FINANCING CHALLENGES FOR P3 PROJECTS

AFTER THE CREDIT CRISIS

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1. Introduction

The global financial crisis of 2008 and early 2009 drastically reduced available credit and made those willing to risk any money very wary. This "credit drought" affected all asset classes and sectors, including infrastructure projects procured through public-private partnerships ("**P3s**").[1] This paper explores some of the key impacts the crisis and tightening credit conditions have created for P3 financing.

Part II of the paper highlights some of the key features of P3 financing that prevailed during pre-crisis years. Part III deals with certain changes to the forms of P3 financing in response to the crisis, namely the bank-bond financing dynamics, and the emergence of mini-perms. Part IV touches on certain developments affecting the P3 procurement process. Part V discusses the changes to documentation adopted in response to the crisis. More specifically, this involves looking at the increased focus by lenders on default, market-flex and market-out provisions. It also involves looking at the increased collateral security requirements imposed by lenders on project companies. Part VI centres on the highly restrictive credit-approval practices adopted by lenders in the aftermath of the crisis. Part VII discusses the increased cost of borrowing that has prevailed in the recent P3 context. Part VIII outlines some of the promising solutions to the present challenging P3 financing situation.

[1] The Canadian Council for Public-Private Partnerships ("**CCPPP**"), "The Impact of Global Credit Retraction and the Canadian P3 Market: Deliberations by the Industry Members of CCPPP", (Spring/Summer 2009) at iv, online: <http://www.pppcouncil.ca/pdf/credit_retraction_report_summer2009.pdf> [CCPPP Report].

2. The "Good Old Days" of P3 Financing

Prior to the credit crunch, credit was widely available, spreads were low, pricing was held for long periods, 'market out' and 'MAC' clauses were rare and covenants were light. While not quite achieving the 'NINJA' status seen in the US mortgage market, borrowers held a pretty good hand - until, of course, the bid was accepted. As a result, establishing that P3s could provide value-for-money, when compared to traditional procurements using only government funds, was an easy task. P3s transferred the significant construction risk of on-time and on-budget delivery as well as operational and lifecycle risk to the private sector at rates that were not far off the cost of money for Canadian provincial governments.

The credit crunch had two significant short term effects, which together had significant ramifications for P3 deals. First, credit became much less widely available and what was available came in smaller tranches with the result that more lenders were required for each deal. This drastically reduced the bargaining power of borrowers. Second and unsurprisingly, spreads climbed dramatically. The implications of these changes on the forms of P3 financing, the covenants required by lenders and the responses of governments and bidders are outlined below.

3. Changes to the Form of P3 Financing

(a) Bonds and Traditional Debt Financing

Prior to the crisis, debt financing in the P3 context usually took two main forms: direct borrowing from the capital markets via the issuance of bonds[2] and borrowing from domestic and

[2] These bonds were often 'wrapped' through an insurance product provided by monoline insurers to enhance the credit rating. See, for example, Graham D. Vinter, *Project Finance: A Legal Guide*, 3d ed., (London: Sweet & Maxwell, 2006) at 32 [Vinter, *Project Finance*]. As it turned out, the monoline insurers were an early victim of the credit crunch.

international commercial banks,[3] with insurance companies as prominent players. While international bond-based solutions were often 'wrapped' to enhance the ratings and hence pricing - and Canadian projects were just beginning to use wrapped bonds for larger projects - in the immediate aftermath of the credit crunch, this pillar of debt financing "essentially vanished".[4] Because the monoline insurance industry largely collapsed,[5] project companies could only issue unwrapped bonds with minimum investment grade rating. As a result, these bonds became unattractive to long-term investors, such as pensions funds.[6]

With the bond market effectively closed[7], private-sector debt financing for P3s had to be sourced from more traditional sectors, certain banks, both domestic and foreign and life insurance companies. However, bank lending itself experienced substantial transformation due, in part, to the virtual elimination of the "underwrite and syndicate" lending approach.[8] Banks, looking to build capital, ratcheted down the size of the loan they would provide to any single project, moved to reduce their exposure to any one concessionaire and, in many cases, were unwilling to take syndication risk. For project companies, this meant that the "[t]he only way to

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[3] E. R. Yescombe, *Public-Private Partnerships: Principles of Policy and Finance*, (London: Elsevier Ltd., 2007) at 124 [Yescombe, *Public-Private Partnerships*].

[4] Columbia Institute, "Public-Private Partnerships: Understanding the Challenge" (June 2009) at 32, online <http://www.civicgovernance.ca/files/uploads/columbiap3_eng_v8-webpdf.pdf> [Columbia Institute, "Understanding the Challenge"].

[5] European P3 Expertise Centre, "The Financial Crisis and the P3 Market: Potential Remedial Actions", (August 2009) at 5, online: <http://www.eib.org/epec/infocentre/documents/EPEC_Credit_crisis_paper-abridged.pdf> [EPEC Report]. The monoline insurers had a critical role in unlocking the bond market to project companies. As AAA-rated companies, monoline insurers would grant financial guarantees over project company bonds, enabling those bonds to receive AAA-rating as well. Although project companies had to pay a fee for such guarantees, there was a net benefit to purchasing them as they ensured greater demand and liquidity for the bonds, which in turn translated into higher bond prices.

[6] See Matheson Ormsby Prentice *et al*., "Pension Fund Investment in P3 Schemes", (Association of Corporate Counsel, 10 December 2009) online: <http://www.lexology.com/library/detail.aspx?g=70f1c4fb-530c-41f0-a041-1d7f84416703>.

[7] See Andy Rose, "Speech by PUK's Executive Director", (P3 Financing Conference, 27 November 2008) online: <http://www.partnershipsuk.org.uk/uploads/documents/SPEECHANDY ROSE2.pdf>.

[8] CCPPP Report, *supra* note 1 at 2.

successfully raise funds - especially for a larger project over $500 M - is via a club deal. Even then, the transaction's success is dependent on having enough banks on board and the club holding together".[9] Even on smaller projects, where banks and life insurance companies played an important role,[10] single-source solutions were rare as most lenders were not interested in large exposures to single projects.

(b) Emergence of Mini-Perms

Mini-perms emerged as a form of P3 financing in response to the reduced tolerance of banks to the long terms required by the conventional P3 structure. Generally, mini-perm financing involves the extension of bank loans on a shorter-term basis, which corresponds with the construction and, in some cases, the immediate post-construction phase of the project. Project companies will use this type of financing prior to securing longer-term financing or permanent financing solutions.

It should be noted that this is not an entirely new concept. Even prior to the crisis, banks did lend from time to time on a medium term basis while expecting a rapid take-out through refinancing, although this was subject to project performance.[11] Hence, banks would impose a margin step-up after a period of 7 to 15 years to "compel" refinancing.[12]

However, the crisis led to an aggressive extension of this approach due, in part, to the demise of the syndication market.[13] As most of the bigger P3 projects are being funded via club

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[9] Daniel Roth, "A Matter of Time: Will the Credit Crisis Impact Canadian P3s? - For the Record" (CCPPP, February 2009) at 2, online*:* <www.pppcouncil.ca/pdf/matteroftime.pdf> [Roth, "A Matter of Time"].

[10] *Ibid.*

[11] EPEC Report, *supra* note 5 at 12.

[12] *Ibid*.

[13] KPMG Ireland, "The Use of Mini-Perms" (August, 2009) at 2, online: <http://www.kpmg.ie/services/cfinance/publications/MiniPerms.pdf> [KPMG, Use of Mini-Perms].

deals, it only takes one club member to require mini-perms, and the other members will follow suit.[14]

Mini-perms fall into two categories: hard and soft. A hard mini-perm is a project finance structure where legal maturity of the loan is typically set at 3-5 and sometimes 7 years, compelling the project company to refinance before maturity, or face default. By contrast, a soft mini-perm is a project finance structure where the legal maturity of the loan remains long-term (e.g., 25 years for a 30-year concession), but there is an aggressive margin step-up and cash sweep to incentivize the borrower to refinance.[15] The underlying rationale for the introduction of mini-perms is to increase the probability of an early exit for the banks and avoid locking the project into unfavourable conditions in the long-term.

At the moment, it is unclear whether mini-perms are passing fads or long-term features of P3 financing. In Canada, mini-perms have certainly not been widely used in the P3 context. A CCPPP panel, gathered in June of 2009, expressed a general consensus that if mini-perms are introduced in Canada, they should be soft mini-perms, as opposed to hard mini-perms, allowing some flexibility as to the timing of refinancing.[16] More recently, market analysts have observed that those foreign banks returning to the Canadian P3 market are looking at 5 to 9 year mini-perm terms.[17]

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[14] *Ibid.*

[15] EPEC Report, *supra* note 5 at 12.

[16] CCPPP, "An In-Depth Discussion of the State of Canadian PPP at a Time of Credit Uncertainty - For the Record", (CCPPP,24 June 2009) at 1, online: <http://www.pppcouncil.ca/pdf/vancouver_panel_ftr_06242009.pdf>.

[17] Doug Turnbull, "Recent Trends in Infrastructure Finance" (Presentation at 1st Annual Strategic Northern Infrastructure Symposium, Yellowknife, 15 October 2009) at slide 3, online: <www.northernstrategygroup.com/.../infrastructure.../DTurnbull%20%20Recent%20Trends%20in%20Infrastructure%20-%20Final.pptx>.

In the United Kingdom, as of last August, only three P3 projects had closed using mini-perms, all of which were soft mini-perms.[18] However, in other parts of the world, hard mini-perms have started to emerge. For instance, in Bahrain, the Al Dur independent water and power project, faced with initial funding difficulties due to the crisis, closed using hard mini-perm financing totaling US $1.7 billion.[19] Also, the US $1 billion P3 debt financing for the Zayed University in Abu Dhabi took the form of a 10-year hard mini-perm, with a balloon of about 65% of the total debt amount and no cash sweep.[20] Yet, it remains to be seen whether these instances of hard mini-perm are one-off solutions to a difficult situation (when the markets were virtually frozen) or whether they will become the new model for P3 financing.[21]

The primary concern with mini-perms revolves around who bears the refinancing risk and associated costs. In the case of soft mini-perms, the European P3 Expertise Centre ("**EPEC**"), for example, suggests that the procuring authority should ensure that:

- the sponsors fully underwrite the refinancing risk;
- the bidders adopt transparent and realistic refinancing assumptions, so that financing can withstand a potential downside scenario;
- the finance plan details the mitigation measures provided to cover a potential downside, (e.g., additional equity, to be evaluated against the sponsor's or guarantor's balance sheets);

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[18] KPMG, "Use of Mini-Perms", *supra* note 13 at 3.

[19] Charles July & William Breeze, "Saudi Arabia: The Landscape For Lending: The Shifting Sands of Middle Eastern Infrastructure Investment " (Mondaq Publications, 10 December 2009), online: <http://www.mondaq.com/article.asp?articleid=90732> [July & Breeze, "The Landscape for Lending"].

[20] "PFI/P3/Municipal Finance", *Project Finance* (July/August, 2009) online: <http://find.galegroup.com.proxy1.lib.uwo.ca:2048/gtx/start.do?prodId=ITOF&userGroupName=lond95336> ["PFI/P3/Municipal Finance"].

[21] July & Breeze, "The Landscape for Lending", *supra* note 19.

- the benefit of the primary refinancing is factored into the price, or the additional short-term costs still provide value for money; and
- there is an equitable sharing of any refinancing benefits between the authority and the sponsors, at least over and above what is assumed in the base case.[22]

In the less likely case of hard mini-perms, EPEC sees no clear choice for who should bear the risk of refinancing. However, what is most critical here is that banks should not be given a "free exit option", while passing an indeterminate amount of risk to the procurer.[23] Such an option puts banks in an opportunistic position where they can "apply whatever margin, gearing, cover ratios and other covenants [that] are applicable" when the project is nearing default.[24]

4. Changes to the P3 Process

(a) Reduced Risk Tolerance at the Bid Phase

Prior to the credit crunch, government agencies required and lenders were willing to hold credit spreads for 90 to 120 days from the time of bid submission. Even with the risks involved in holding pricing for long periods, lender commitments included very few, if any, market out or material adverse change clauses. Afterwards, lenders became much more hard-nosed. Lenders were generally unwilling to hold credit spreads beyond thirty days and market flex and market out clauses became common. As noted later in the paper, this required procuring authorities to create complicated re-pricing mechanisms which balanced the realities of the market with the desire not to provide bidders and their lenders with an open-ended ability to re-price their bids after selection of a preferred proponent.

(b) The Rise of the Club Deal

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[22] EPEC Report, *supra* note 5 at 12.
[23] *Ibid*. at 13.
[24] KPMG, "Use of Mini-Perms", *supra* note 13 at 2.

As noted previously, any one lender was not willing to take the syndication risk and sign up for the entire debt requirements. As a result, deals of any significance would require multiple lenders in a club deal, each of whom would take a much smaller part of the debt financing than in previous P3 transactions. In addition, some arrangers and advisors who could assist in placing financing by offering their own tranche to the club were also less willing to put their own money at risk. Consortium members who were used to having their pick of lenders and who could even run a competition among interested lenders now faced the prospect of going door to door to sell their project and could only wince as they watched pricing rise and commitment, agency and other fees climbed - and even then some lenders were saying 'no'. A related consequence was a change to the gearing ratio on these projects such that the consortium backers were required to put more equity at risk in order to make a project financeable.

5. Changes to Legal Documentation

The crisis has also led to changes in the P3 contractual framework, the most important of which are discussed below.

(a) Lenders' Increased Focus on Default Provisions

Lenders have increased their focus on the default provisions of credit agreements. Traditionally, borrower events of default in project finance loans have resembled events of default in other commercial loan transactions. Typically, such events include:

- non-payment of principal, interest, fees or other amounts when due;
- breach of representations and warranties;
- failure to comply with positive and negative covenants or the terms of any loan document or material project document;

- insolvency of the borrower or commencement of insolvency proceedings in respect of the borrower;
- judgments against the borrower in excess of an agreed threshold, or foreclosure against the project or the borrower's assets; and
- any event or circumstance which results in the lenders' security becoming invalid or unenforceable.

In the P3 context, there will be some additional events of default specifically tailored to project performance. Usually, these events include the failure to achieve construction completion within a fixed period of time after the scheduled completion date, and the insolvency of the contractor or other parties that are material to project completion. Lenders may also require that any material adverse change in the financial condition of the borrower, any guarantor or, in some cases, the contractor, or their operations or prospects constitute an event of default.

In other words, default provisions are an important instrument for banks to impose contractual controls on borrowers, and banks tend to apply such controls quite rigorously. For some early P3 deals, controls in bond issues were focused on broader key conditions and ratings oversight. For instance, one control technique used where a bond issue is rated "is to state that a certain event will not constitute an event of default unless it results in a rating downgrade by the relevant rating agency or agencies".[25] As the bond market collapsed, project companies had to deal almost exclusively with banks, and were thus subject to the generally stricter contractual controls therein. Life insurance lenders have also pushed for a thorough policing of risk through default provisions.

[25] Vinter, *Project Finance*, *supra* note 2 at 37.

As bonds are again returning to the P3 sector, their requirements have toughened considerably. In a number of cases, bond underwriters were not willing to take construction risk and bank financing was required for the construction phase with complicated intercreditor arrangements - and therefore higher transaction costs for bidders - being imposed on consortiums.

Deals already concluded before the crisis are not immune either as many banks examined the default provisions of credit agreements already executed. For instance, in the United Kingdom, Catalyst Healthcare's Romford Hospital P3 project had its rating slashed by Standard & Poor's to BB+ with a negative outlook due to the impact of deflation on its index-linked bonds.[26] This type of downgrade event raises the possibility that controlling lenders may claim that this deteriorating financial profile of the project amounts to a technical event of default. If so, the lender would have, in principle, the legal right to take actions such as enforcing its security or demanding immediate repayment of all outstanding debt.[27]

(b) Lenders' Increased Focus on Market-Flex Provisions

Another development following the crisis was that banks became increasingly interested in market-flex provisions. A market-flex clause allows the arranger bank to alter key financial terms in the proposed loan agreement if it encounters difficulties attracting other bankers to participate in the loan syndication. If drafted very broadly, these clauses can be open-ended with respect to the quantum of pricing changes, the period during which lenders can flex, and the scope of changes to structure or terms. However, because of the many potentially severe consequences for the sponsors and the project company, it has usually been possible in project

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[26] "PFI/P3/Municipal Finance", *supra* note 20.

[27] *Ibid*.

finance mandate letters to restrict the market-flex clause to one that relates to pricing only, and to insert caps on any price increases.[28]

However, with the crisis, market-flex clauses are being used with greater frequency by lenders. Market analysts started to observe in the fall of 2008 that "[t]he syndication market [in certain regions] is closed, and the notion of bank underwriting now exists in an inhospitable legal space between market flex and material adverse change clauses".[29] Similar observations came from leading practitioners in the field: "Whereas prior to the credit crunch, flex clauses could be found in emerging market deals (and even the terms of the flex were restricted), now we are seeing flex clauses on virtually every transaction irrespective of market".[30] Furthermore, flex clauses became broader in scope: "Market flex provisions are also being tied to the duration of the underwriting commitments. Commercial banks are more reluctant to underwrite for long periods of time and those that do will demand more flex to cushion against the risk of deteriorating debt markets prior to syndication".[31]

The presence of market-flex provisions has often been viewed with trepidation by some, who worry that they can undermine the very nature of loan underwriting. Banks have usually addressed these concerns by stating that flex clauses simply enable them to adjust the financial terms of the loan, and that they are still on the hook to advance the funds originally promised. This response, however, has failed to convince some commentators who note that "the market

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[28] Vinter, *Project Finance*, *supra* note 2 at 171.

[29] Paul Smith, "Bridge to the past", *Project Finance* (November, 2008) online: <http://find.galegroup.com.proxy1.lib.uwo.ca:2048/gtx/start.do?prodId=ITOF&userGroupName=lond95336> [Smith, "Bridge to the past"].

[30] Norton Rose LLP, "Project finance - underwritings in the credit crunch" (October, 2008) online: <http://www.nortonrose.co.uk/knowledge/publications/2008/pub17651.aspx?page=all&lang=en-gb>.

[31] *Ibid*.

flex could be operated in a way which would ruin the finely balanced economics of the project in question".[32] Specifically, they argue that these clauses can be fatal to the project if exercised after a preferred bidder has been selected, because they can force that bidder to withdraw completely.[33]

Another commentator has noted that the results of exercising market-flex clauses can be more uncertain than this.[34] As a rule, if banks exercise flex rights, changes to the financing documents are required. But does the flex clause require the borrower and other parties to execute the documents needed to amend the financing agreement? If the borrower refuses to sign the documents, what remedies are available to the banks? The traditional legal remedies are specific performance (i.e., a court orders a party to do what it agreed to do) or damages (i.e., monetary compensation for the loss). Then, this leads to the question of what loss is suffered by banks if they cannot syndicate successfully and reach their final hold position. According to one commentator, at least in Australia, "it is not entirely clear that banks could get an order for specific performance".[35]

Notwithstanding the precise legal consequences of exercising market-flex clauses, the potential for their more frequent inclusion and broader scope, put the P3 financing model at some risk.

(c) Lenders' Increased Focus on Market-Out Provisions

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[32] Vinter, *Project Finance*, *supra* note 2 at 34-35.

[33] *Ibid.*

[34] Peter Doyle, "Project Finance Revisited", (Banking and Financial Services Law Association: Twenty-First Annual Conference, Tasmania, Australia, August, 2004) online: <http://www.mallesons.com/publications/alerts/7633317W.htm>.

[35] *Ibid.*

A market-out provision is a more drastic version of the market-flex clause: it is a provision in an underwriting agreement that allows the arranger bank to cancel the agreement for certain specified reasons without penalty. The typical reason for cancellation is an unexpected change in the market that makes it difficult to syndicate the loan.

As early as several months prior to the crystallization of the crisis in 2008, the *National Post* reported that lenders had already become interested in these clauses. It quoted leading practitioners in the industry as saying: "Previously the concept of a market out provision or material adverse change would not have been seriously considered in a P3. Now, lenders are seriously considering those type[s] of issues".[36]

It should be noted that there is no widespread consensus as to the precise nature of the change in the market needed to trigger the cancellation right under this clause. However, in the context of the private placement of shares, for example, there is Canadian judicial authority for the proposition that a 20% drop in the price of the impugned shares within a 45-day period from the signing of the underwriting agreement constitutes a triggering event sufficient for the exercise of a typical market-out clause.[37] Also, some investment analysts have taken the view that the negative reaction of the securities market to the terrorist attack on September 11, 2001 qualifies as a change sufficient to trigger the cancellation rights under market-out provisions.[38] In some cases, lenders have dealt with this issue by leaving the question to the opinion of the lender. For example, commitment and mandate letters may include a clause along these lines:

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[36] Jim Middlemiss, "Crunch cools bank fervour; Credit Tightens" *National Post* (14 May 2008) LP 3.

[37] See *Retrieve Resources Ltd. v. Canaccord Capital Corp.*, [1994] B.C.J. No. 1897, 8 C.C.L.S. 123 (S.C.).

[38] Barry Critchley, "Now we know what disaster-out means: Clause allows parties to back out when a 'world event' strikes" *National Post* (12 September 2001) C.17.

> "Each Funder's commitment to enter into the financing documentation on the terms and conditions set out in the term sheet is also subject to the further conditions that in the opinion of each Funder: (i) no major disabling event or circumstance has occurred relating to the Project, between the date of this letter and the date of Financial Close, which would substantially frustrate or render it impossible for any party, including the Funders to perform its obligations under the material project documents to which it is a party, and (ii) no material adverse change shall have occurred between the date of the commitment letter and the date of financial close in the international or domestic money, debt, bank or capital markets."

Obviously, bidders faced with such a clause are taking a risk if lenders get cold feet. However, as banks return to lending and the markets stabilize, bidders get more comfortable proceeding even in the face of problematic language.

(d) Increased Security Requirements by Lenders

A central concept to P3 financing is that the lenders' recourse against the sponsors is limited to the assets of the project company, which is normally structured as a special purpose vehicle (SPV). Even with respect to the assets of the project company, lenders cannot expect to take security over the facility which is the object of the P3 contract.[39] This is because the maintenance of the public service "has to take priority over any claims by lenders in this respect - clearly the idea of lenders foreclosing on a public sector school and selling it would be unacceptable, and selling off a road or a bridge is impossible".[40] In Ontario, project agreements typically provide that the project company has no interest of any kind in the land or the facilities being constructed so there is nothing in which to have security. Hence, the lenders' security interest has typically consisted of the four following layers:

- reliance on the cash flow of a successful project company for repayment;
- security over the project company's contracts and financial assets;
- security over the project company's shares; and

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[39] Yescombe, *Public-Private Partnerships*, *supra* note 3 at 208.

[40] *Ibid.*

- step-in rights if the project company defaults, (which rights are acknowledged directly by the counterparties).[41]

As of November 2008, market participants started to observe that with the pool of lenders shrinking in light of the crisis, "those lenders remaining in the market [were] requiring more stringent covenants and security requirements to reduce their exposure to risks associated with the project, with the result being a reduction in the overall risk associated with the project".[42] This increased appetite for security by lenders was also confirmed by the CCPPP.[43]

When lenders fear that typical security interests are insufficient to bring the investment risk to acceptable levels, they ask sponsors, among other things, to provide guarantees, some of which include:

- *contingent equity commitment*: the sponsors contract to inject a specific additional amount as equity into the project company to meet specified cash-flow requirements;
- *cost-overrun guarantee*: the sponsors agree to inject additional equity up to a certain limit to cover any cost overruns during construction or operation;
- *completion guarantee*: the sponsors agree to inject extra funding if necessary to ensure that construction of the project is completed by a certain date; or a
- *shortfall guarantee*: the sponsors undertake to pay any sums remaining due to the lenders after the termination of the loan and realization of other security.[44]

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[41] *Ibid.*

[42] Fengate Management Capital Group Ltd., "The 2008 Financial Crisis and its Impact on Public Private Partnerships" (10 November 2008) at 2, online: <http://www.fengatecapital.com/1.pdf> [Fengate, "The 2008 Financial Crisis"].

[43] CCPPP Report, *supra* note 1 at 2.

[44] Yescombe, *Public-Private Partnerships*, *supra* note 3 at 170.

In some cases, parent company guarantees ("PCG") are often limited to a set percentage of the contract price but some lenders have pushed for higher limits. Further, lenders have pushed for additional forms of security, such as a letter of credit, cash sweeps or reserves, where certain events, such as a ratings downgrade for the parent, occur. Obviously, as PCGs expands in scale and scope, the essential concept of limited recourse in P3 financing starts to weaken, because the lenders are effectively able to look to assets other than those of the project company.

Of course, as lenders became much more focused on the credit-worthiness of the counterparty to the construction and service obligations, they also focused on having liquid security available to fund any requirements the lenders might have to step-in to remedy performance defaults. As a result, letters of credit requirements for both construction and service operations become standard for lender term sheets. Although the quantum varies, a 5% letter of credit for construction obligations was and is not an uncommon bank request. In addition, lenders have required the establishment of reserve accounts for lifecycle costs and the posting of liquid security before, for example, certain payouts can be made to equity.

6. Tighter Credit-Approval Practices

A further effect of the crisis was to make credit approval for P3 financing much more difficult. As a result, banks' credit committees took a much more cautious approach to approving loans for P3 projects than they had previously. Even in stable economic times, banks adopt stringent credit approval practices: "Banks' credit committees hate surprises and crave predictability. As a general rule, they will not accept risks which are either incapable of proper assessment or analysis or which are potentially open-ended in their effect".[45] The weakened market created an uncomfortable amount of unpredictability for credit committees. As observed

[45] Vinter, *Project Finance*, *supra* note 2 at 139.

by market analysts, "[f]or banks to obtain credit approval, credit committees are demanding a higher degree of comfort than previously required"[46] Even a consortium with the same project team members as had been previously approved faced increased scrutiny and skepticism. Public authority payment risk suddenly required greater due diligence. (In Ontario, for example, hospitals, which are required to pay 10% of the approved project cost, were subject to a real assessment of their ability to pay.) Projects with innovative concepts or in an untried sector were tougher to fund. In sum, the credit crisis reinforced credit committee conservatism and many if not all of the consequences that have been outlined in this paper were the result of credit committees seeking to drastically reduce the risk profile of approved loans.

7. The Increased Cost of Borrowing

In the aftermath of the crisis, debt financing for P3 projects has not only become harder to get, but also more expensive when provided. In a survey of selected countries (Canada being one of them), conducted by the International Monetary Fund ("**IMF**"), most of the respondents identified the increased cost of borrowing as one of the predominant challenges posed by the crisis. These results accord with the IMF's own finding that "[i]n most economies, developed or emerging, spreads between corporate and sovereign rates have increased since mid 2008 to levels not seen since the Asian crisis, the dotcom bubble or the Argentine crisis, indicating an increase in risk premium".[47] This overall increase in the cost of borrowing affected not only new projects

[46] Michael O'Connor & David Quinlan, "Projected Returns", *Legal Week*. (9 April 2009) online: <http://proquest.umi.com.proxy1.lib.uwo.ca:2048/pqdweb?index=0&did=1729141611&SrchMode=2&sid=4&Fmt=3&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1263239964&clientId=11263>.

[47] Philippe Burger *et al.*, "The Effects of the Financial Crisis on Public-Private Partnerships" (Working Paper, International Monetary Fund, 2009) at 5, online: <http://www.imf.org/external/pubs/ft/wp/2009/wp09144.pdf>.

in the pipeline, but also existing projects that have refinancing needs and/or variable interest payment obligations.[48]

In Canada, as of November 2008, P3 deals were pricing "well in excess of the 200bps mark with a majority of projects pricing over 300bps, while only a year [before that] deals were able to close around 100bps".[49] It has been suggested by some that this jump in Canadian margins is in part attributable to the 'bumpy' volume of P3 projects in the years leading to the crisis. For instance, while evaluating Canada's P3 market in 2008, the *Project Finance* magazine quoted a project finance banker as saying: "There are too many projects at once, as well as a decline in available credit. If the deal flow were more steady, I doubt that the spreads would have widened so much on these projects. Deal flow, particularly in Ontario but also in BC and Alberta, is putting pressure on margins".[50] This diagnosis seems to have resonated with the CCPPP as well. One of its primary recommendations for the revitalization of the P3 market was that Canada should organize a national pipeline of P3 projects so that the timing of the projects corresponds with the supply of resources needed to complete them.[51] In CCPPP's view, a coordinated flow of deals "will increase lender participation and ease the burden on private-sector sponsors, contractors and operators thereby stimulating more competition and potentially a better price".[52]

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[48] *Ibid.*

[49] Fengate, "The 2008 Financial Crisis", *supra* note 42 at 4.

[50] Catherine McGuirk, "Canadian Infrastructure Report 2008—Testing Times," supplement, *Project Finance* (September 2008) online: <http://www.projectfinancemagazine.com/default.asp?Page=20&PUB=157&ISS=24984&SID=711189>.

[51] CCPPP Report, *supra* note 1 at 31.

[52] *Ibid.*

Critics of P3 procurement have been quick to stress that this hike in spreads reinforces their argument that P3s do not provide value for money ("**VFM**").[53] Generally, VFM refers to the amount by which the estimated cost to the public sector of delivering an infrastructure project via public procurement exceeds the estimated costs of delivering an identical project using P3 procurement.[54] The critics' argument is that because governments can now borrow at much lower rates than project companies, the cost of public procurement is highly unlikely to exceed the cost of P3 procurement, thus resulting in no VFM with P3 procurement.[55]

However, this focus on the lower borrowing rates available to governments has traditionally rested on an unwarranted assumption. As Yescombe notes, "a project's risks do not disappear just because the public sector is funding it - it can thus be argued that these risks are retained by the public sector and constitute a concealed cost of the project, which should be added to the lower cost of public-sector financing to make this comparable with a P3's financing costs".[56] As the CCPPP Report points out, one of the key challenge for the public-sector in this financial environment is "[m]anaging public perception of public risk related to decisions by the government to support P3 through increased contributions or financial support".[57]

As the crisis has receded and credit markets have rejuvenated to a certain degree, P3 financing has benefited from two salutary effects. First, spreads have come down significantly. While not at the pre-crisis levels, they have returned to more competitive levels. Second, base

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[53] See generally Columbia Institute, "Understanding the Challenge", *supra* note 4.

[54] CCPPP Report, *supra* note 1 at 26.

[55] See generally Columbia Institute, "Understanding the Challenge", *supra* note 4.

[56] Yescombe, *Public-Private Partnerships*, *supra* note 3 at 18.

[57] CCPPP Report, *supra* note 1 at 4.

rates are also relatively low. The combined result is that the overall pricing is very competitive, which enhances the VFM claim of the P3 model.

8. Solutions to P3 Financing Constraints

As indicated by the changes canvassed in the preceding discussion, P3 financing, both in Canada and elsewhere, faced real challenges because of the crisis. A number of public-sector based options have been mooted to alleviate these difficulties, at least in the short term. These options have either been implemented or recommended for implementation in various jurisdictions.

(a) Government Co-Lending

One remedy was to have the government make loans alongside private-sector lenders to projects sponsors. Some jurisdictions have already implemented this measure: the United Kingdom, France, the United States and the European Union. For instance, the U.K. Treasury instituted a lending initiative under which the U.K. government would lend on commercial terms with other lenders to those projects unable to reach financial close otherwise.[58] The government also established a Treasury Infrastructure Finance Unit ("**TIFU**") to execute this initiative. When lending is provided under this initiative, TIFU will rank *pari passu* with other commercial creditors and will also have voting rights. While these loans will bear interest and be repaid during the life of the project, TIFU will make efforts to sell them prior to maturity once a favourable market is created for them. In other words, this is a temporary measure to help P3 projects in the existing pipeline reach financial close, despite disruptions in the debt market.[59]

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[58] U.K., HM Treasury, "Safeguarding Government infrastructure investment", (Media Releases, 3 March 2009) online: <http://www.hm-treasury.gov.uk/press_20_09.htm>.

[59] *Ibid.*

This form of co-lending has not yet been implemented in Canada, but the CCPPP strongly recommended it, although with a key difference. The CCPPP view was that senior debt provided by Canadian governments should be passive and subordinate to the senior debt provided by private lenders, rather than on a *pari passu* basis as in the U.K.[60] A key advantage of this form of lending is that it would incentivize a maximal amount of Canadian P3 transactions by attracting risk averse investors to enter the market once the higher risk phases of the project have been completed.

However, as the CCPPP acknowledges, these benefits of the passive and subordinate government lending are not without costs. First and foremost, this form of lending places governments' investment in jeopardy, due to potential project default. As a passive and subordinate lender, the government would be the last creditor to get repaid in case of default. As such, the government is likely to provide further funding to keep the project company afloat. The public could perceive this funding as a de facto government "bailout", thereby providing additional ammunition to P3 critics. Further, as conceded in the CCPPP Report, the emergence of a secondary market for government P3 debt may encounter difficulties. As the government's P3 debt would be subordinate and with certain limits on voting rights, it may not prove attractive to investors in the secondary market, thus rendering the government an involuntary long-term lender. In short, government P3 co-lending is at best a viable option in a financial crisis environment, although designing its precise structure requires a delicate balancing act between the need to stimulate private lending and the need to ensure that taxpayer dollars are spent wisely.

(b) Government Grants

[60] CCPPP Report, *supra* note 1 at 21.

Another proposed remedy was for the government to make "grants" to private-sector sponsors during the construction period, at substantial completion and/or at a specified time after the commencement of operations. Several Canadian provinces have implemented this approach.[61] A key benefit of this measure is that it decreases the need for private lending. For instance, the club of lenders may not have the capacity to finance a large project by itself; however, with a government grant, the club of lenders would have to provide a smaller amount of capital, thereby enabling the procurement of a project otherwise beyond reach. Another upside to government grants is that they are easy to implement, provided that they are identified at the request-for-proposals stage ("**RFP**"), and the terms are not altered during the contract finalization stage.

However, there are downsides to this measure as well, especially if the grants are not structured properly. A major drawback is that the very essence of the P3 procurement model begins to be compromised with an increase in the government-grant / sponsor-equity ratio. In other words, the greater this ratio, both the risk and the potential profit on equity for private sponsors declines. Another shortcoming of government grants is that they can potentially complicate the procurement process and/or give rise to inter-creditor issues, with respect to matters such as step-in, voting, enforcement or acceleration.[62] Notwithstanding these concerns, government grants can be an appropriate short-term response to the shortage of credit. This is especially so if the government-grant / sponsor-equity ratio is kept at an optimal level and the administrative execution of the grant is performed effectively.

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[61] *Ibid.*

[62] *Ibid.* at 22.

A variation of the "grant" approach - and one used with some frequency in Ontario and in some cases in other jurisdictions - is to provide an interim payment or payments from the public authority linked to milestones in the construction process, including substantial completion. This has the twin result of reducing the amount of overall financing required while providing a mechanism for both short and long term debt in the same deal. The construction phase, which generally carries with it the greater risk profile, can be matched to a shorter term loan which is paid out on a milestone basis or in whole on substantial completion. The service phase (including, in some cases, part of the construction phase costs) can be matched to long term lenders through a second facility or a bond. This solution creates room for the return of financing competitiveness and innovation while keeping most of the advantages of the P3 model.

(c) Government Credit Guarantees

Another potential approach to encouraging P3 private lending in the current environment is for governments to provide credit default guarantees to private-sector lenders. This measure has been implemented in France, the U.S. and the E.U. For instance, in France, as part of the stimulus package (*Plan de Relance*), the government instituted a guarantee program, under which it guarantees up to 80% of the total debt for projects that reach financial close before December 31, 2010.[63] In the U.S., under the Transportation Infrastructure Finance and Innovation Act ("**TIFIA**"), the Department of Transportation is authorized to provide credit assistance in the form loan guarantees and standby lines of credit to finance surface transportation projects of national and regional significance.[64] If the government is called upon to pay a third-party lender under the guarantee, the borrower is then required to eventually repay

[63] Miles Lang, "New French project guarantee debuts", *Project Finance* (September 2009) online: <http://www.projectfinancemagazine.com/default.asp?page=7&PubID=4&ISS=25481&SID=722439>.

[64] U.S. Department of Transportation, "TIFIA", online: <http://www.fhwa.dot.gov/ipd/tifia/index.htm>.

that full amount to the government, pursuant to a reimbursement agreement executed simultaneously with the loan guarantee. In the E.U., public-sector credit guarantees are provided by the European Commission and the European Investment Bank ("**EIB**") under the Loan Guarantee Instrument for Trans-European Transport Network projects ("**LGTT**").[65] This instrument is specifically designed to guarantee lenders against revenue risks in the early operational period of infrastructure projects across Europe. The credit guarantee programs in all these jurisdictions are expected to decrease interest rate spreads and to speed up financial close for P3 projects.

Despite their potential benefits, government guarantees have not found favour in the Canadian P3 market. In particular, there are two main concerns with them: they add an extra layer of complexity to the procurement process; and there is no clear evidence as to their soundness on a cost-benefit analysis basis.[66] These concerns seem to be warranted in the context of blanket guarantees covering all types of risks. However, there may be fewer reasons for concern if government guarantees are tailored to a limited set of specific risks, such as revenue risks during the initial operating phase of the project, as in the case of LGTT in the E.U. Under this more tailored approach, the private sector assumes the remaining risks.

(d) Response by Infrastructure Ontario ("IO")

A package of measures aimed at alleviating the effect of P3 financing constraints has been implemented by the Province of Ontario. IO, the provincial government agency whose mandate is to supervise the P3 infrastructure procurements in Ontario, has adopted a number of

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[65] E.U., European Investment Bank, "European Commission and European Investment Bank Launch new Instrument to Finance European Transport Network", (News Release, 11 January 2008) online: <http://www.eib.europa.eu/about/press/2008/2008-005-european-commission-and-european-investment-bank-launch-new-instrument-to-finance-european-transport-network.htm>.

[66] CCPPP Report, *supra* note 1 at 23.

changes to increase financing flexibility for bidders, while simultaneously advancing the government's stated policy to ensure public interest paramountcy and VFM in each procurement.

On the one hand, to encourage private-sector lending to bidders, IO has increased the financing flexibility in a number of ways. First, it has allowed bidders to submit their proposal package in two separate stages: the financial proposal can now be submitted at a later date than the technical proposal. This is attractive to lenders since it means that pricing has to be held at a fixed level for a shorter period. Second, bidders are now given a second chance to modify their proposal package, starting thirty days after the original submission deadline. In this revised financial submission, bidders can alter certain financing related elements of their bid, including credit spreads, and credit spread benchmarks. With respect to credit spreads, for instance, IO sets a date before which each bidder can either change or confirm its originally proposed credit spread; this is referred to as the "first credit spread lock-in date". Further, the *selected* bidder is given an additional date before which it can either change or confirm its most recently proposed credit spread; this is referred to as the "final credit spread lock-in date". Moreover, bidders can price their short-term and long-term financing instruments in way that is consistent with publicly verifiable rates (e.g., those listed on the Bloomberg or Reuters screens); this is referred to as the "benchmark rate". The benchmark rate proposed by the selected bidder, is then adjusted to reflect current market rates as of a specific date selected by IO; this is referred to as the "benchmarking date". If on the benchmarking date it is concluded that the selected bidder has secured more favourable lending terms than originally presented in its financial proposal, then any increase in its return on equity will be considered a gain; this is referred to as a "financial close refinancing gain". Any such gain is then shared equally between the selected bidder and the procuring authority.

On the other hand, to protect the public interest and ensure VFM, IO has adopted several simultaneous changes to the RFP process. First, IO requires each bidder to evidence the stability of their proposed financial structure through the submission of a confirmation letter stating that the bidder has not entered into any exclusivity arrangements with respect to the project with any lenders, including any prospective lenders. Second, IO requires each bidder to evidence the achievability and robustness of their proposed financing through commitment letters from lenders. MAC or market-flex clauses are either prohibited or can be a serious flaw in the proposed financing plan of the relevant bidder. Lastly, IO has included a "severe market disruption event" clause in the project agreement. This clause gives IO the option to terminate the project agreement should the selected bidder fail to achieve financial close by the set financial close date as a result of a suspension or cessation of normal lending activity in major markets. Based on these measures, Ontario managed to close a number of projects during the crisis and subsequently.

(e) Other P3 Financing Options

Other measures, such as staple financing and funding competitions after the RFP stage, have also surfaced as potential solutions to the current P3 financing challenges. However, the general consensus seems to be that the drawbacks of these measures outweigh any potential advantages they may have.[67] Under the staple financing option, the government arranges financing terms with the lenders in advance, and then offers that financing package to the bidders at the RFP stage. This arrangement is especially unattractive for lenders because they are under a 'veil of ignorance' with respect to the risk profile of the ultimate borrower. Under the option of organizing funding competitions after the RFP stage, the selected bidder would be selected

[67] *Ibid*. at 24-25.

before committed financing has been secured. The public-sector authority could be heavily prejudiced under this approach because it would lose the benefit of an extra layer of due diligence usually performed by lenders during the RFP stage. Private-sector participants, such as bidders who may have an edge on the procurement of financing, would also be prejudiced. In short, these options are considered undesirable for the most part.

(f) Removing the "F" from "DBFM"

One final option is to turn the project into a traditional design - build project onto which, in some circumstances, a maintenance contract can be added. While a few projects proceeded on this basis during the height of the crisis (and some projects still face this risk where the project is simply too large or too complex), this has the effect of removing the project from the P3 orbit along with any of its concomitant benefits. To date, the overall flow of deals from many provinces and the federal government which use the P3 model suggests that the benefits of lender oversight to large infrastructure projects and the risk transfer that comes with the P3 model continue to out-weigh the costs and complexity of the post-crisis lending environment.

9. Conclusion

In the teeth of the credit crisis, obtaining private-sector financing for P3 procurements became a serious challenge to bidders and to the rationale of the model itself. The crisis resulted in various changes to the way P3 financing was structured, documented, negotiated and ultimately provided. In practice, while lenders have imposed tougher covenants and are reviewing these projects with a higher level of scrutiny, money is available and prices are coming down. As these trends continue, the P3 model retains its value as a superior method for the procurement of public infrastructure.