

Infrastructure/Europe
Criteria Report

PPP-PFI: UK Market Trends and Fitch Rating Criteria for European PPP Transactions

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Related Research

- “Public-Private Partnership, the Next Generation of Infrastructure finance”, January 2003
- “European Construction Outlook for 2003”, April 2003
- “Rating Approach to Project Finance”, April 2001

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Executive Summary

The 10-year-old Private Finance Initiative (PFI) programme in the United Kingdom has been very successful, as demonstrated by the number of transactions closed to date, even though high bid costs remain a deterrent for many private contractors. It is now entering a more mature phase, characterised by contract standardisation, pooling of resources, and the development of a secondary market for debt and equity. Other European governments, spurred on by the need to rejuvenate public infrastructure while the economic slowdown and Maastricht criteria are reducing their financial flexibility, are also championing the development of such Public Private Partnership (PPP) programmes.

Fitch has rated a number of PPP transactions, on both a private and a public basis. Fitch’s analysis includes a detailed review of construction risk, performance risk, counterparty risk and the regulatory framework, a review of the financial structure and documentation. A sensitivity analysis will be conducted to assess the capacity of a project to withstand a number of adverse circumstances. In less mature markets, the review of the PPP regulatory framework and government support will constitute a larger part of the analysis.

The good credit quality of the sector is evidenced by the fact that, with over 200 projects in operation in the UK, very few have experienced significant problems – even during construction, arguably the riskier phase of any transaction. However, the risk profile of PPP transactions is far from homogeneous. New trends (detailed overleaf) are emerging in the UK market, which, in Fitch’s view, do not have a fundamental effect on the rating approach to these projects. The political pressure is on the government to increase the type of risk transferred to the private sector. Nevertheless, for large transactions requiring wide market acceptance, the private sector has been able to negotiate significant government support in order to offset any unusual risk. As new transactions have different levels of risk, they could have lower ratings than have been historically assigned in this sector. However, Fitch expects the sector to retain investment grade characteristics overall.

In the rest of Europe, the PPP programme is in various stages of development. Fitch sees a wide disparity between the PPP programmes in each European country, many of which are still in their infancy. At this stage, few PPP transactions have been financed by bonds. Fitch expects this financing source to play an increasingly visible role going forward.

■ The UK Market: Some Trends

To date, more than 500 contracts have been signed with an aggregate value of over GBP25 billion, equating to an average cost per project of about GBP50 million. The projects financed range from traditional social infrastructure (schools, hospitals, government buildings, prisons) to transport (roads, rail, underground), equipment projects (IT, power and street lighting) and the military (Ministry of Defence contracts). They vary in size from a few million pounds to more than GBP1bn. The PFI programme, initiated by a Conservative government over a decade ago, has continued to be supported and expanded by the following governments across the political spectrum since then. In 2002, the debt market grew by 45% to GBP4.9bn. Future growth is expected to be fuelled by the government's significant investment programme in new schools, hospitals and transport, as well as defence equipment. Current government forecasts show that expenditure on PFI is set to remain constant at about GBP4bn per year in the foreseeable future, a level equivalent to about 10% of total capital expenditure on public services.

The market is now entering a new and more mature phase, with the following characteristics:

Standardisation of Contracts

Given the diversity of infrastructure type and the number of players (local authorities, government, NHS trusts, construction companies, insurers and banks) active in the PPP-PFI sector, it may never be possible, nor indeed desirable, to fully standardise the concession contract used in PFI deals. Nevertheless, the Office of Government Commerce (OGC) and Partnerships UK have published a guidance that aims to harmonise the contractual terms used in the PPP-PFI markets. These standards will not abolish the need for reviews of individual contracts, as each contract may contain variations on specific points. In addition, the guidance itself will vary over time, in line with market trends. For instance, until two years ago, the risk of insurance premium was fully borne by the private sector. Since 11 September 2001, insurance terms have tightened considerably, both in terms of availability and price of cover. It has now become accepted practice that the public body shares the insurance risk with the private body, both in terms of taking the "insurer of last resort" role and of sharing the increase in insurance premium beyond a certain threshold. This is just one example of how market trends may lead to a revision of guidance over time. Nevertheless, the existence of PFI contract guidance is evidence of the current standardisation trend prevailing in the UK

PFI sector, and may contribute towards a reduction in the significant bid costs incurred by sponsors in this market – a key concern for market participants, which have become increasingly reluctant to bid for new transactions.

"Batching"

Given the complexity, time and costs involved in bringing a PPP transaction to financial close, the private and public sectors are also keen to increase the average size of these transactions. In some sectors (schools, social housing), individual projects are typically small. Given the significant fixed costs involved in closing a transaction, it makes economic sense to lump several smaller projects together into one financing, a technique that has already been used in the education sector, with the Glasgow and Edinburgh Schools, for example. This technique will also be applied in the health sector, with the first batch of hospitals under procurement. The NHS Local Improvement Finance Trust (LIFT) programme, under which the project company is responsible for the progressive refurbishment of a number of surgeries over time, is another example of the trend towards batching small individual projects. This programme is expected to be replicated in the education sector, although LIFT transactions remain generally too small for bond financing.

Refinancing

The PPP-PFI market in the UK has now reached the stage where a significant number of transactions have passed completion. The key issue of how to split the financial benefit of refinancing between the private and the public sector has now been resolved, with a mandatory 50/50 profit split on all new transactions and a 70/30 voluntary split on existing ones. This has opened the way for a wave of refinancing for the first-generation PPP projects, many of them hospitals. Fitch expects that this refinancing may entail higher leverage than the original transactions, as a result of the market's increased comfort with the sector, the absence of construction risk, and the availability of longer-term finance at lower interest rates.

Longer Maturities

Another trend in the UK market is the progressive lengthening of tenure for both concessions and bonds. A decade ago, typical PFI transactions in the UK would have a debt maturity of 20 years or less for concessions of over 25 years. The concessions have now been extended to take advantage of the availability of long-term bonds on the sterling market, as well as the willingness of some banks to lend for longer maturities. Bond maturities at or

above 30 years are now commonplace in the UK, as evidenced by the recent 38-year bond issued on the Walsgrave hospital transaction. At the same time, the “tail”, or difference between the maturity of the financing and the concession length, has progressively shrunk: recent transactions typically have a tail of 18 months, compared with over five years for the first transactions that came to the market. These trends, combined with tighter debt service coverage ratios, have led over the years to increasingly leveraged structures, with a debt/equity ratio of 90/10 being usual for recent transactions.

The government is currently refining the rules used to assess the value-for-money of new PPP transactions. The proposals included in the recently published Green Book include the unbundling of various cost components and the change of the discount rate from 6% to 3.5%. This revision of the government’s methodology for comparing the benefits of PPP against public procurement may, over time, erode the benefit of longer-term financing for PPP transactions, as a lower discount rate could increase the comparative cost of long-term financing.

Increasing Role for Mezzanine, Emergence of Secondary Market

Construction companies play a key role in the PPP market, as both the primary contractors and initial equity providers on the projects. While these equity investments have often been profitable, construction companies’ funding constraints are becoming more acute. Combined with revised accounting standards, these constraints put pressure on traditional sponsors to sell their existing investments and to limit future equity participation in this market. Recent examples include the sale by Amey of its PPP equity portfolio to Laing. As industrial companies’ appetite for equity investment diminishes, financial participants are entering this market to take their place.

In the first wave of PPP/PFI transactions, payments due by the public body to the project in case of termination usually had an “underpinned amount”, or floor, which covered the full senior debt outstanding and breakage cost – making the senior debt clearly better protected in case of default than the equity or mezzanine. During the past few years, the reference to a floor covering all or substantially all of the senior debt in case of termination has all but disappeared: it only remains in place for the most complex transactions with significant construction or operating risk, such as the privatisation of the companies managing the infrastructure for London Underground (Tubeline and Metronet transactions).

In general, termination payments by the public body (except when termination is due to a default of the public authority) are purely based on either market value testing or the Net Present Value of future revenues minus the future costs of the project, including any cost of remedying the existing default. The disappearance of the “underpinned amount” concept has eroded the previously clear difference between senior debt on one side and equity and subordinated debt on the other; this has contributed to mezzanine’s attractiveness – although the remedies in case of default are still largely in the hands of senior lenders, who also benefit from better security and control packages.

The emergence of a new class of mezzanine investors and the pressure on construction companies to cash in on their investments has led to the growth of a secondary market for such investments. Fitch also expects that Debt or Equity CDOs could emerge as another way to monetise significant investments in this sector, although progress in this area may be slow.

Emergence of Different Risks

As market participants, both in the private and the public sector, become more comfortable with the asset class, financiers are being presented with an increasingly diverse range of risk for PPP transactions, Fitch believes – although the majority of rated transactions still follow the traditional PPP model.

Different Structures

While the classic PPP projects have a clear distinction between the construction and operating phases, this is not the case for some of the most recent and complex transactions, such as the privatisation of the three companies operating London Underground infrastructure. In this case, the significant investment programme necessary to renovate London Underground continues throughout the 30-year contract, and the concession revenues start immediately. The debt drawdown and repayment profile is dictated by the net funding need of the company, which will be reviewed every 7.5 years through the periodic review process. This type of transaction is more similar in nature to the financing of a regulated monopoly (with a life limited to the concession term) than to a traditional PPP scheme. Risk assessment for this type of transaction relies less on traditional modelling, and more on the assessment of government support, the role of the regulator and the amount of debt at risk in case of termination of the concession contract.

New Technological Risks

Initially focused on low-tech hospitals, schools and accommodation, the PPP programme has been rolled out to a number of other, more technologically advanced asset classes. The Ministry of Defence has long been a key user of the programme, and uses it for increasingly large and technologically complex transactions. The UK Atomic Energy Authority is considering PFI procurement for managing its nuclear waste disposal scheme.

More Challenging Operating Environment

Post-construction, there is also a requirement for delivery by the private sector of increasingly complex services beyond the more traditional cleaning, catering, portering and maintenance services. Fitch also notes that the employment practice of the private partner can be constrained by PPP rules. An example is the Retention of Employment (RoE) obligation for PPP hospital deals, under which public sector staff are seconded to the private sector. The first transaction to use the RoE model was the recent Walsgrave hospital transaction. Fitch notes that the cost impact of RoE for the SPV can be largely mitigated through the concession contract, but also that it is too early to assess the operational practicality of the scheme or its impact on operating performance levels.

Different Market Risks

New types of market risk have emerged in recent years. Traffic risk can now take the form of “congestion risk”. This is the case for the Dishforth to Darrington road transaction (D2D) for instance, as the project revenues are negatively affected by low-speed traffic on the road. Some recent MoD transactions for mobile assets (Heavy Equipment Transport, Strategic Sealift RoRo project) also include market risk on the utilisation of the available manpower (strategic reserve) and equipment in peacetime.

Fitch believes that the government is currently testing the acceptance by private financiers of an increasingly diverse type of market risk on PFI transactions, although this trend is more evident in the smaller unrated bank deals than on larger bond transactions. This process, however, is by no means unidirectional. For instance, after well publicised difficulties on a number of light rail projects, the private sector has become reluctant to accept traffic and fare risk in that sector. As a consequence, recent transactions, such as the extension of the Docklands Light Railway (DLR) to London City Airport, have been awarded based on pure availability and performance risk.

■ Fitch’s Rating Criteria for PPP Transactions

In rating a PPP transaction, Fitch’s analysis encompasses the following issues:

- Legal framework and government support
- Construction risk
- Credit risk of the payer
- Market risk
- Operations: performance risk and contractual structure
- Financial and sensitivity analyses

The Legal Framework and Public Support

As stated above, the PPP programme in the UK has now reached a mature state, with over 200 projects already in operation. The regulatory framework supporting these transactions, including the role of such local bodies as NHS trusts, and the nature of government support are now well understood by market participants. Fitch notes that there has not been a single instance to date when government support for PPP-PFI financing has been tested in court. However, in Fitch’s view, the mere fact that no public body, however financially stretched, has yet been known to default under its payment obligation for a PPP contract is evidence of the government’s strong support for these contracts. In addition, Fitch believes that the market has now reached critical mass, and that any real or perceived failure by the government to honour its obligation under a PPP contract could have very wide-ranging consequences for the future of the programme. In general, Fitch takes a positive view of the legal environment for PPP transactions in the UK.

In other continental European countries, the PPP initiative is more recent, and Fitch sees a wide disparity between the application of the PPP concept in each country. Portugal, for instance, has a strongly established programme, which initially focused on shadow toll roads (“SCUTs”) but which also extends to many other sectors. Other markets (Germany and the Netherlands) have only seen a few transactions to date. In some countries (France, Eastern Europe), new legislation is needed to foster PPP programmes despite the fact that private concessions of public infrastructure have long been in existence in France.

In all cases, Fitch will analyse the regulatory framework specific to each country. Particular aspects that will be reviewed by Fitch include:

Political Support for PPP

In this area, Fitch will review the origin of the programme and its leadership, as well as the

respective role of central government, local authorities and other market players.

In some countries, “development banks” are being set up to support PPP programmes, such as Infrastructure Spa (ISPA) in Italy. The Irish National Development Finance Agency (NDFFA) also has financing capacity, in addition to its primary role as an advisory body. This differs from the UK, which resorts exclusively to private finance, supplemented where needed by punctual grants. As part of the rating process, Fitch will clarify the role and influence of such authorities on the instrument rated.

Fitch will also assess the extent to which political change has affected or could affect the application of the programme (including provisions to cover “change of law” risk).

Legal and Contractual Framework

Fitch will review the legal framework for PPP transactions in the relevant jurisdiction, and the extent to which contracts can be constrained or supported by general law. Fitch notes that many countries (such as France, Portugal and other “civil code” countries) have a more regimented legal framework than the UK, which relies heavily on contractual terms and case law. As such, the review of the contract should always be supplemented by a review of the relevant legislative framework.

Risk Structure Embedded in the Programme

The type of risk involved in PPP transactions will depend to a large extent on the political will of each government. For instance, Ireland’s road programme is focused on full toll roads, with a free alternative being available to end users. This contrasts with the Dutch experience, where road concession payments are based purely on availability. In Spain and Portugal, the concept of “financial equilibrium” gives comfort with regard to the possibility of government intervention on setting the toll, but this concept does not exist in other countries. Another example can be seen in the Portuguese government’s current plan to privatise clinical services in new hospital transactions, a feat that has not been attempted in other European countries. Fitch will assess the risk philosophy in each country and its impact on the risk profile of specific transactions.

In general, Fitch will look for stability, transparency, and predictability as key elements of its assessment of legal and government support. A demonstrable enforceability of contracts between the public and private sectors – as may have been tested on non-PPP deals – and a clear allocation of roles and

responsibilities between local and national governments will also be viewed as important elements of the analysis. A more detailed list of criteria that are viewed by Fitch as favourable to the PPP markets, including Emerging Markets, can be found in Fitch’s report entitled “Public Private Partnerships: The Next Generation of Infrastructure Finance”, published on 14 January 2003.

As each market matures, the theoretical analysis of the support enjoyed by PPP in each country will be supplemented by empirical experience. One example is the possible transformation of the original SCUT programme in Portugal from shadow tolls to explicit toll roads. The conditions in which this conversion takes place for the lenders will test the application of the “financial equilibrium” concept for road concessions in Portugal, and provide evidence of regulatory support in this country.

Construction Risk

Construction risk represents one of the largest single risk areas for new PPP transactions. Delay and cost over-runs in construction can expose the project to loss of revenue, or in a worst case, to termination of the contract by contractor’s default. The infrastructure also has to meet certain parameters in order to be accepted by the public partner, and failure to meet these criteria can similarly harm the project company. In assessing the construction risk, Fitch will focus on the following areas:

Asset Complexity, Completion Requirements

Most PPP transactions have a clear delineation between the construction period (generally less than five years) and the much longer operating period, although such clear distinction does not always exist (see Appendix 1).

In any case, Fitch will focus on the complexity of the construction and the parameters that the project must meet in order to be accepted by the public body as “complete”. The majority of PPP transactions (schools, accommodation) involve relatively standard, tried and tested construction techniques, with a low risk that the completion parameters will not be met. Hospitals and prisons, as well as roads, also generally involve low-tech construction techniques, but may include some complex technical components that need to be assessed. On the other side of the spectrum, some defence transactions involve very sophisticated technology. In all cases, Fitch will review the opinion of the Independent Engineer on the completion risk associated with the asset specifications set in the contract. Fitch also expects the Independent Engineer to comment on the

appropriateness of the budget (including the level of contingencies) and the timing allowed for building the asset. Fitch notes that there has been limited experience to date of any significant delays or cost over-runs on PPP projects. As a number of large and complex transactions are brought to market, and political pressure to improve the performance of privately operated public infrastructure increases, Fitch will continue to monitor this area for any adverse developments.

Contractors : Expertise and Creditworthiness

In Fitch's view, there is no stronger mitigating factor against construction risk than the contractor's track record of building similar assets on time and on budget. Relevant contractor experience will thus constitute a key area of Fitch's rating analysis.

Construction is a relatively high-risk industry. Fitch's assessment of the trends affecting this sector can be found in Fitch's special report entitled "European Construction Outlook for 2003" published in April 2003. However, the creditworthiness of the contractor, while incorporated into the agency's analysis, is rarely a limitation factor on the rating assigned to individual PPP projects (i.e. the projects can be, and often are, rated above the rating of the construction company). Concerns about the creditworthiness of a contractor can be mitigated by a guarantee from a stronger parent, a surety bond, or a letter of credit issued by a highly rated institution. Nevertheless, the credit quality of the contractor can become a critical rating factor for projects with a particularly long construction period, or for more complex projects that could not be easily transferred to another party in case of contractor default (for instance due to technology). In all cases, Fitch will consider in its rating the "vulnerability" of the project in case of contractor default, the availability of alternative contractors, and the mitigants, financial, contractual or otherwise, existing in the structure.

Contractual Protections

Most infrastructure projects are built under fixed-price contracts with a set completion date. The risk of cost over-runs is thus essentially passed through to the contractors, except for cost variations due to changes of law or variation orders issued by the public partner, which are addressed through different mechanisms (revenue increases and stand-by facilities). The construction contract will specify the level of liquidated damages (LD) due by the contractor in case of delay or underperformance, usually subject to an overall cap. Fitch will review whether the level of LD is sufficient to allow the

project to mitigate the effect of delayed revenue, or, in a worst case, to allow the company to step in and find a suitable replacement contractor. In this respect, the safeguards existing in the PPP structure, including monitoring by an independent engineer and milestone-related payments, should be sufficient to ensure that any problem with construction is detected at an early stage, allowing the project to address the issue before the public body can enforce its remedies.

Credit Risk of the Public Body

Payment streams on PPP projects can come from a wide array of public entities: central government, local authorities, or some other local entity (NHS trusts, universities, etc). In many instances, when the creditworthiness of the public body is not sufficiently strong in relation to its payment obligation, the government has issued Letters of Support on specific projects to back the obligation of the public body. This was the case, for example, for the first wave of hospital transactions, although recent structures have relied on government support enshrined in the law. Letters of Support have also been issued on transport transactions. In the City-Greenwich-Lewisham DLR extension, rated by Fitch, the payment flow is due from Docklands Light Railways, but the Secretary of State has issued a Letter of Support to back DLR's payment obligations. Similarly, for the recent Tubeline and Metronet transactions, the contractual payment obligations of Transport for London are supported by a Letter of Support. Fitch notes that these documents should not be mistaken for government guarantees, and that their enforceability has never been tested. Nevertheless, the issuance of such letters must be approved by the Treasury and minuted before Parliament, which testifies to the serious consideration given by the government to the possible liability they entail. Fitch will review the text of each Letter of Support individually, but Fitch's rating generally incorporates a strong reliance on government support for those transactions for which a Letter of Support has been issued, or which benefit from similarly supportive law. This is one of the elements which allow the Meridian Hospital transaction to be rated 'BBB+' by Fitch, while the underlying revenue of the project is paid by the Greenwich Healthcare NHS Trust, an unrated entity.

For more details on Fitch's methodology for assessing the risk of local governments, please refer to the Fitch report "International Rating Methodology for Regional and Local Governments", published on 4 April 2002.

Market Risk

The degree of market risk varies considerably between PFI transactions. For hospitals, government accommodation and prisons, revenues are purely based on availability and performance. Water treatment transactions are usually exposed to performance but also to volume risk. This is the case, for example, for Catchment Tay Limited, rated by Fitch, which operates four waste water treatment plants in the Dundee area. For transport deals, the degree of traffic risk varies. In the light rail sector, the City-Greenwich-Lewisham DLR extension incorporates some market risk towards the end of the concession, while revenues until 2009 are based on availability and performance. However, the more recently awarded extension of the DLR to London City Airport has no traffic risk throughout the concession period.

Some transactions are exposed to different degrees of market risk in their ancillary revenues, such as the recent mobile equipment transactions for the MoD mentioned above.

For those transactions that involve market risk, Fitch's analysis will focus on the sensitivity of the project to market risk. A market study, conducted by an Independent Expert, will provide certain base case and downside assumptions for the project.

In Fitch's experience, traffic studies have not always been able to predict accurately the future traffic flow of a new infrastructure. The predictability of traffic flow will be higher for refurbishment of existing roads, or for transactions with clear benefits and a limited number of alternative routes. Shadow toll roads are also easier to forecast, due to the lack of incentive for the user to take another route. As part of its rating process, Fitch will not simply use the forecasts of the Independent Consultant, but also analyse the rationale behind the forecasts and test the effect of various possible downside scenarios. For all market studies, Fitch may require additional sensitivity analysis, whether linked to certain "event risks" (for instance, new and competing infrastructure) or to certain systemic risks.

For more details on Fitch's approach for rating toll roads, please refer to the Fitch report entitled "Challenges of Start-Up Toll Roads" dated 9 June 1999.

Operating Risk and Contractual Recourse

Apart from market risk, the project's revenue and costs can be affected during the operating phase by the project's availability, its operating performance, and its maintenance costs. Other project costs such

as insurance and tax can also affect net cash flow, as can inflation.

The most significant component of revenue is usually the availability payment. Non-availability of the assets can lead to availability deductions, the severity of which is related to the importance of the unavailable assets. For instance, for a hospital deal, unavailability of an operating theatre will be more severely penalised than unavailability of an administrative area. To date, availability deductions observed on rated transactions have been minimal, reflecting the strong incentive to correct any fault before it leads to unavailability deductions, as well as the newness of the assets.

Revenues for most PFI transactions are also linked to target performance measures. Penalty points for poor performance will lead to revenue deductions and could ultimately lead to the termination of the contract. Under most PFI contracts, there are mechanisms that allow some time to remedy either poor performance or unavailability before significant financial deductions take place.

The project company generally has contracts with one company that provides "soft services" (catering, cleaning, etc) and with another that provides "hard services" (maintenance). The degree to which availability and performance deductions are passed through the subcontractor varies from project to project. Fitch will review the contract to measure whether the incentive and penalties of the subcontractor match those of the project. There is generally a cap on the liability of the subcontractor for poor performance, and Fitch will review the adequacy of such a cap. For example, in the case of Meridian Hospital, the facility management is provided by ISS Mediclean, and the cap on its liability for under-performance is equal to one full year of service fee, a very large amount compared with the minimal deductions that have occurred to date. While Fitch believes that a pass-through of risk to the subcontractor is a positive rating factor, this does not totally insulate the project from negative industry trends, which would equally affect all contractors (such as high wage inflation in a particular sector). Fitch believes that an uneconomic contract for the subcontractor will ultimately lead to the termination of the subcontract and will expose the project to the risk of cost increases. On the soft facility management side, this risk is mitigated by periodic benchmarking, which permits the pass-through of such systemic price changes to the public sector. In that respect, Fitch views periodic benchmarking as a positive rating factor, despite the fact that the fairness and transparency of the market testing process, where the incumbent has

significantly more experience, remains to be tested. The performance of the rated projects to date has been good with regard to availability and performance deductions (i.e. deductions have been limited), and most issues have been resolved through negotiations between the public body and the concession holder.

Given the long maturity of PPP financing, another area of risk could become more apparent as the assets mature: maintenance costs. Maintenance is provided by the hard facility manager, generally for the duration of the contract. However, life cycle costs remain the responsibility of the project company. Depending on the project, a maintenance reserve account may be set up in advance of major maintenance expenditure in order to smooth the cash profile. Periodic life cycle reviews by an Independent Engineer also facilitate early planning of future expenditure, so that cash can be retained in the project ahead of major maintenance. Nevertheless, it is too early at this stage to see whether maintenance cost forecasts are accurate, as Fitch does not expect these assets to need major refurbishment during the first ten, say, years of operation. Fitch also suspects that the expenditure profile could be lumpier than usually presented in models, introducing more volatility in the coverage ratios. As part of its rating process, Fitch will review the Independent Engineer's opinion on capex forecasts, and will test the sensitivity of cash flows to increases in capex. Structural mitigants, such as the degree of contractual pass-through and the maintenance reserve account, will also be reviewed.

Lastly, Fitch will also analyse the extent to which the project company is protected under the concession terms against the detrimental impact of a change of law or *force majeure* events. These fall under the category of "event risk", which cannot be assessed using traditional sensitivity analysis. For UK PFI, it is customary for the project company to be protected from the impact of specific or discriminatory changes of law, but protection from general changes of law varies. Similarly, risk sharing in the case of *force majeure* is detailed in the concession contract. As part of the rating process, Fitch will analyse the precise definition of those terms under the concession contract and the extent of the risk retained by the SPV.

■ Financial Analysis

The financial aspect of Fitch's analysis will incorporate the following areas:

- a. a review of the financing structure (proportion of Senior Debt, Mezzanine, Equity), including timing of equity and debt contribution;

- b. a review of the security package (including shares, Debt Service Reserve Account and Maintenance Reserve Account);
- c. an analysis of the financing documentation (including, if relevant, inter-creditor agreement) and the debt protection covenants (including *inter alia* triggers for cash lock-up, events of default, additional indebtedness clause and step-in rights); and
- d. a review of cash flow forecasts under a base case and a number of downside sensitivities.

When reviewing the cash forecasts, Fitch will conduct sensitivity analysis on the main categories of risk:

- construction risk
- operating and performance risk
- market risk, if appropriate
- the project's own costs (insurance, tax) and, if appropriate, the impact of inflation and interest rate

One of the key characteristics of PPP transactions is that prolonged and severe under-performance of the company (or delays in construction) can lead either to the replacement of the subcontractor that performs the service in question, or in a worst case, to the termination of the contract. To Fitch's knowledge, the termination provisions under a PPP contract have never yet been tested, as most problems are being addressed through negotiation between the parties. Nevertheless, the agency does expect terminations to take place as the market matures. Fitch will review, for the first two categories above (construction and operation), the circumstances that could lead to the termination of the concession contract, and the level of termination payment received by the SPV under those scenarios. For transactions involving simple and objectively measurable performance criteria, and limited construction risk, reliance on contract termination provision is limited. For more complex transactions involving higher technological, market or construction risks, the analysis of contract termination provisions will play a more critical role in Fitch's analysis.

In addition to considering these critical downside factors, Fitch will also test the financial impact of long-term under-performance at a level that is not quite sufficient to lead to contract termination.

Sensitivity analysis will also be conducted with regard to the future capex requirements of the project. While this cost may be passed through to the subcontractor to varying degrees, Fitch believes that

this risk should not be ignored, especially given the absence of periodic benchmarking. In this respect, the opinion of the Independent Expert provides a valuable benchmark for sensitivity analysis. Fitch will also look at comparable data for similar assets.

In conducting the sensitivity analysis, Fitch will look at the Annual Debt Service Cover Ratio (ADSCR)¹ and the Loan Life Cover Ratio (LLCR)² as key indicators of the creditworthiness of the project, and Fitch will also attempt to compare different projects in the same sector on a similar maturity basis.

In Fitch's view, there is no "standard" ADSCR that will secure a given rating for a PPP transaction. This is due to the wide diversity of risk profiles for these projects, which is demonstrated by the examples given in this report. For instance, projects exposed to market risk are likely to need higher coverage ratios than a simple accommodation transaction, in order to secure the same rating.

■ **Conclusion: Not All PPPs are Created Equal**

On the whole, the PPP market in the UK has been a success story so far, both for the government, which

uses it for about 10% of its public infrastructure spending, and for the private sector, construction companies and financial partners that are involved in it. Many market players remain discouraged by the significant bid costs, although these are likely to fall as a result of contract standardization and project aggregation. The good credit experience for this asset class to date has led to an increasing sense of investor comfort with the sector. This, combined with the appetite for long-term investment opportunities for sterling investors, has led to progressive increases in leverage and tenure, while margins for PPP loans have been falling. Increasingly, new structures and new types of market risk are being accepted by the private sector. For the larger and more complex transactions, however, these risks have been mitigated, for instance by ultimate recourse to the public sector with an "underpinned amount" covering a substantial part of the debt in case of termination.

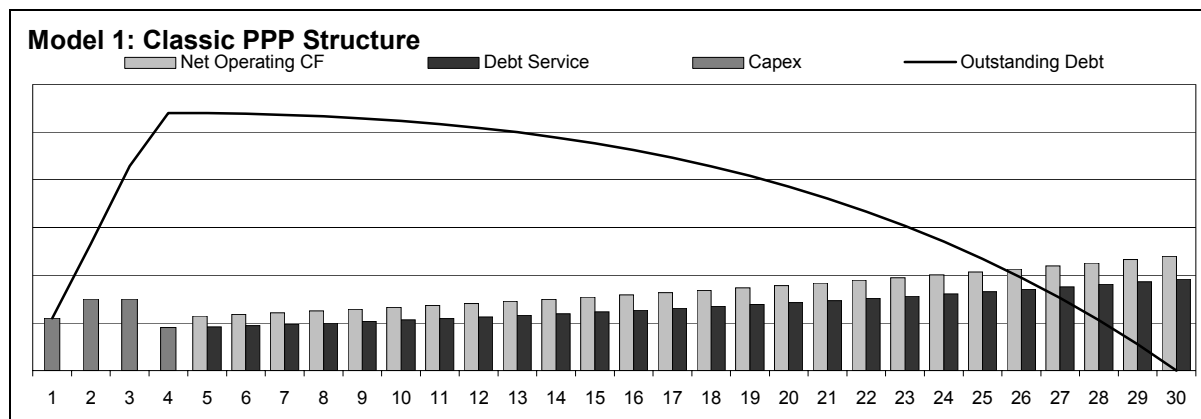
Fitch will continue to monitor developments in terms of technology risk, market risk and financial risk. Despite the changing risk landscape, Fitch expects the sector to remain an investment grade sector in general and to continue to offer a comparatively safe haven in times of economic downturn.

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¹ ASDCR: Annual Cash flow available for debt service (before dividend payment but after tax), divided by debt service.

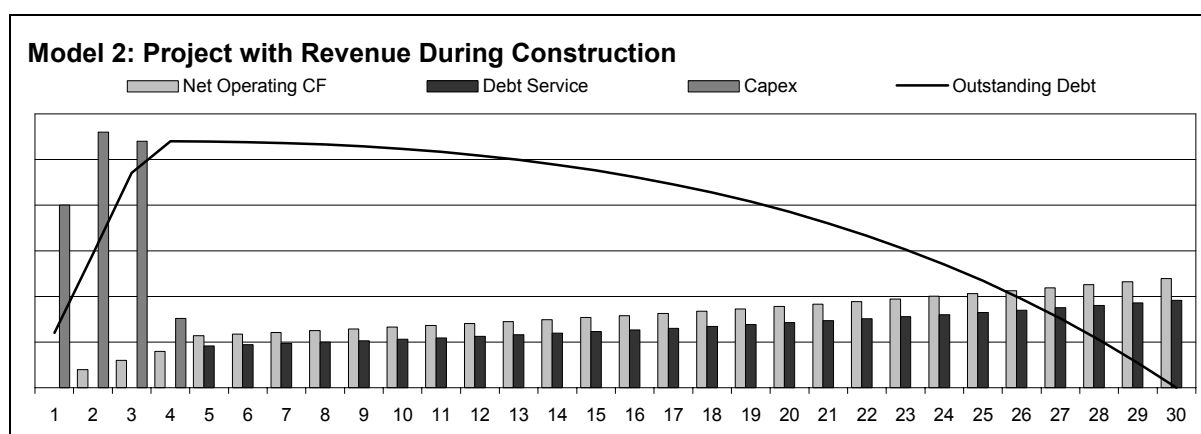
² LLCR: Net Present Value, using the debt interest rate, of all cash flows available for debt service (before dividends) throughout the life of the loan, divided by the loan amount.

■ Appendix 1

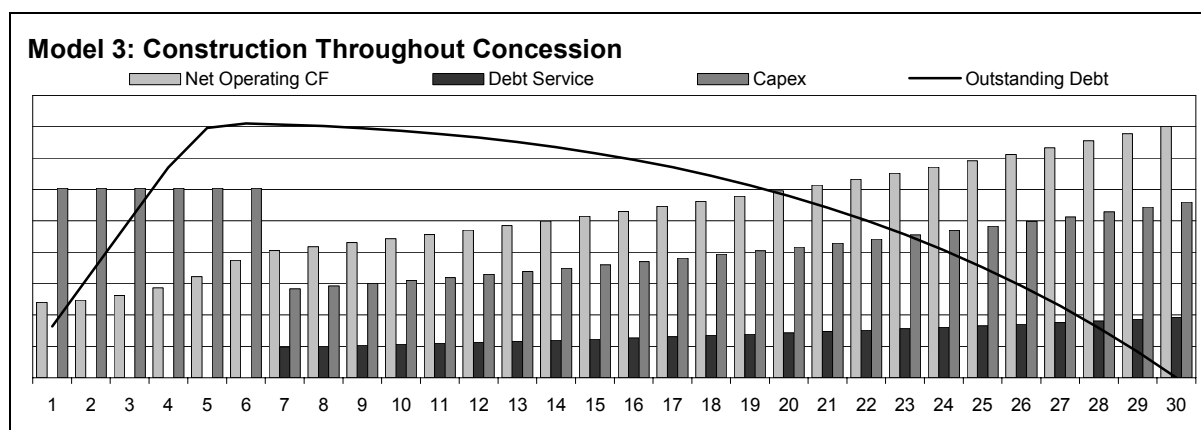
The traditional PPP project has a clear demarcation between the construction phase, during which the asset is built or refurbished and debt drawdown occurs, and the much longer operating period, during which the project earns performance-linked revenues and repays debt.



Some projects start to earn revenues during construction, as is the case in redevelopments of government buildings, such as the new Government Communication Headquarters (GCHQ). This does not change the underlying analysis of construction risk, although Fitch will scrutinise the extent to which the project is sheltered from poor performance during construction.



Some projects have ongoing quasi “construction risk” throughout the length of the concession, such as the LIFT schemes or the London Underground transactions. At the same time, operating revenues may start from the beginning of the concession. In that case, the distinction between operating and construction risk is less clear.



■ Appendix 2

Government Spending on PFI : Signed Transactions and Transactions at Preferred Bidder Stage (Source : 2003 Budget Report)

Table C18: Departmental Estimate of Capital Spending by the Private Sector (Signed Deals)

(GBPm)	Projections		
	2003-04	2004-05	2005-06
Education and Skills ¹	0	0	0
Health	338	210	89
Transport ²	6,624	552	370
Local Government ^{3, 4}	1,940	2,330	2,700
Home Office	186	150	46
Lord Chancellor's Department	52	6	11
Defence	175	0	0
Foreign and Commonwealth Office	5	5	5
Trade and Industry	6	2	0
Environment, Food and Rural Affairs	3	0	0
Work and Pensions	14	22	0
Scotland	381	330	1
Wales	43	34	0
Northern Ireland Executive	13	3	0
Chancellor's Departments	49	24	11
Cabinet Office	12	4	0
Total	9,841	3,672	3,233

¹ Excludes private finance activity in education institutions classified to the private sector. Schools projects funded through Revenue Support Grant are included in the local government figures.

² Includes the capital expenditure for Tubelines (part of the London Underground Limited Public Private Partnerships (LUL PPP) contracts) in 2003-04. Such investments that are found to be on balance sheet also score as public sector net investment.

³ Figures represent spending on projects supported by central government through Revenue Support Grant.

⁴ PFI activity in local authority schools is included in the local government line.

Source: Office of Government Commerce.

Table C19: Estimated Aggregated Capital Value of Projects at Preferred Bidder Stage

(GBPm)	Projections		
	2003-04	2004-05	2005-06
Health	145	197	193
Transport ¹	10,759	32	11
Home Office	26	17	0
Lord Chancellor's Department	19	19	0
Defence	1,364	1,393	0
Scotland	9	48	16
Wales	96	0	0
Northern Ireland Executive	31	33	0
Total	12,449	1,739	220

¹ The 2003-04 figure includes the estimated capital value of the LUL PPP contracts not yet signed over the next 15 years.

Source: Office of Government Commerce.

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