investors to their programmes/projects. In these situations, a more standardized approach can build investor confidence by promoting projects in a consistent and market-recognized way which should reduce upfront transaction costs for all investors. At a global level, this may help justify investors expanding overall managerial capacity or reallocating capital to EMDE infrastructure as an asset class.

Several countries have made efforts to develop complete standardized PPP agreements for different types of projects such as roads, railways, ports or power generation. To date, however, there is no universally accepted language for such agreements on an international basis. Given the variety of PPP transactions carried out globally, the different legal systems existing in various countries and the need to have 'tailor-made' provisions to deal with the individual char-

1 Richard Dobbs, Herbert Pohl, Diaan-Yi Lin, Jan Mischke, Nicklas Garemo, Jimmy Hexter, Stefan Matzinger, Robert Palter, and Rushad Nanavatty "Infrastructure productivity: How to save $1 trillion a year" McKinsey Global Institute, 2013 https://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/infrastructure-productivity acteristics of specific projects, the development of complete PPP agreements on an international basis is unlikely to be a realistic goal.

Against this backdrop, the World Bank Group developed the Report on Recommended PPP Contractual Provisions, 2015 (the 2015 Edition), a first attempt by a Multilateral Development Bank to prepare a compilation of guidance and example language in respect of a selection of provisions typically encountered in PPP projects. In response to internal and external industry feedback on the 2015 Edition, the World Bank Group's PPP team produced an updated edition that was published in 2017 (the Guidance). As part of this process, the Guidance has been presented to a range of public and private sector participants in Paris (alongside the OECD and Global Infrastructure Hub) and to African government PPP unit representatives in Pretoria (in conjunction with the African Legal Support Facility). The resulting draft has also been consulted on within the World Bank and publicly.

The GIF supports the standardization and development of infrastructure as an asset class through its knowledge programme. In addition to the traditional standard project finance structure based on bank debt, the GIF also supports EMDE governments seeking to engage institutional investors in projects through bond financing arrangements and low-income countries where project finance structures are very difficult and some deals are financed on corporate balance sheets. The GIF has identified standard contractual provisions for these alternative financing arrangements as a gap in existing knowledge resources. By supplementing the Guidance with sections on bond financing and corporate financing, the GIF hopes to enhance existing knowledge resources available to its clients.



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2

OVERVIEW OF THE GUIDANCE

The Guidance's target audience is contracting authorities, particularly in emerging markets. It aims to provide them with an analysis of, and drafting guidance for, specific provisions that are typically included in a PPP Contract and/or related agreements. The goal is to provide a more comprehensive understanding of these provisions, including the related legal issues and the parties' different perspectives, to help reduce the time and cost of procurement and achieve a successfully financed PPP Project that will deliver the service or asset desired. It is based on the premise that PPP has been chosen as the appropriate procurement method so does not go into the process for deciding between procurement methods.

The Guidance includes:

- Detailed commentaries regarding key considerations relevant to contracting authorities due to different levels of PPP transactional experience;
- Detailed commentaries relevant to contracting authorities due to the characteristics of different legal systems;
- Guidance on specific matters relevant in the context of each of the selected contractual provisions in order to help contracting authorities carefully assess the issues specific to their own PPP project and jurisdiction in developing contractual language;
- Sample drafting for certain provisions.

The example drafting included in the Guidance is not prescriptive or comprehensive, but should be seen as a starting point for teams working on PPP transactions. This is true of the whole Guidance, as the appropriateness of a transaction's overall risk allocation can only be assessed by consideration of the PPP Contract and related agreements as a whole.

The Guidance primarily focuses on PPP transactions on a project finance basis, as reflected by the attention given to bankability and the expectations of lenders in terms of protection of their rights, as well as the sharing of the benefits of refinancing. The Guidance sets out language for eight selected provisions typically encountered in PPP agreements: force majeure; material adverse government action; change in law; termination payments; refinancing; lender step-in rights; confidentiality and transparency; and dispute resolution.

The Guidance assumes a project financing approach and explains that lenders' due diligence will focus on bankability – i.e. the Private Partner's ability to service the debt it has borrowed to deliver the PPP project. The Private Partner is the private company that enters into the PPP Contract with the Contracting Authority, the public authority that enters into the PPP Contract with the Private Partner. The Private Partner often takes the form of a special purpose company. Lenders will analyse the payment mechanism and any risks which could adversely affect the expected payment (including delays, poor performance, liabilities and possible termination). Equity investors are similarly looking to protect their investment and ensure the Private Partner will be able to generate high enough revenues not only to service debt but also to meet their expected equity return.

The Guidance explains that private sector parties will not lend or invest if they cannot satisfy themselves as to the likelihood of achieving the necessary repayment or return. If the terms are not sufficient to attract their private financing, they will simply lend or invest elsewhere. This is why bankability and risk allocation are fundamental issues for contracting authorities to understand when choosing to procure infrastructure using private finance on a PPP basis. The Guidance looks at these issues in the context of the contractual topics outlined and explains why market practice in PPP has evolved so that the contracting authority is liable for payments which in other contractual contexts might seem inappropriate (e.g. on termination for Private Partner default or force majeure or as compensation for certain changes in law). It also explains why structures are seen which allow Lenders the opportunity to step in and rescue poorly performing projects before the PPP Contract is terminated.

While the Guidance applies to both bank and bond financing, the new bond financing section commissioned by the GIF highlights in more detail specific considerations when bond financing is the project financing method used. The corporate financing section explores the factors to be considered when third party lending is not the prime source of funding and a project is instead financed using the corporate balance sheet. While the Private Partner will ultimately decide on its financing approach, the Contracting Authority's role is to be neutral as to the financing method to the extent appropriate for its PPP project, but to facilitate, where appropriate, different financing methods. This may include adjusting procurement timelines and drafting bidding documents to facilitate bid evaluations that require comparing different types of financing solutions.

3

BOND FINANCING

Prior to the 2008 financial crisis most PPP projects were successfully financed through long-term commercial bank debt borrowed by the Private Partner. However, as a result of the crisis and ensuing banking regulation, the volume of bank debt available for large infrastructure projects has declined and loan tenor has shortened, which has made commercial debt more expensive for these projects. Bidders for PPP projects have therefore had to consider alternative forms of finance, such as bond financing, to ensure that they can finance their bids and that their bids remain competitive. This section on bond financing provides an overview of the bond financing for PPP projects, and highlights the factors a Contracting Authority should consider when assessing whether bond financing could be a suitable option for its project.

Bond financing can both offer long-term finance for PPP projects at a more affordable price than bank debt, as bonds typically offer a longer-term repayment profile, which results in lower scheduled repayments, lower contract price, and more cash available for shareholder distribution. The long-term (and generally fixed rate) nature of bond financing also enables the Private Partner to fix its financing costs for the life of the PPP project (or the remaining life if after a refinancing) without the need for separate interest rate hedging arrangements, giving it certainty and reducing the likelihood of a subsequent refinancing.

Bond financing also facilitates the entry of non-bank financial institutions such as insurers, specialist fund managers, pension funds, and sovereign wealth funds to the PPP debt market. These institutional investors recognise that the long term predictable returns in PPP projects can provide a hedge to the profile of their long-term liabilities. One of the main challenges for institutional investors looking to invest in PPP projects is understanding the risk profile of the asset. Some investors may be limited by regulation to investments that have an investment grade credit rating, and/or investments that are publicly listed. Investors may also be unwilling to accept certain risks, such as construction risk in greenfield projects, and may require credit enhancements to mitigate against these risks.

Credit enhancements provide first loss coverage against certain risks, which insulates bondholders against a certain level of loss and/or provides liquidity in times of cashflow stress. This can reassure potential investors that the risk profile of a project is suitable for their investment, and can result in a higher credit rating for the bond issuance. Credit enhancements can be used to mitigate sovereign and macroeconomic risks, as well as project-specific risks. These include sponsor guarantees, sovereign (government) guarantees, bank guarantees, letters of credit, and multilateral guarantees and insurance products.

Key Considerations for Contracting Authorities

Contracting Authorities considering bonds as a potential source of financing for projects need to be prepared to adapt their approach to facilitate bond financing, although this should not require the Contracting Authority to take on more risk or responsibility than under a bank financing. The key factors Contracting Authorities will need to take into account to facilitate a bond financing include:

- The time and cost for bidders in preparing bond financings, and recognizing that bond solutions generally require more time to prepare than bank solutions as there is usually a need to obtain credit ratings, prepare the bond placement documentation, market the bonds with investors and meet regulatory requirements;
- Increased complexity in comparing bids where different financing solutions are presented;
- Deliverability and pricing of the bonds and (for public bonds in particular) how to address price fluctuation between bid and financial close;
- Risk profile of the project and assessing whether investors will require credit enhancements;
- Regulatory and disclosure requirements for private placement and publicly listed bonds; and
- Risk profiles of investors and regulatory or policy requirements for institutional investors.

The Contracting Authority and its advisors will need to draft bid documentation in a way that facilitates a transparent comparison of all finance solutions or categories of solutions. The changes required to the PPP Contract to accommodate bond financing solutions are relatively minimal. Although the relevant financing documents are different and there is a different process to be gone through to reach financial close, in practical terms a bond financing is not that dissimilar to a bank financing. Broadly speaking, the main provisions affected are:

- Definition of financing documents;
- References to the relevant parties;
- Termination payments;

- Confidentiality; and
- Refinancing.

Similar changes will also be required to the Direct Agreement[2]. Additional changes may be required to reflect certain bond mechanics (e.g. different reporting requirements/timing) and more than one party may want step-in rights. In considering amendments to documents, a Contracting Authority wishing to attract the full range of financing options will want to avoid making bond-specific amendments beyond those strictly necessary to ensure that it is not making other financing solutions less attractive.

The Contracting Authority may also need to adapt the procurement timetable to allow for the additional time required to prepare a bond solution. Once a preferred bidder has been selected and the PPP project documentation is finalized, it may take four to six weeks to seek a final rating (if required) and to market the bonds.

In addition to the timing of financial close, the timing of a bond issuance introduces price uncertainty into the bid evaluations. The pricing of public bonds (and some private placements) is only confirmed a few days prior to the actual issuance, and final public bond pricing is largely market-driven, so there is a risk of price fluctuation between final offers and financial close. The Contracting Authority and bidders should discuss a risk sharing mechanism early in the procurement process to help eliminate pricing uncertainty. Following the appointment of the preferred bidder, the Contracting Authority should require the preferred bidder to track pricing movements and inform it on a regular basis up to financial close.

2 *The Direct Agreement (or in some jurisdictions the Consent Agreement) is an agreement between the Lenders and the Contracting Authority that will entitle the Lenders to be altered to a potential termination and take steps to prevent it by addressing the problem. This is also referred to as Lenders' "step-in" rights.*

4

CORPORATE FINANCING

Corporate entities typically use a range of financing means to fund their daily business needs across their corporate group. Some corporates may not even need to enter into specific additional financing arrangements for particular investments, as their balance sheets are so strong that they have sufficient financial reserves to finance the investment in question. The funding of investments in this way is called corporate financing and is also known as "on balance sheet" financing. This section explores the circumstances where corporate financing is appropriate for PPP projects. It further highlights procurement and bid evaluation implications, due diligence, creditworthiness of bidder, fixed pricing, transparency considerations, addressing poor performance, flexibility, changes to documentation and possible approaches to termination payment calculation.

There are several circumstances where corporate financing is appropriate for a PPP project, including when:

- A bidder is the sole sponsor, has a strong balance sheet and typically uses corporate finance for new projects as part of its normal business model;
- It is more cost-effective to use balance sheet financing to reduce transaction costs (e.g. on smaller transactions); and
- A bidder may be willing to take more risk in a particular market than third party lenders (and may have access to export credit or other support).

The benefits of using corporate financing for projects may include increased flexibility to implement variations and the prospect of a fixed price bid not subject to interest rate fluctuations before financial close, as well as in some cases a potentially simpler, faster and more cost-effective process (e.g. because of the fewer parties and debt mechanics involved).

Financing a PPP Project with corporate financing will require a bespoke approach. As "on-balance" sheet financing is not commonly used and is typically based on special circumstances, a standardized form of contract may not work for such transactions. So a bespoke approach is feasible because it can be customized for a sole sponsor or the risk-taking bidder. In addition, the procurement process for a PPP project will need to adapt in order to accommodate bids using corporate financing, as the documentation and parties involved will be different. The PPP Contract terms will require some amendment, particularly where they are based on third party senior debt and equity elements and an assumption of a high debt to equity ratio. Key considerations for the contracting authority include:

- Appointing advisers with the requisite experience at an early stage to assist with procurement documentation, bid evaluation and negotiation;
- Considering from the start of the procurement process implications of a corporate financed bid as compared with a limited recourse project financed bid;
- Focusing on contracting authority due diligence in the absence of third party lender due diligence;
- Establishing the creditworthiness of the private counterparty appropriately;
- Recognizing price fluctuation between preferred bidder and financial close;
- Addressing the potential reduced transparency as regards costs, contractual structures and payments;
- Recognizing fewer stages in addressing poor performance and termination (without lenders to step in or other shareholder parties to fix sub-contractor failings);
- Considering the flexibility in scope of work/services if there are no third-party lenders in the process; and
- Assessing the appropriate level of compensation payable in different termination scenarios where typically these would be based on outstanding senior debt or equity elements (these are likely to depend on the project specifics, however, as there is little established market practice).

A final issue that Contracting Authorities will need to consider when a bid is financed using corporate finance is the Termination Payment Calculation. In a corporate financing, the Private Partner is still likely to expect full compensation if the PPP Contract is terminated early for Contracting Authority Default, MAGA, Change in Law or Voluntary Termination. However, it is important to note that there is no senior debt when corporate financing is used because transactions are effectively financed with equity. Further, the Private Partner may be able to more effectively mitigate costs to the Contracting Authority, particularly on a Voluntary Termination, in a way, which proves less expensive to the Contracting Authority than in a project financing.

5 CONCLUSION

The standardization of PPP contractual provisions and structures is a tool in maximising the potential of available bank finance and opening up the PPP market to alternative financing and investors. It can help financiers with resource constraints as projects become more commoditised and, from contracting authorities' perspective, can facilitate the roll out of multiple programmes, create market confidence and attract a wider range of investors. Combined with a common understanding of relevant contractual issues, it can also save parties time and cost in the project procurement process. All this ultimately contributes to establishing infrastructure as an asset class in its own right. The Guidance as a whole aims to facilitate this.

The GIF supports the standardization and development of infrastructure as an asset class through its knowledge programme. The GIF has identified standard contractual provisions for these alternative financing arrangements as a gap in existing knowledge resources available to its clients. By supplementing the Guidance with sections on bond financing and corporate financing, the GIF hopes to enhance existing knowledge resources available to its clients.

Global Infrastructure Facility

2017

The Global Infrastructure Facility (GIF) was established in March 2015 as a partnership program housed at the World Bank Group. The GIF provides a global platform to integrate efforts to invest in infrastructure in Emerging Markets and Developing Economies (EMDEs), enable collective action among a wide range of partners, and thereby leverage resources and knowledge to find solutions to complex infrastructure financing challenges that no single institution could achieve alone. The GIF provides end-to-end project preparation, appraisal, structuring, and transaction support needed to bring well-structured and bankable infrastructure projects to market, with the objective of increasing private investment, in particular long-term finance, in complex EMDE infrastructure projects.

GIF is uniquely positioned to harvest market intelligence and knowledge that can be shared with its partners and the wider infrastructure community in the form of high-quality knowledge products that aim to improve understanding and best practice around key trends and issues in the infrastructure finance market.

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