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PF2: A CLEAR INVESTMENT

Although PF2 represents a relatively minor iteration of the previous PFI model, a number of policy changes that accompany the reform are transforming the nature of the market and the types of institutions involved

The introduction of PF2 will transform the market for infrastructure finance. One important outcome will be to place limits on the role of commercial banks (previously the dominant PFI debt fund providers) and require the entry of institutional investors such as pension funds and insurance companies.

Unlike their predecessors, institutional investors often lack dedicated specialist teams to undertake due diligence to ensure that risks have been property identified, allocated and mitigated. And they are unlikely to be comfortable bearing the costs that banks, for example, have borne when undertaking or commissioning independent forecasts, due diligence and risk assessments.

Thus, PF2 projects may not be a straightforward proposition for all investors. Those that do enter the market will be unlikely to be able to accept at face value the forecasts of project managers and promoters. For private sector partners to attract institutional investment (and also for government agencies to sign off on new equity investments), there will be an enhanced need for clarity about the true magnitude and severity of project risks – alongside much better assurance that risks have been allocated to the parties best placed to manage them.

New market entrants will demand clear documentation and adequate systems of risk-identification and mitigation among project companies. For the new debt providers, which are likely to require strong credit ratings in order to regard PF2 projects as economically attractive, absolute transparency of the contractual documentation and a high level of clarity about how the transaction will operate in practice will be of decisive importance.

In a PF2, deductions can be imposed by the authority if the availability of the physical assets or the quality of services fall below contracted standards. Understandably, authorities are often keen to see greater transparency in terms of the provider's performance against the contract.

For the operator, which is reliant on direct revenues from the project to cover its capital, operational and financial costs, it is imperative that information is available to manage project risks effectively. Where there are repeat failures and ratchet percentages for sustained under-performance, the financial impact for the service provider can be severe.

The changes greatly strengthen the need to adopt integrated payment mechanism software as a means of creating shared understanding between the various project stakeholders about the nature and scale of project risks, and giving assurance to investors that these will be mitigated effectively.

This software application will automatically calculate deductions from events that have been entered into the system. In the operational phase of the contract, the performance of the service provider can be monitored on a real-time basis and in a transparent manner through the use of remote monitoring and running of abatement and performance reports.

In the PF2 environment, it will therefore be increasingly important that the contract management software supplier is engaged during the bid and procurement stage at the point when the basis for a good relationship between the contracting parties is established and the key commercial and financing agreements are put into place. This will give investors and lenders a clear view of how the contract is to be implemented. And, in enhancing the quality of information available to the parties involved in negotiations, it will give investors greater assurance that the project is based on a mutual understanding of requirements and a shared interpretation of how these will be realised.

By engaging the counterparties in discussions about project operations during the negotiation stage, the software provider understands the service provider's requirements, culture and expectations as well as the expectations of the authority and its staff and any differences can be addressed early in the contract process.

The public authority also gains crucial insight from understanding how the payment mechanism will operate as part of the performance management software. This provides an opportunity for the public authority to analyse clauses in detail and apply a common sense approach that is agreed by all. From the perspective of an investor, the shared understanding of how terms are to be interpreted by the authority will give greater assurance about cashflow stability.

Essential components for attracting new private investors are:

- Stakeholder recognition of the barriers that institutional investors face in engaging with PF2 contracts, and seek to address these by improving the quality of information available pre- and post-contract
- Engagement by project companies and service providers of the contract management software supplier during the preferred bidder phase
- Ensuring that the selected software solution incorporates an integrated payment mechanism that is capable of delivering consistent, auditable and transparent management of data that can be monitored on a real-time basis
- Committing to world-class information technology in the post-contractual phase to enable effective risk mitigation and stability of cashflow. PB