

Many of Canada's largest pension plans have sought exposure to infrastructure over the last decade, attracted to its combination of stable, long duration, and non-correlated returns. However, the vast majority of Canadian institutions remain on the sidelines, intrigued by its distinctive investment attributes, but wary of illiquidity and uncertain about how best to get exposure to it amidst a proliferation of infrastructure investment funds. Many also wonder how infrastructure, dependent as it is on the availability of cost effective debt financing, will fare in a world of elevated credit risk.

On the latter point, there is reason for optimism. Public-private partnerships (P3), the primary model through which institutional investors access infrastructure assets in Canada, have proven remarkably resilient in the face of the recent credit market tumult. As relative calm appears to be returning to the credit markets and governments at all levels confront the reality of rapidly expanding deficits, the prospect for private investment in Canadian infrastructure through the P3 model appears bright.

productivity and economic growth.

Highly publicized examples of infrastructure deterioration – such as the 2006 collapse of a bridge in Laval, QC – underscore the potentially dire consequences that can arise from years of government underfunding.

In the P3 model, the government contracts with one or more private sector companies (a consortium) to design, build, finance, and operate an infrastructure project such as a highway, healthcare facility, or courthouse. In exchange, the consortium receives a long-term contract (or concession) from the government delivering a stream of cash payments over the term of the project.

From the government's perspective, private sector participation in infrastructure projects yields many benefits including market discipline in the form of competitive pricing and the transfer of project procurement risk – the risk of construction delays or over-runs and the risk of maintenance cost inflation – from the government to the private sector. In evaluating the merits of P3-based projects, governments must generally weigh these benefits against the costs of private procurement, namely the incremental expense of private sector debt financing



INVESTMENT

By: **Matt O'Brien**

The Credit Crisis And Private Infrastructure

Robust Market

P3 initiatives in Canada date back to the late 1980s and early 1990s with the Pearson Airport Terminal 3 and Confederation Bridge projects. Since then, a robust Canadian P3 market has developed, particularly in British Columbia, Alberta, Ontario, and Quebec, with numerous projects in the transportation, healthcare, and education sectors. Over \$5 billion of infrastructure projects have been funded via the P3 model in Canada over the last five years.



More recently, adoption of the P3 approach has accelerated, prompted by widespread concern that decades of deferred spending on infrastructure would eventually take a toll on business

over the cost of government funding.

Significant Appetite

In an environment of abundant, affordable, and flexible credit, the justification for the P3 approach is compelling. For much of the last decade, such an environment existed. Low cost, fixed price debt was available for projects of all sizes and types. Moreover, banks and other private lenders had a significant appetite for long maturity debt, which was ideally suited to funding infrastructure projects. By matching the term of the debt financing with that of

the underlying government infrastructure concessions (generally 15 to 30 years), P3 consortia were able to eliminate refinancing risk and thereby gain greater certainty over the cash flow stream from the project.

However, as credit conditions deteriorated in 2008 and 2009, cracks started to appear in the foundation of the P3 model.

The immediate and direct challenge to Canadian P3 initiatives was driven by the higher cost and reduced availability of private debt and lenders' growing aversion to longer-term maturities in a volatile and uncertain credit market.

Many private European lenders who had been active in the Canadian P3 debt financing market withdrew from Canada and/or credit markets entirely. At the same time, pricing on what limited credit supply was available skyrocketed in response to an extreme widening of spreads between non-government and government bond yields.

As the credit crisis worsened in late 2008 and early 2009, governments faced increased pressure to stimulate (or be perceived to stimulate) economic activity in a very challenging environment. However, the economic challenges facing the traditional P3 model meant few, if any, P3 projects were undertaken. Somewhat surprisingly, pension funds – considered logical owners of P3 long-term debt – remained on the sidelines, choosing not to become active buyers of infrastructure debt securities.

Need For Change

The confluence of these factors has driven the need for change and flexibility in structuring P3 initiatives in order to preserve the strong benefits inherent in public-private partnerships as a mechanism for financing basic infrastructure.

In need of a quick response, governments announced plans to directly fund massive amounts of infrastructure spending. The Canadian 2009 Federal Budget earmarked \$12 billion in additional funding for infrastructure projects to be completed by 2010. It is still unclear to what extent these funds have been invested in actual projects and, where funds have been deployed, whether these projects have been built on time and on budget.

Despite the short-term government funding solution, a number of Canadian P3 initiatives have proceeded, albeit with certain fundamental shifts in their debt financing structure and a heightened emphasis on the importance of counter-party risk.

Limited bank appetite for long-term maturities has led to the emergence of the 'mini-perm' structure – debt with maturities shorter than the term of the underlying P3 concession from the government. Typically, the term of a mini-perm loan is five to seven years (including the construction period), exposing borrowers to refinancing risk after the construction phase of the project is complete. As a result of this fundamen-

tal shift in the risk profile of the underlying infrastructure investment, equity investors expect increased returns.

The emergence of large syndicates of lenders has created additional complexity in P3 debt financing structures. Where agreements prior to the credit crisis were often signed with a single lender, consortia now find themselves dealing with large syndicates of lenders. With more parties at the table, many of whom are demanding greater opt-out flexibility, reaching agreement and ultimately closing on the investment becomes increasingly difficult. Project execution risk for consortia increases.

Transfer Of Risk

In part, the success of the P3 model hinges on the successful transfer of risk from the government to the private sector participants. Contracts are the mechanism by which these risks are transferred. For example, in providing a fixed price to design and build a piece of infrastructure, the builder assumes the risk of cost overruns. Similarly, fixed cost maintenance or service contracts transfer the risk of cost escalations over the duration of the concession to the service provider. However, these contracts are only effective in transferring risk to the extent that the parties that stand behind them are ultimately able to meet their obligations. The recent credit crisis reinforced the existence of counter-party risk in the P3 model as no party, not even the largest financial institutions, seemed to be immune to the risk of financial distress.

Governments in many jurisdictions have recognized that the P3 model can and should be adapted to meet changing credit circumstances in order to preserve the inherent benefits of the P3 model. A range of options to modify the P3 model in order to enhance debt availability and reduce private borrowing costs has been proposed, including the formation of new government-sponsored funds that can lend alongside private companies, the funding of infrastructure projects with a mix of public and private capital, the use of government-backed credit enhancement guarantees on private loans, and the use of tax incentives to attract capital to the sector.

Canadian provincial governments have experimented with a number of alternative P3-based approaches in response to the credit downturn. The government of British Columbia has evaluated a number of new funding models for P3, including the 'wide equity model' where providers of equity capital are required to fund 20 per cent of a project's costs with equity (compared to 10 to 15 per cent equity for most conventional P3 projects). Under this

scheme, investors are not required to raise private debt as the government provides 80 per cent of the project costs by way of a funding agreement which advances notional 'debt capital' to the project through a series of government grants. By adopting this approach, the government ensures sufficient private sector equity to preserve the risk transfer and market discipline of the P3 model, while, at the same time, taking advantage of the lower cost of government debt financing.

The governments of Alberta, Ontario, and Quebec have chosen a slightly different tack, opting instead to adopt a partial 'direct funding' approach. Under this model, governments fund a portion of a project's costs themselves through milestone payments and leave the remainder to the private sector using a conventional P3 approach. For example, in a project with a total cost of \$500 million, the government may directly fund \$250 million leaving the remaining \$250 million to be allocated between private lenders and equity holders under a traditional P3 arrangement. This approach effectively reduces the size of the private funding requirement, making it easier to finance in an environment of scarce and costly debt.

Strong Evidence

While no consensus has emerged around which adaptation of the P3 model works best in a credit-constrained world, most would agree that the willingness of governments to retain the basic elements of the P3 approach is strong evidence of its effectiveness as a mechanism for efficiently procuring new infrastructure investment.

Over the last few years, the P3 model has proven to be robust and able to adapt to the most difficult credit environment in a generation. With increased government and market recognition of the discipline and value created by this model, both public and private sector participants in P3 have been motivated to find ways to preserve and adapt the P3 model.

With credit markets now 'thawing' and increased pressure on governments to curtail spending and reign in burgeoning deficits, it is expected that the P3 model will play an even more prominent role in future infrastructure investment in Canada. Private pension plan investors should increasingly have the opportunity to invest directly in Canada's basic infrastructure and avail themselves of the unique attributes of this distinct asset class. ■

Matt O'Brien is president of Connor, Clark & Lunn Infrastructure (mobrien@cclgroup.com).

