To: Neil Smith, Financial Secretary, British Virgin Islands Government

From: James Ballingall and Paul Illingworth, Infrastructure UK

Subject: **BRITISH VIRGIN ISLANDS' AIRPORT EXPANSION PROJECT - INFRASTRUCTURE UK REVIEW AND STRATEGIC ADVICE**

1. Introduction and Background

1.1 The British Virgin Islands Government (the "*BVIG*") through the Overseas Territories team of the Foreign and Commonwealth Office (the "*FCO*"), has engaged Infrastructure UK ("*IUK*"), a division of Her Majesty's Treasury, to provide commercial support services in respect of the BVIG Airport Expansion Project (the "*Project*").

1.2 IUK's role has been to review the project, provide advice and make recommendations to the BVIG, focusing principally on its commercial and financing proposals. The aim is to help ensure that project delivery is well executed, including commercial and financing proposals that are viable and deliverable. Our review has been undertaken by James Ballingall, Head of IUK's International Team and Paul Illingworth, Project Director in IUK's Delivery Team. This memo is for the BVIG in the first instance but we are content for it to be shared more widely with the FCO, the project's advisers and the Governor's office.

1.3 IUK's support has comprised:

a. reading key documents, principally the Outline Business Case (OBC) and an additional briefing document, which updated and supplemented information provided by PwC during our visit;
b. face to face discussions with key stakeholders, including a series of meetings with the BVIG project staff and project advisers during our visit to BVI on 28th April to 2nd May 2014;
c. telephone conference calls with the project's advisers on 12th and 21st May; and
d. providing verbal feedback to BVIG in the first instance and then in writing, through this memo.

1.4 The IUK Team would like to thank the BVIG, its officials and the project's advisers for their hospitality during our visit to BVI. We would also like to record our appreciation for the open and constructive manner in which individuals have engaged with IUK.

2. Issues and Recommendations

2.1 Our commentary and recommendations are set out in this Section 2. We have outlined a number of key issues we believe are known to the BVIG and its advisers but have tried to bring them into sharper focus, outline possible solutions and provide a suggested route-map for taking them forward.

The content of this memo is based on the information provided and discussions held, and the views expressed in this memo are honestly and impartially held on the basis of that information. This memo does not, however, represent legal, financial or technical advice on the BVIG's proposed scoping, design, legislative, commercial or contractual arrangements for the project.

2.2 Summary

2.2.1 The project has a strong strategic case, with a clear need and obvious benefits. The engineering and technical plan is well progressed and environmental concerns appear to have been integrated into the developing reference design. We think the economic case can be improved with the addition of analysis on wider economic benefits and the stark contrast for economic development of the BVI of the "do-nothing" option. The commercial case for the project is least developed and urgently must address the following critical issues to outline a viable delivery model and demonstrate it is financeable:

a. Volume risk – understanding and underpinning this better is fundamental to the way forward;
b. BVIG project support – debt, equity and existing bidders are not currently prepared to take volume risk, especially with existing airport losses, and acceptable mechanisms need to be included in the commercial structure to deal appropriately with this risk;
c. Delivery Options – a BVIG objective for the project is for it to be privately financed and, taking into account the most recent information provided, it is not at this stage clear that this is possible (at least without a full BVIG guarantee – which would have balance sheet implications). More work is needed to demonstrate the viability of a privately financed project;
d. Existing procurement – updated bids have recently been received but all bidder proposals so far have been on a design & build basis. The final delivery model will require operation and finance, so the BVIG will need to determine how to align this with its existing procurement; and
e. Timetable – a re-base-lined timetable following resolution of the key commercial issues outlined above needs to include clear and realistic recommendations for reconciling Ministerial requirements for an early project conclusion on the one hand with quality, affordability and value for money on the other.

2.2.2 The project is at a pivotal point and at this stage it is not possible to predict whether these significant challenges can be met. There is further work that can be done and we have made six key recommendations which outline actions for the BVIG to take and we believe will help determine the viability of the project. These key recommendations are set out in Section 2.3 below and repeated , for ease of reference, in Appendix 2. Given the significance of these issues, our overall rating for the delivery confidence of the project is Amber/Red. This means that in our view successful delivery of the project is in doubt, with major risks or issues in a number of key areas and urgent action is needed to address these and demonstrate whether resolution is feasible.

2.2.3 We suggest the project team works the outcomes from our recommendations into a set of papers to be presented to the governance board and Ministers, seeking endorsement to a clear way ahead for the project. If officials move quickly and with the cooperation of the project's advisers, this should be possible by the end of June.

2.3 Key Issues

2.3.1 Volume Risk. For the project to succeed it must be able to offer a commercially acceptable and financeable proposition to the market at the same time as being affordable to the BVIG. The key to financing the project is to have reliable income flows which lenders will lend against, especially as the airport is currently loss making.

2.3.2 The fundamental conditions for private sector financing of this project are the reliability of projections for increased passenger numbers and the commercial acceptability of an additional $150 passenger levy (the Boyd Report suggests airlines may require an incentive rather than a levy). In particular, lenders will need to have confidence that a “step change” in passenger numbers will materialise (as a result of direct flights from the USA and possibly tag-flights from Europe). Since our five day visit to the BVI we have been able to read further PWC reports on this and had a further conference call with PWC Canada and Trinidad.

2.3.3 Taking into account this further information it is our view that the project in its current state is not financeable by the private sector, that more supporting evidence is needed, and that attempts to obtain private sector finance off the back of current evidence will likely result in demands for the finance to be wholly or substantially underwritten by the BVIG. Clearly BVIG will have a better idea when they have reviewed bids received on the 12th May, but it seems unlikely they will contain any real level of commitment from lenders, especially as the financing proposals in the bids are for information only. Until a reliable “investment grade” volume forecast is available to the market and a clearer idea of what airlines can commit to, in terms of direct flights, is obtained it may not be productive to attempt any serious engagement with the financing community.

Recommendation: BVIG should urgently:

- ***a. commission a detailed “investment grade” expert report on traffic forecast and airline/passenger pricing (including the effect of a $150 passenger levy and other increased airline and passenger fees); and***
- ***b. enter into meaningful talks with relevant airlines (e.g. AA, JetBlue, BA and Virgin etc) with a view to confirming the commercial acceptability of the levies and charges proposed (particularly the $150 development levy) and signing MOUs with them as to future use of the expanded airport.***

2.3.4 Government Support. Notwithstanding the clarity that understanding future passenger volumes will bring, lenders are likely to remain averse to accepting volume risk on this project and an investment grade forecast will not be enough to persuade them to lend without some BVIG support. Responses to the recent market sounding support this view and also suggest there is limited appetite for the provision of equity. Equity in the structure will be helpful to provide private sector “skin in the game” which is normally necessary for project finance. Equity may be persuaded if volume risk is appropriately dealt with.

Recommendation : In order to circumscribe the volume risk PWC should produce detailed sensitivity studies for BVIG to gauge the extent of any potential cash-flow shortfalls and then to

***consider the nature of an appropriate and minimum support package to plug any shortfalls in a clearly defined way*.**

At present the default position of lenders is likely to be to ask for 100% cover.

2.3.5 There is currently too much uncertainty for us to outline what an appropriate support package should look like but we know that PWC have already looked at the possible need for some capital contribution (subsidy) as well as a guarantee. It will be important for BVIG that any support is clearly quantifiable and does not exceed government's capacity to pay.

2.3.6 In order to provide the minimum support necessary, any support should be tied specifically to meeting any cash-flow shortfalls and dealing with the volume risk. It should not available for wider risks of project stress such as project delay, cost overruns or defective work. Lenders should have recourse against the design and build contractor for these risks in the usual way. Ideally any support should be provided only to senior debt (not equity or mezzanine). We suggest that consideration is also given to the sort of support that Government Export Credit Agencies may be able to make available - by way of example, UK Export Finance have extended their range of support instruments and can provide project finance as well as credit support, and have products dealing with refinancing risk. It may be that relevant agencies for other countries can offer similar products. Consideration could also be given to any possible multi-lateral support (e.g. Caribbean Development Bank). Other considerations when structuring the support package include:

a. structuring the risk of volume shortfalls into tranches (first loss, second loss etc) e.g. BVIG could take the first loss tranche, with equity or another party taking second loss etc;
b. financial structuring of loss contributions – revolving facility, standby facility, mezzanine debt etc;
c. structuring of any up front risk capital investments (classes of investor /share /coupon etc); and
d. it is also worth BVIG and PwC investigating the extent to which any projected additional BVIG revenues arising from an expanded airport (see paragraph 2.4.22a below) could be hypothecated and "privatised" for the support of airport project cash-flows. BVIG will need to manage compliance with the Protocols which have specific requirements on hypothecation.

2.3.7 One methodology for providing targeted cover (or subsidy) rather than blanket guarantees is the "viability gap funding" model (used in some parts of the world to support concession projects which are not economically viable on their own). Under this model, if traffic forecasts are inadequate for funding, bidders are asked to bid how much "public sector gap funding" they need and (subject to quality test too) the bidder asking for the smallest subsidy wins. An issue to note though is trying to avoid contributing the subsidy until after the build is completed or in tranches in the operational phase, so as not to take back construction risk. This has the quality of being a finite known sum, but of course is a real subsidy not a contingent liability.

Recommendation: The project team and its advisers need urgently to explore options for government support to the project to manage the volume risk as this is essential to making the project financeable under any delivery option. The solution may be a combination of mechanisms

but BVIG risk exposure must be quantifiable and the solution must be in accordance with the requirements of the Protocols and MTFP (i.e. debt ratios, balance sheet, contingent liabilities).

2.3.8 Delivery Options. Volume risk is fundamental to project viability under all delivery options. However, once greater certainty on passenger volumes and airline commitments is obtained a better view can be taken on the best delivery model. PWC has undertaken analysis and, we understand, have identified two front runners:

a. Concession model; and
b. Independent Airport Authority all debt model.

We suggest that a third model (Joint Venture or JV) is considered alongside these. Under this model the BVIG would receive an equity stake in the SPV in return for a land lease and any capital contribution that it might put in. Arguably the JV has some characteristics of the Minority or 50% Sale option, but more details for the JV approach are set out in Appendix 1.

2.3.9 PwC has completed a high-level qualitative analysis of a long list of options and this needs taking to a detailed level, alongside a quantitative analysis, for the two shortlisted options and the JV in order to determine the optimum one. The balance sheet treatment of all these options needs to be considered, (this is something PwC should be able to advise the BVIG on) alongside implications for the Protocols; both will also depend on the extent of the support package.

2.3.10 All three models currently appear unworkable as the project is currently configured and their viability hinges on:

a. the route levy, which is essential to project affordability and without which significant BVIG subsidy would be needed; and
b. confidence in passenger volumes, without which a revenue guarantee equivalent to repayment of all debt principal and interest over the term of the loan would be needed.

2.3.11 We believe that any model that requires significant subsidy and/or a full guarantee to lenders would be in conflict with the Protocols. It should also be noted that some sort of economic regulatory regime for airport fees is likely to be needed for all of the options and the task of implementing this should not be underestimated.

Recommendation: BVIG should task PwC with completing urgently a more detailed qualitative and quantitative analysis of the three shortlisted options (Concession, Independent Airport Authority all debt model and Joint Venture), following which an informed decision can be made on the best delivery model. This preferred model must be commercially viable, financeable and capable of integration with the existing procurement exercise.

2.3.12 Existing Procurement. Procurement of the ultimate delivery model is made more complicated by BVIG having a "live" procurement for its airport expansion project, especially as the competition has been going for some time and is now down to a shortlist of three bidders who have not been selected on the basis of their operating and financing proposals. Once BVIG has a better view of passenger volumes and concluded what its preferred delivery and financing model is for the project, officials will then need to work out how to align this with the existing procurement. BVIG may need to sound out the market further before implementing a revised approach, recognising this needs to be done in a way that deals with market fatigue and retains project credibility as far as possible.

2.3.13 At this stage it should also be possible to determine whether it is feasible simply to add the proposed delivery structure and financing approach into the ongoing process or whether it is necessary to start a new competition for it. Options are:

a. asking existing bidders to add finance and operating components to their existing bids, which would appear to be the quickest solution, though this would clearly only test the market in a limited way and could put value for money at risk;
b. start the competition again, which risks losing credibility in the market, especially with existing bidders, and is the option likely to take the longest time to complete; or
b. completing the current procurement on a design & build only basis, agreeing the form of contract, and then holding a further finance and operate competition, the winner of which would take on the design & build contract with appropriate warranties.

2.3.14 Under Option C there is the opportunity to begin design & build (D&B) work before completing the finance and operate (F&O) competition, either through BVIG entering into the contract on a bridging basis until the F&O company is in place or entering into separate early works arrangements to maintain the construction programme, leaving the F&O company to enter into the D&B contracts when established. The second approach relies on there being appropriate and meaningful work that can be split out of the main works and placed in an early works agreement. Neither option is risk free and would ordinarily only be considered where overriding timetable issues applied. Under both approaches the bidder for the F&O company may require warranties from BVIG for the contracts and/or the works and there will need to be an agreed mechanism for bid validity.

2.2.15 There is a degree of procurement risk with each of these options and we are aware that Baker and McKenzie are advising you in this respect. It seems to us that there is only one more opportunity to go back formally to the market on this, so it will be vitally important to get it right.

Recommendation: BVIG and its advisers need urgently to evaluate the benefits, risks and timetable implications of the different procurement options, to enable a decision to be taken on this immediately after investment grade analysis of passenger volumes, assessment of the required BVIG support package and selection of a preferred delivery model and evaluation of the latest bids has taken place.

2.3.16 <u>Timetable.</u> We are aware that progress with delivering the airport expansion project was an important election pledge of the current BVIG Ministers. We believe that this has been a significant determinant in the approach to the project so far. Until the work outlined earlier in this report is complete however, it is not possible to re-establish a reliable timeline or restructure the procurement approach; clearly the approach of an election in late 2015/early 2016 will put pressure on the timeline. It should also be recognised that bidders and lenders may have concerns about signing a contract with such significance to the BVI shortly before an election.

2.3.17 We understand that Ministers would like to see "diggers in the ground" before the next election, but we doubt this is feasible without compromising the value for money or falling foul of the Protocols or. BVIG officials will need to work with Ministers to establish the minimum acceptable and possible progress for the project by the next election, striking an appropriate balance between time on the one hand and quality, affordability and value for money on the other.

Recommendation: Once the key commercial and financial decisions have been taken, independent of timetable considerations, BVIG should work-up a revised timeline and provide options for a realistic and acceptable project milestone ahead of the next BVI election and secure Ministerial endorsement to these.

2.4 Other Issues

2.4.1 Refinancing risk. PwC's assumptions for debt tenor in the project are for an initial term of approximately 10-12 years and we agree that it is quite likely the project will be unable to support a longer tenor in the current market. In this scenario and under current assumptions for the contract length there will be a need to refinance the debt roughly part-way through the contract term. This gives rise to refinancing risk/gain, so the BVIG will need to consider where to allocate this risk and on what basis.[1]

2.4.2 Market sounding responses suggest equity has little appetite to accept this risk and BVIG will need to consider its own appetite alongside its desire to capture all or part of any refinancing gain. Where finance markets will be approximately 15 years from now is unpredictable, but if market conditions remain the same, it is fair to assume that de-risking of the project due to successful construction completion and an operating track record will allow the debt to be financed on preferable terms. BVIG will need to establish treatment of this risk under the Protocol where it chooses to accept it.

2.4.3 Alignment of vision. Through our meetings in BVI we detected a conflict in the vision for the project between a political desire to minimise social impact on the BVI and focus on high-end tourism and the need for the airport operator to maximise tourist numbers in order to maximise revenue and maintain commercial viability. It will be important for BVIG to reconcile these legitimate but conflicting views on tourist development and social impact so that stakeholder, including bidder, expectations are properly managed.

2.4.4 Project Scope. We are aware that the original scope for the project contained 11 elements and that following initial bids and apparent affordability issues, the scope was subsequently split into two phases, with Phase 1 containing only the runway extension and a few ancillary items. We have two concerns with this approach:

a. having personally experienced transit at the airport we think the passenger experience through immigration is poor (by global standards for Western travellers) and likely to be made worse with increased volumes both overall and with the arrival of bigger aircraft; and

[1] Export Credit Agencies may be able to take positions on this.

b. there is scope for expansion of revenue streams around the airport, exploiting a captured market as passengers check-in and await their departure.

2.4.5 The BVIG should re-evaluate what the core project needs to be and whether a reduction from 11 elements to 1 element in Phase 1 is sufficient to support the airport operator's needs for improving the passenger experience alongside increasing volumes. As a minimum, in addition to extending the runway, there is a need to: reconfigure the existing arrivals hall; re-plan immigration; and re-plan the tourist flow from the airport into the islands, ensuring bottlenecks don't arise. The BVIG should further ensure that the commercial model is flexible enough to accommodate future changes in scope and to capture an appropriate share of any additional future revenues for the BVI.

2.4.6 We understand that the Environmental Impact Assessment (EAI) process is underway and that this and planning related requirements for the project are not a "blocker" for the project or an issue for the timetable, although these are not areas we have particularly tested. The project and BVIG will want to assure that this is the case and that the timetables for these processes dovetail appropriately with the procurement processes.

2.4.7 Economic Case. Whilst we understand the economic case to be strong, we believe it's documentation should be strengthened further by the inclusion of:

a. wider benefits in the cost benefit analysis (e.g. stamp duty, tourist tax, hotel industry revenues); and
b. the "counterfactual" (e.g. it may not be a level baseline but a declining one through loss of markets to other islands as tourists and businessmen go elsewhere (due to possible tightening of bell-curve around US vacation length to 4 days) and loss of future or extended high-end resort developments such as Oil Nut Bay).

2.4.8 Market Management. The project team needs to develop a coherent communications plan for its stakeholders and be particularly careful on how communications to bidders are handled. This should be approved by the governance board and the approvals and decisions outlined in paragraph 2.4.10 below used as an opportunity to give confidence to the market.

2.4.9 Business Case. A key component of the ongoing work should be the drawing together of a revised outline business case (following the UK 5 case model format or similar). This should include a clear articulation and measurement of the benefits this project will bring to the Islands as well as its costs, the commercial and financial arrangements and the management proposals for pulling it together and delivering it. Above all the BVIG should require the project team to pull together a more comprehensive Business Case which clearly demonstrates value for money.

2.4.10 Information from a comprehensive business case can be used to demonstrate to bidders and financiers that the project and its procurement are clearly thought through as well as giving confidence to the BVIG and other stakeholders. If the BVIG is to support the project with financial backing, it will need to have the same degree of confidence in its success and, in particular, the key risks (including volume risk), as lenders.

2.4.11 Project Team Skills and Capacity. The BVIG appears to have assembled a strong technical and project management team for the project and appointed recognised advisers in Baker & Mckenzie and PwC. BVIG should now consider if the project team needs expanding, especially in light of the need to support potential future negotiations, evaluation and bidder and financier due diligence. In particular the BVIG should consider the appointment of a commercial expert to lead negotiations with bidders and financiers given the delivery model will be commercially and financially complex. The extent to which the project is able to call on PwC London and Canada and the nature of their support to the competition should be clarified.

2.4.12 Approvals. BVIG should clarify the project's future approvals requirements in terms of the content, timing and process, especially with the FCO. In light of our suggestion at paragraph 2.2.4 of the Summary above and the wider recommendations for action in this report the project team needs to clarify what decisions it requires senior officials, Ministers and the FCO to take in the near term and on what basis they will be asked to take them. We suggest as a minimum these include approval of the:

- Business Case and a decision to go forward to the next stage of competition (including confirmation of overall VfM, affordability and compliance with the Protocols);
- commercial and financial structure for delivery (including the nature of any BVIG support);
- outcome from the evaluation of bids;
- strategy for aligning the proposed way forward with the existing procurement (including communications to the bidders and wider market); and
- proposed timetable and option for the pre-election milestone

The project's oversight board should consider these things and make recommendations to the Minister.

3 Next Steps

3.1 In the near term we recognise that the Financial Secretary may wish to discuss our advice further and we are happy to do this via conference call/video conference. This would provide opportunity for us to elaborate further and for the Financial Secretary to clarify his understanding.

3.2 The next key step for the project is to see the quality of bids recently received and especially if they have viable proposals for financing the project, so as to offer competitive tension and the likelihood of value for money for the BVI.

3.3 If the BVIG wishes, we can discuss how Infrastructure UK might be able to support the project going forward in a way that meets the needs of BVIG and best complements existing capabilities engaged on the project. We believe that any further Infrastructure UK support would best be provided on an ad-hoc basis and is likely to be assurance and strategic advice around key project milestones, with the next obvious one being after evaluation of the latest bids and following completion of the Recommendations identified in this memo.

APPENDIX 1: OUTLINE OF THE JV OPTION

1. Key features of the JV Option are:

    a. BVIG or Bidder sets up a new SPV JV company. Winning bidder contributes capital and BVIG contributes a lease of the airport to JV Co (and any capital contribution) - in return for equity (say [75 or more]% bidder and [25 or less]% BVIG).
    b. Both investments are on market terms and carry equal rights, save that BVIG shares get a special share of “super-profits” once target IRR is achieved. Above this BVIG would have a substantial majority share.
    c. JV Co would also have a concession over the airport (as per the Concession option) and would raise debt finance.
    d. The advantages of this model over the standard one (where the winning bidder owns the SPV 100%) are:

        i. BVIG receives real value for the assets they contribute to the JV
        ii. BVIG has a real interest in the concession vehicle and can be a more active partner, properly involved in the decision making and operations of the company
        iii. The taking of a public sector stake may help give confidence to the bidding market that BVIG will want the Company to be a success and to make a profit
        iv. BVIG will have complete transparency as to profits and proper working of the SPV
        v. Provides protection against criticism that the private sector is making secret profits or getting windfalls, or that BVIG is giving away core national assets cheaply.

2. All figures in this appendix are for illustration only. Actual percentages should be determined following due diligence from PWC if this option is pursued.

3. The balance sheet/Protocol treatment of the JV option would need considering further when the extent of the overall BVIG support package to the project is known.

APPENDIX 2: KEY RECOMMENDATIONS

Recommendation 1*: BVIG should urgently:*

> *a. commission a detailed "investment grade" expert report on traffic forecast and airline/passenger pricing (including the effect of a $150 passenger levy and other increased airline and passenger fees); and*
>
> *b. enter into meaningful talks with relevant airlines (e.g. AA, JetBlue, BA and Virgin etc) with a view to confirming the commercial acceptability of the levies and charges proposed (particularly the $150 development levy) and signing MOUs with them as to future use of the expanded airport*.

***Recommendation** 2: In order to circumscribe the volume risk PWC should produce detailed sensitivity studies for BVIG to gauge the extent of any potential cash-flow shortfalls and then to consider the nature of an appropriate and minimum support package to plug any shortfalls in a clearly defined way.*

***Recommendation 3:** The project team and its advisers need urgently to explore options for government support to the project to manage the volume risk as this is essential to making the project financeable under any delivery option. The solution may be a combination of mechanisms but BVIG risk exposure must be quantifiable and the solution must be in accordance with the requirements of the Protocols and MTFP (i.e. debt ratios, balance sheet, contingent liabilities).*

Recommendation 4*: BVIG should task PwC with completing urgently a more detailed qualitative and quantitative analysis of the three shortlisted options (Concession, Independent Airport Authority all debt model and Joint Venture), following which an informed decision can be made on the best delivery model. This preferred model must be commercially viable, financeable and capable of integration with the existing procurement exercise.*

***Recommendation 5:** BVIG and its advisers need urgently to evaluate the benefits, risks and timetable implications of the different procurement options, to enable a decision to be taken on this immediately after investment grade analysis of passenger volumes, assessment of the required BVIG support package and selection of a preferred delivery model and evaluation of the latest bids has taken place.*

***Recommendation 6:** Once the key commercial and financial decisions have been taken, independent of timetable considerations, BVIG should work-up a revised timeline and provide options for a realistic and acceptable project milestone ahead of the next BVI election and secure Ministerial endorsement to these*