Infrastructure and Projects Authority

PFI Guidance Document

Navigating the risks of PFI project distress

Part 2 Project company financial stress

Reporting to
Cabinet Office
and HM Treasury

Guidance structure

Contents

Project company financial stress

It is important that you understand:

- the potential for performance and contractual issues to cause project company financial stress;
- why project companies might not have access to new money to resolve problems;
- what capacity a project company has to absorb the financial consequences of project distress; and,
- how you can assess and monitor project company financial strength.

Part 2 is recommended for contract managers and in-house finance teams wanting more explanation of the causes and signs of project company financial stress.

Although project company insolvency is rare, contracting authorities should monitor the financial performance of their counterparties, especially when projects are distressed. You should be inquisitive: understand what information you are entitled to receive under the contract, ask questions of the project company and service providers and request financial models and updates regularly. You and your technical advisers should satisfy yourselves that you have as much information as you are entitled to in order to remain informed. Discussing this regularly will also help you to maintain your responsiveness to any changes.

How are PFI project companies structured?

PFI project companies are almost invariably set up as *special purpose companies* (also known as special purpose vehicles) i.e. their only purpose is to deliver the PFI contract. The project company passes construction and service delivery risk down, as far as possible, to its subcontractors. Lifecycle risk can remain with the project company or be passed down to a service provider. This structure is intended to leave only a limited number of risks with the project company.

This approach allowed project companies to finance projects with a relatively small amount of shareholder funding (typically 10% to 15% of the total funding needed, provided as equity and shareholder loans) and a larger amount of senior debt (typically 85% to 90% of the total funding).

The diagram below shows a generic PFI contractual structure, with the contracting authority, the project company and its holding company, investors, lenders and subcontractors.

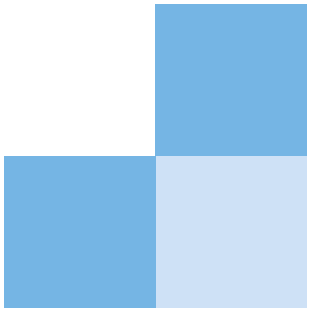
PFI project companies are usually financed on a limited-recourse basis – this means that the lenders have recourse against the project company and its assets but not against the shareholders. The shareholders (and lenders) do not usually have any obligation to put more money into the project company over and above their original investment.

This is an important consideration for contracting authorities because it means that project companies may not have access to additional funds if they get into financial difficulty and/or need to spend money to fix problems. If the contracting authority is making large payment deductions, this could exacerbate the project company's financial problems.

It is, therefore, important for you to understand the wider commercial structure that supports your project company and the basis on which the financing has been provided. Whilst, as a general principle, contracting authorities should apply deductions in accordance with their contracts, there are circumstances where the level of deductions may result in project distress. Where there is project distress, you need to understand the capacity of the project company to absorb the financial consequences of the distress, including payment deductions and additional costs (for example, this information will help you understand when the project company might become insolvent, so you can properly prepare).

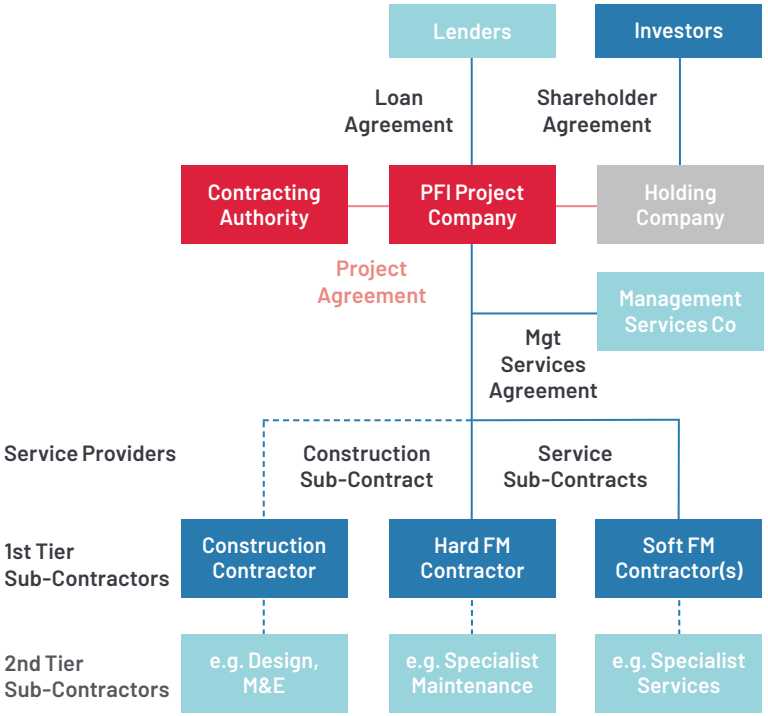
As explained in Part 1, in the context of distressed projects, Best Value/value for money may not always mean applying contractual remedies to the fullest extent, e.g., if applying the maximum payment mechanism deductions could lead to project company insolvency and a worse outcome for the contracting authority. The economic, financial and operational consequences of different potential outcomes should be considered carefully as part of your overall strategy. For example, it may be appropriate in some circumstances to agree to suspend deductions temporarily to achieve wider strategic objectives around rectification of defects and/or compliance issues. In any event, you should still record deductions and seek to preserve your right to deduct those deductions in the situation where the project subsequently terminates.

You may also need to monitor the financial strength of any key project company subcontractors, especially where there are indications of financial stress - the Government Commercial Function has issued separate guidance which provides information on how to do this (*Guidance Note on Corporate Financial Distress*[1]).



1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1165661/Corporate_Financial_Distress_Guidance_Note.pdf

Generic PFI Structure



What can cause project company financial stress?

Project company financial stress usually starts with performance issues - for example, widespread service provider performance failures leading to large payment deductions, or construction defects/ compliance issues resulting in significant rectification works and deductions. Normally the project company will pass the consequences of these performance issues down to its subcontractors, minimising the project company's financial exposure. However, financial issues can remain at project company level. The table below explains some of the main reasons why this can happen.

Service provider liability caps	Payment deductions relating to service provider performance (e.g. hard and soft FM) are usually passed down to the relevant service providers. However, their contracts typically contain caps on liability. These are often set at or around 100% of the service provider's annual fee for liabilities that arise before termination and 200% of the annual fee for liabilities arising as a result of termination. If PFI contract deductions are in excess of the service provider's liability cap, it may not be possible for the project company to pass them down and they would remain at project company level. This can have a big impact where a contracting authority is levying large deductions as a result of payment mechanism ratchets, over long periods of time, and/or for whole facility unavailability.
Construction liability periods	Construction defects and compliance issues arising from the original design and construction are normally the responsibility of the construction contractor. However, the construction contractor only retains liability for a limited period of time - typically twelve years from construction completion. This means that construction defects and compliance issues that come to light after the end of this liability period can remain the liability of the project company. Given the potential cost of fixing widespread construction defects and/or compliance issues, this can cause significant financial stress for project companies.
Disputed deductions	There can be disputes about whether payment deductions (particularly unavailability deductions) are attributable to service performance, poor maintenance, lifecycle failure or construction defects. The project company may have to make a reasonable assessment of responsibility but this can be difficult where issues are technical and require expert determination. If the parties are arguing over who is responsible to fix issues, the project company may have to pay to fix problems and/or take the deductions before responsibility has been determined.
Lifecycle costs	Sufficiency of lifecycle budgets can sit with the service provider or with the project company. Where responsibility sits with the project company, it may have to meet higher than expected costs and/or absorb payment deductions arising from a failure to carry out required lifecycle works. This risk is particularly acute where (i) there are construction defects/compliance issues that cannot be passed down (see above) or (ii) projects are nearing expiry and the project company has insufficient remaining cash flow to carry out the rectification works needed to meet the handback requirements.
Service provider insolvency/ termination	Where a key service provider becomes insolvent, or is terminated for performance issues, the project company will have to find a replacement provider, possibly at a higher cost than originally budgeted and/or with a different risk allocation. There can be subsequent disagreements about where responsibility for faults lie following replacement of a service provider.
Other issues	There are a number of other factors that can financially impact project companies, compounding the financial effects of the issues raised above. These include insurance cost increases, tax rate changes and financial modelling errors. Other issues can arise on more specialist projects, including: – technology issues (e.g. waste projects, specialist facilities) – revenue issues (e.g. waste projects, shadow toll roads, projects with significant third-party revenue elements, including retail and car parking)

How to monitor project company financial stress?

Given the significant jeopardy arising from PFI project company insolvency, it is important that you have the tools to assess and monitor the financial health of your project company and to look out for signs of financial stress. There are various ways in which you can do this.

1. The financial model

Financial models are at the heart of PFI projects because they reflect the financial and economic effect of the entire suite of project contracts. A financial model is usually an Excel-based spreadsheet that details the financial prospects of the project company over the full length of the contract, including historic and forecast cash flow, profit and loss and balance sheet statements. It is, therefore, the key tool used by investors and lenders to monitor ongoing financial performance of a project.

Financial models are used for a variety of purposes and there will usually be different versions of the financial model for the same project, including:

- *Financial close/contract financial model:* this is the financial model that was included or referenced in the PFI contract at financial close. In line with best practice, it should be updated for variations, refinancings and in the event of termination, and used when required under the PFI contract. However, it is unlikely to fully reflect the actual financial performance of the project for investors and lenders at any given point in time;
- *Lender/operational financial model:* lenders use an updated version of the financial model to monitor compliance with the lenders' financial covenants - e.g. financial *cover ratios*. The lender/operational financial model is typically developed from the financial close model and then updated regularly (e.g. quarterly). It reflects all changes to the project company (i.e. outturn revenues and costs, and updated forecasts) and, as such, reflects its actual and expected performance. The lender model may use more conservative assumptions than the model the shareholders use to monitor returns, which may have more advantageous assumptions on lifecycle spend, inflation etc.

Getting access to the lender financial model: whether or not you are contractually entitled to receive the lender financial model depends on the information rights set out in your PFI contract. SOPC based contracts are likely to include the right for contracting authorities to receive information provided by the project company to the lenders during the term of the contract, which would normally include the lender financial model. However, this will not be the same in all contracts.

Where possible, you should use your contractual rights to obtain regular (e.g. semi-annual) updates of the lender financial model as well as other information provided to lenders. Where you do not have contractual rights to information, your project company should be encouraged to provide sufficient information to help you make the right decisions.

What to look out for: PFI project financial models are often large and complex. However, there are a number of potential indicators of financial stress that you should look out for, as described below. You may need professional support and advice to help you review the financial model.

I. *Low debt service cover ratios:* PFI lenders typically require the project company to report certain financial ratio tests. The most important of these is the *annual debt service cover ratio (ADSCR)*, which tests the amount of cash that the project company generates in a given year (after payment of operating costs, maintenance costs and tax) against the amount it has to pay to lenders in the same year. An ADSCR of *1x* means that the project company is only generating enough surplus cash in that year to pay exactly the amounts owed to the lenders; whereas an ADSCR of 1.1x means the project company is generating 10% more surplus cash than it needs to pay to lenders.

The financial model should show ADSCRs for the current period and for all future periods during the term of the loan. Lenders set pre-agreed minimum levels for the ADSCR; a level, below which, they can stop the project company making any payments (or *distributions*) to shareholders (*distribution lock-up*), and a level (lower than the distribution lock-up level), below which, lenders can call an event of default and demand repayment of the loan. For example, lenders might set the distribution lock-up level at 1.1x and the default level at 1.05x. The financial model almost always includes ADSCRs and you should be able to see whether the project is breaching the distribution lock-up or default levels, or is likely to in the future.

Related, but more forward-looking debt service cover ratios may also be included; the *Loan Life Cover Ratio (LLCR)* or, less often, the *Project Life Cover Ratio (PLCR)*, with their own distribution lock-up and default thresholds;

II. *Insufficient forecast shareholder payments:* whilst the investors' Internal Rate of Return (IRR) shows past, as well as future, performance, you can also look at the quantum of shareholder payments forecast to be made over the remainder of the contract term. These payments are usually made up of (i) dividends and (ii) interest and capital payments for shareholder loans. If the remaining shareholder payments are very low, then the project company may find it difficult to cope with any unforeseen financial shocks e.g. large unitary charge deductions, additional lifecycle costs etc. In addition, low remaining shareholder distributions mean that shareholders may be reluctant to make any 'rescue' investment because there is little remaining shareholder value to be rescued.

Whilst this analysis is useful for all distressed projects, it may be particularly important for projects approaching expiry, as you can compare the size of the remaining shareholder payments, plus forecast lifecycle spend, with the expected lifecycle costs to achieve the contractual handback requirements (for example, coming out of a recent condition survey). If the expected lifecycle costs exceed the forecast lifecycle spend plus projected shareholder payments, then the project company may not have sufficient cash over the remainder of the contract to meet its obligations, and may become insolvent;

III. *Investor Internal Rate of Return:* investors calculate the return on their investment over the life of the contract. This IRR takes account of the size and timing of any investment into the project company, and the size and timing of any dividends and shareholder loan payments that investors receive from it. It typically measures return from the start of the project through to the end, not from the present period onwards.

Investor IRRs can be difficult to interpret, however. For example, a low investor IRR may reflect ongoing difficulties with a project and, potentially, lock-up of shareholder payments by lenders. On the other hand, a financial model may show a healthy investor IRR even when a project is in financial distress, because a relatively high IRR has been achieved from shareholder payments paid out in the past - especially when a refinancing has already taken place. Even when an investor IRR looks healthy, there may be insufficient remaining shareholder payments to resolve problems (see II above).

Similarly, where a new investor has bought a project from the original investor, the return for the new investor will reflect the price it paid for the investment (which is unlikely to be public knowledge) and the new investor's return will be different to the IRR shown in the model.

IV. *Under-funded reserve accounts:* most PFI projects have a number of designated bank accounts, including a Major Maintenance Reserve Account (sometimes called a Lifecycle Reserve Account), that puts cash aside in a separate bank account for future lifecycle costs, and a Debt Service Reserve Account, a separate bank account typically funded with six months-worth of debt service payments. The project company usually has to fund these reserves according to rules set out in the financing documents, before making payments to shareholders. However, if the project company is in financial distress, it may not have enough cash to do this, or may have to draw on these bank accounts to meet financial commitments, such as paying the banks. Failure to fully fund the Debt Service Reserve Account is likely to be an event of default under the loan agreement. This may or may not be the case with the Major Maintenance Reserve Account, but under-funding may, nevertheless, indicate project company financial issues. Therefore, under-funded reserve accounts are likely to be an indicator of financial stress.

2. Lender reports

As with the financial model, you may be entitled to receive other information that the project company provides to its lenders. This could include regular (e.g. quarterly or semi-annual) operational and financial reports. These reports should flag signs of project distress, including significant disputes, performance issues and deductions, and project company financial results. The lender information should also include any notices of default under the loan agreement or service contracts, waiver requests (requests by the project company to waive certain requirements under the loan agreement) and notification of any events likely to have a material adverse effect on the project company.

3. Report and Accounts

All private companies have to submit annual Report and Accounts to Companies House, and these are then made publicly available online for free[2]. Due to the nature of financial reporting requirements, the accounts of a PFI project company can be difficult to interpret and may not be easy to reconcile to the financial model. However, there are certain aspects of the Report and Accounts that might indicate financial stress:

Directors' report: at the start of the Report and Accounts there is usually a Directors' report. This should include details of material financial and/or contractual issues affecting the company, for example a material dispute or significant deductions. You should read the Directors' report for any issues that could cause financial stress;

Going concern: financial statements are prepared on a *going-concern* basis; that is, on the assumption that the company will be able to continue in business for the foreseeable future. This is particularly important when a company is under financial stress because, if a project company's management believes there are material uncertainties relating to the going-concern assumption, then they must disclose this in the Report and Accounts. Auditors also have to satisfy themselves that the going-concern assumption is appropriate and report on this in Report and Accounts. You should check whether any issues regarding the going-concern assumption have been raised in the project company's Report and Accounts by management or the auditors;

Delays: companies have to submit their report and accounts within certain time periods. However, where there are material uncertainties over a company's financial results or concerns over financial viability, there can be delays in submitting the report and accounts. If there are delays, then you should investigate further with the project company.

4. External credit ratings

Some project companies issued *bonds* to finance their projects and may have their debt externally rated. This is done by credit rating agencies - the leading agencies are Standard & Poor's (S&P), Moody's Investor Services and Fitch Ratings. Credit ratings may be private (i.e. not publicly available) or public.
Where there is a public rating, you should be able to see (i) whether, and by how much, the current rating of the project is below the rating at financial close, and (ii) whether the rating has been recently reduced. Both of these may indicate financial, performance and/or contractual problems for the project company. Rating agencies typically provide an explanation for credit rating downgrades including a description of any problems identified. Where a project company is in serious financial difficulty, the credit rating should reflect this and the bond debt is likely to be rated *non-investment grade.* This indicates that there are more material risks to repayment of the bonds and is a clear indicator of financial stress.

The table below shows investment and non-investment grades for each of the main rating agencies.

Project companies with public bonds (if they are publicly listed companies) may also have to issue updates using the Stock Exchange's Regulatory News Service. You can access these via the Stock Exchange's News Explorer.[3]

Rating Agency Grades

	INVESTMENT GRADE				NON-INVESTMENT GRADE				DEFAULT
S&P	AAA	AA+ AA AA-	A+ A A-	BBB+ BBB BBB-	BB+ BB BB-	B+ B B-	CCC+ CCC CCC-	CC C C	SD/D
Moody's	Aaa	Aa1 Aa2 Aa3	A1 A2 A3	Baa1 Baa2 Baa3	Ba1 Ba2 Ba3	B1 B2 B3	Caa1 Caa2 Caa3	Ca	C
Fitch	AAA	AA+ AA AA-	A+ A A-	BBB+ BBB BBB-	BB+ BB BB-	B+ B B-	CCC	CC C C	RD/D

2 https://find-and-update.company-information.service.gov.uk/?_ga=2.178331300.1639928776.1704377309-1758343229.1691410926
3 https://www.londonstockexchange.com/news?tab=news-explorer

5. Other indicators

Other indicators that a project company may be at risk of becoming financially stressed, include:

Service provider payments: late payment, or non-payment, of service providers may be a sign of project company financial stress. There may, of course, be genuine disputes regarding payment, but you should seek to understand the reasons for late payment, or non-payment;

Major contractual disputes: major contractual disputes with the contracting authority and/or the project company's subcontractors could, if they are not resolved in the project company's favour, result in significant additional costs or loss of revenues. Where you are aware of such disputes, you should monitor them closely and consider the potential impact of an adverse result on the project company's financial position;

Change in contract management approach: financial stress may lead a project company to take a more formal contractual approach to its relationship with the contracting authority, for example, seeking additional payments for services or variations, or increased willingness to dispute issues;

Unexpected staff changes: unexpected staff changes (particularly senior management), can be a sign of potential financial stress, especially when work-out consultants and/or more senior staff are engaged;

Large deductions: similar to contract disputes, if the contracting authority imposes large payment deductions on the project company, this may put it under financial stress, especially if the deductions are higher than the liability cap under the service provider's subcontract or relate to construction defects/compliance issues outside of the contractor's liability period (and, therefore, cannot be passed down and remain at project company level). You should be aware of the potential impact of payment deductions on the solvency of the project company;

Waiver requests: if a project company is unable to meet its financial or other covenants under the loan agreement, then it may seek a *waiver* from the lenders. For example, if a project company is unable to meet the ADSCR requirement in a given period, the shareholders might offer to put more cash into the project to resolve this, which would require a waiver from the lenders. Therefore, waiver requests may be a sign of potential financial stress. You may have access to waiver requests through the information rights referenced above;

Increased lender involvement/monitoring: some lenders are more active in monitoring their loans than others. In general, lenders will monitor loans that are performing satisfactorily through a portfolio management team. If a project comes under financial stress, or there are significant disputes/relationship issues with the contracting authority or subcontractors, then these should be reported to lenders, who may increase the level of monitoring of the company. If these issues become more serious, and the project company comes under severe financial stress, then the loan may move from the portfolio team to a restructuring/distressed asset team. Increased monitoring by lenders and/or movement of a loan to a restructuring/distressed asset team are indicators of project company financial stress.

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