The Value of an SPV Board

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Introduction

Camels, as it turns out, are not afraid of trains. They should be but they are not. They take them head on and come off second best, but in the process they cause considerable damage, delay the train, traumatise and sometimes injure the driver and undermine the reputation for safety and reliability of rail transport.

Try as I may, I could not find any reference to camels in any of the Adelaide to Darwin railway project documents, not the financing documents, not the information memorandum nor even the risk analysis.

The fact is that, no matter what early due diligence is undertaken on a project, something unanticipated will go wrong, whether it is camels or court cases, and that is when, as investors, you rely on the SPV Board to represent your interests and manage your risk.

But not only as investors; as bankers, government clients, contractors – both construction and operation - bond holders or the ultimate users of the facilities provided. It is the board of the SPV that is key to delivering your planned outcomes.

Over the top perhaps? I don't think so, and I hope tonight to convince you otherwise. In order to do so, I will review the following topics:-

- Main Responsibility of SPV Board
- De Risked Projects – Really?

  This will be the main part of the discussion and I will then draw together the ideas presented in this section to comment on the following areas of discussion
- SPV Board Tasks
- Changing Requirements for boards over time
- The road ahead – the investor
- The road ahead – the state
- Alternative Future
- Postmodern Board

Main Responsibility of SPV Board

Let us turn to the main responsibility of an SPV Board.

The board must act in the best interests of the company it directs. I interpret this responsibility as translating to a primary task of looking after the interests of the investors. This is different to a company listed on the ASX, because the investors are generally a small group, well known to each other; they have entered into a shareholders agreement to manage the company and they normally give the company a restricted set of tasks through the Company Constitution and the obligations under a project deed and construction and operation contracts. Under these circumstances the board has no choice but to direct the company to act for the investors as a whole. In order to do this, it must first establish what the interests of the investors are and then it must provide a framework within which management can operate, confident that the intent of the shareholders is being honoured in the company. The key process which underwrites this management of intent is the identification and control of risk.

Considerable effort and negotiation time is expended on allocation of risks during the documentation of any major infrastructure project. But from the day the documents are singed onwards, it is a constant battle to maintain the risk allocation set out in the original deal, and to avoid risk creep from either the government or contractors. The battle runs through discussions about contractor performance, government changed requirements and cost and time overruns. A particularly critical time for risk creep comes at the change over from construction to operation, when everyone seems to think the project is de-risked and the job is done.

De-risked? Really?

But is it really de-risked? I accept that it is uncommon for a project to fall apart irretrievably at this stage of its life. However, it is far from de-risked. By way of observation, the NPV of operating costs on a tollroad with tunnel is of the same order as the NPV of the construction costs. If you take the view that risk flows with the expenditure of funds, only half the risk has disappeared by the end of the construction period.

Moving from that general idea to the more particular, there is an unspoken risk which hangs over the head of every PPP for its whole life. It is the hardest to define, to manage or to transfer. This risk is the possibility of a transformation of a Public Private Partnership into a Public vs Private Contest - a PPP to a PvP, - and it can emerge in three ways.

Firstly, is the issue of the wrong individual in a key position for the project. By way of illustration, in the mid-1990s one roads authority appointed a new leader to its Tollroad Management Group. This manager's basic view of the world was that all roads should be government owned, government financed and government operated. He felt that the toll road companies were making too much money and should spend some of that money for the good of the road system. From that day onwards, it was difficult to see the relationship between the state and private tollroads as a partnership. The idea of reward for risk taken or compensation for future risk was never a consideration.

But PvP risk does not only arise as the result of a non-cooperative individual. Public vs Private can also arise in the political process. For example, a project may become the subject of carefully argued reasoned discussion during an election campaign. An current example is the treatment of the East West Link in the Victoria State Election which will result in excessive focus on the detail of this complex project every step of the way over the next few years.

A more subtle Institutional PvP risk arises from the politicisation of the Public Service. Senior public servants on short term contracts are forced to constantly look over their shoulder to see Ministers, Auditors General, Advisors and other interested parties watching every move. The result is often a hard line, black letter law interpretation of project deeds. This becomes particularly important during refinance activity when quick approvals can facilitate the capture of a market position, or importantly, where documentation gaps or errors are identified. These situations often result in petty administrative overreactions such as the enforcement of abatements for minor infractions which make no difference to the administration of the project.

Major Unmitigated Risks in Operating PPPs

Apart from this relationship risk, there are six main issues which need to be managed continuously by the board and management. Along with camels, these rarely appear in due diligence reviews or project documentation

Refinancing

Refinancing used to be the pot of gold which investors shared in regularly as the project matured. Now it is either shared with the government or bid away in the tender process. So why is it a risk? Refinancing is the subject of two unrealistic assumptions in many bid Financial Models. Firstly, the margins assumed in future refinancing events are often indefensibly low. Many recent projects I have reviewed have assumed 60 bp margins throughout the project life compared to the 140 to 200 bp currently on offer. The second assumption often understated is the debt free period assumed at the end of the concession period. Almost every model I see assumes that the project will maintain considerable debt until the last 12 months of the concession period. Banks are more likely to require 2 years, while under pressure they may relent to 18 months but one year is now impossible to achieve. These assumptions in combination can shave returns by 1.5% to 2% over a long concession period. So refinancing can be a considerable risk to investor returns in modern projects.

Counterparty

Counterparty risk is the big lesson from the Global Financial Crisis. You never know who you are dealing with until they try to call your loan. Counterparty risk is not helped by well-meaning documents which give 16 senior banks and 12 mezzanine lenders a right to 100% agreement for any changes in finance documents and arrangements. This risk becomes white hot in times of difficulty for the project when a “Special Situations Fund” acquires slice of debt a discount with a view to negotiating a superprofit in the sale or refinance of the distressed asset. Exactly this situation cost the mezzanine lenders to the Adelaide to Darwin Rail all of their return – and their principal – so it is not only the investors who could suffer.

System – liquidity

Liquidity is not an issue today, the financial system remains awash with liquidity. It won’t last. What makes it more dangerous is the size of the refinance task of major projects which can seek \$3bn to \$5bn at the first refinance. During the Global Financial Crisis, many otherwise viable operating projects experienced considerable difficulty refinancing one tenth of this amount in the Australian market with the departure of many foreign banks and the emergence of portfolio concentration risk in the few that remained. The bond market was nowhere in sight so there was no alternative finance stream. System illiquidity will return from time to time in the future, and it falls on all parties – but the consequences are greatest for investors.

Complexity

These projects are complex, made more so by the finance structures used and, more particularly, the accounting standards applied to them. I will focus for the moment on accounting standards. In infrastructure projects, an interest rate swap is a standard risk management instrument required by lenders, investors and governments as part of the project structure. Accounting standards seem to have a very different view. It seems we are all budding Jeffery Skillings waiting to pounce on the world with our own Enron avatar. The result is accounts reporting hundreds of millions of dollars of loss which reflecting one side of the swap transaction – which, according to accounting standards, somehow has greater relevancy to the profit and loss than the debt that it hedges. With major shareholders able to exert control over a company, they can find those same accounting standards causing them to consolidate hundreds of millions of loss.

Complexity also impacts on public perception, with the series in the Age on the Melbourne Convention Centre in 2010 demonstrating that the finance journalist had completely misinterpreted the published accounts assuming that the initial net asset deficiency reflected the need for a government bail out of the project.

These complexities have impacts from financial to stakeholder management and beyond, impacting on suppliers, contractors, staff, investors and governments.

Documentation

The other side of the complexity coin is the difficulty in documenting what everyone has agreed in a way that actually reflects that agreement. There is always the chance that back to back documents will not match while phrases and expressions don’t actually mean what we thought they did. That is normal. However the area I would like to focus on is the mismatch between banking documents and operations contract.

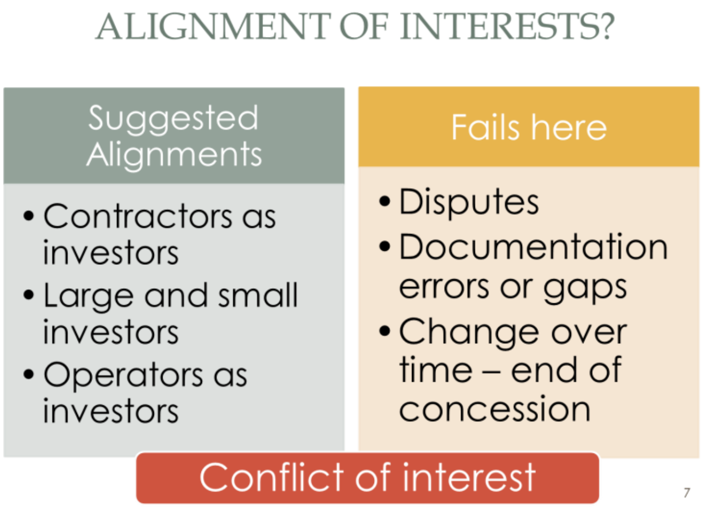
While operators insist on having six months to a year to remedy defaults, banks see an operator default as an immediate trigger to allow withdrawal of their funding, with cure periods set in the order of 30 to sixty days. This mismatch is incurable and creates a risk, however unlikely, that turns an operator default into a project failure, even if the default happens in Japan or the United States and has no real bearing on the local operation. Of course, the banks have it in their power to suspend action in such a case, but I am never happy putting my future in the hands of the banks – particularly not 16 of them including a hedge fund.

Change of Law

In addition to these risks, there are also some well recognised risks held by the SPV. Chief among them is the change in law risk, which usually includes taxation law. A current example is the tightening of the thin capitalisation rules which reduce the safe harbour provisions from 75% debt to 60% debt. While these changes are aimed at capturing profit shifting by multinationals, they sit squarely on most major infrastructure projects, the largest of which have majority international investors. The push by State Government agencies to increase competition for major PPPs has brought many large international contractors into the game. Add to that the still common requirement for the contractor to hold significant equity, and the cost of the PPP goes up by the value of the tax flowing to the Federal Government under the thin cap rule.

Alignment of parties changes over time

An important risk mitigant that is relied upon in PPPs is the alignment of interest between participants. Bankers and Governments like to see constructors and operators on the share registers in the belief that they will take a long term view of the project which supports state interests. Many investors take the same view and they also take comfort from an alignment with the interests of larger, more experienced investors.



These alignments break down under a whole range of conditions. Here are just a few:-

1. Construction claims – Contractors and investors usually find themselves at odds in the event of a construction claim, and my experience is that having the construction contractor in the board room brings more problems than it solves. At the very least it places undue pressure on the contractor's board representatives no matter how rigorous they are in maintaining the interests of

the SPV. In addition, it inhibits open discussion on the legal and commercial strategy and investigation of possible settlements. If the constructor is related to the operator the construction dispute can spill over into the operations phase, and undermine the efficiency of the whole enterprise. Construction disputes can destroy the alignment between investors as well. Often large investors have the capacity to carry on a dispute and small investors would prefer to cut losses. Alignment breaks down here.

2. Another time when the alignments break down is in the event of documentation errors or gaps. Given the short time available to bid and negotiate a deal and the complexity of the arrangements, not to mention the conflicts of interest which may be inherent in the negotiation process, gaps and mistakes creep into the documentation. Adjusting these errors or omissions can reveal the true strength of 'Alignment'. If a pass through cost is not passed through properly, it is the SPV who wears the pain. If a pass through benefit somehow becomes trapped in the SPV there is considerable pressure to correct the process.

3. One of the most important factors driving misalignment is the commercial interest of the parties outside the project and how these change over time. Approaching the end of a concession period, it is in the interest of the investors to undertake the minimum maintenance consistent with the concession deed, and to hold the minimum spare parts. The state, however, is quite rightly focused on raising the quality of the asset to the highest possible standard prior to handover. The subtle misalignment comes when the operator sees an opportunity to maximise profit in the last few years of the concession by undertaking as much maintenance as possible, and also sees the opportunity to negotiate an operating contract with the state post the end of the concession period. This situation is made more complex by the fact that the operator holds all the expertise and records about the plant and the SPV is totally in his hands. Alignment of interest no longer provides the protection that it once may have.

Throughout the expression of all these risks the only people who are representing the interests of the investors are the board members. But I will take it one step further. The only way they can deal with the inherent conflicts of interest and pressures to reallocate risk to the SPV is by being independent. The risk mitigation in all of this depends on all parties knowing that the SPV is fairly allocating the risk in accordance with the original intent of the project documentation.

Camel Proof Fence

So what is the relevance of this to Camels? One of the serious proposals to stop collisions with Camels was to build a fence. At around $40,000 per km that is around $112m or 10% of the original capital cost. In the end, the smart camels learned to respect the trains. They benefited from natural selection in the long run and the interests of all parties were protected by the board. So to with the other un-de-risked risks.

Board Tasks

So in summary the task of the board is to identify and manage the key un-de-risked-risks, ranging from the potential for the PPP to end in conflict to the subtle changes in alignment of interest between the parties over time.

Clearly, the important skills and issues will change according to the stage of the project and, to a great extent, the type of business. In moving from Construction to Operation the company must transform

1. From construction administration to operations administration
2. From borrowing to paying back
3. From drawdown to refinance
4. From investment to distribution

Overall it is a change from a Startup company to an operating company.

The key process in managing this transformation is finding the right management team and keeping it interested and involved. This can be a real challenge. For example finding someone who can run the accounts, step up to a refinance challenge and maintain and develop the financial model is a big ask.

Keeping on a legal counsel who can stay on top of a set of complex and changing documents and not get bored is a big ask.

In the early operation years, things are easier. There is the thrill of the first refinance, the task of setting up company policies; the challenge of identifying, mitigating and monitoring operating risk and the pleasure of preparing the operating accounts and working through the structure with the Auditors for the first time. After two years, however, this all becomes drudgery.

Maintaining Capability

The approaches I have seen work for maintaining management capability are:-

1. Coaching CEO for future and replace every five years
2. Promoting accountant to CFO, and CFO to CEO
3. Outsourcing tasks such as public relations, corporate counsel, the finance function and even company secretary.
4. Using younger developing staff with a part time mentor – mentor often women returning to work part time or older employees looking for part time.
5. Avoid key man risk by rigorously documenting processes and developing management reports around the important risks and processes.
6. Martin would suggest outsourcing everything, and that may be an option.

At the board level there is also subtle shift from construction period skills to operation skills. They are different, with the later more focused on refinance, ongoing relationships and mentoring.

SPV Boards – what is coming

So pulling this all together what should an SPV Board be expecting?

The first trend is one of process. The early PPPs in Australia were seen as essentially arrangements between contractors and the state, with the SPV as an administrative arrangement only. State parties liked to deal with the companies actually delivering the assets so as to ensure that the project delivered the desired outcomes.

In recent times, in spite of the existence of side deeds for construction and operation and tripartite deeds for financing, State players have preferred to deal directly through the SPV for everything. This has been a response to the realisation that the only real value in a PPP to the state is the transfer of risk. So the State players direct all correspondence through the SPV, and will not deal with the contractor building or operating the facility without an SPV representative. The outcome of this is that all claims and counter claims are passed through the SPV, and have the possibility of shedding risk to the SPV on the way through. Both the contractors and the States have realised that there is a possible source of funding for problems at the SPV, putting shareholder returns at risk and challenging the risk allocation of the project.

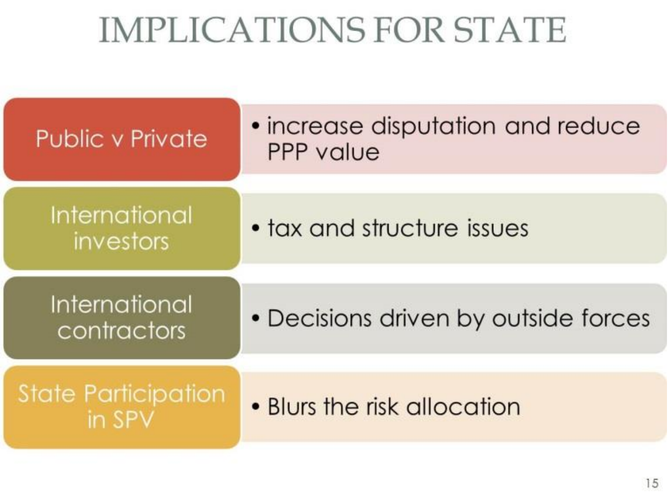
These arrangements are of course documented in the project documents with all the documentary risk that is associated with that process, and the documentary risks I have previously outlined.

The other trend which I have already discussed is the black letter interpretation of contracts by the state, which results in PvP rather that PPP. This, by the way, scares financiers and ratings agencies who have an eye to the state as a final backstop to the project.

I also discussed the risk around taxation and accounting changes and the likelihood of lower liquidity.

Implications for State

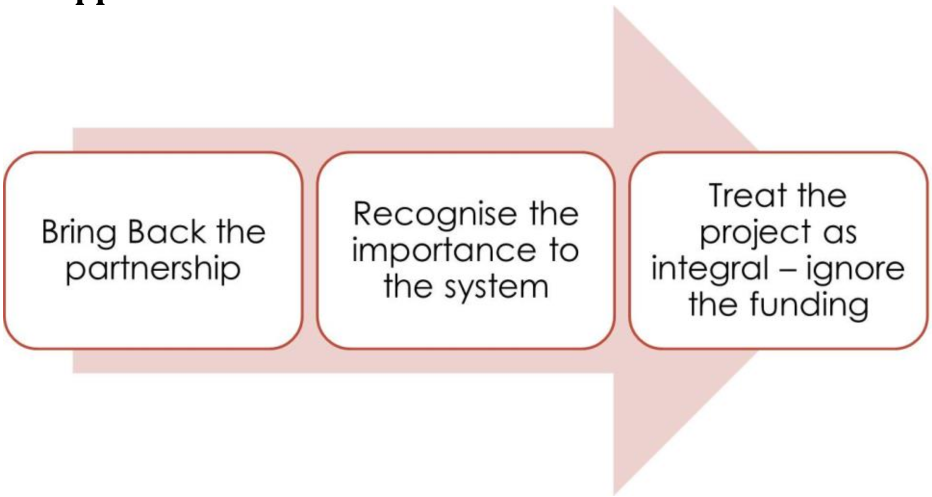
PvP will bring the PPP back to the claim / counter claim model of hard dollar contracting. It will make risk allocation harder to maintain.



Other issues for the state are the arrival of international contractors and funders who will trigger a new set of tax and funding issues; and the option for contractors to walk away given that they work in the rest of the world and may not have a long term view of their Australian operations.

With the new funding models being explored by the State, we may end up with State owned Entities owing some part of the SPV, which will blur the risk transfer and possibly undermine the PPP model.

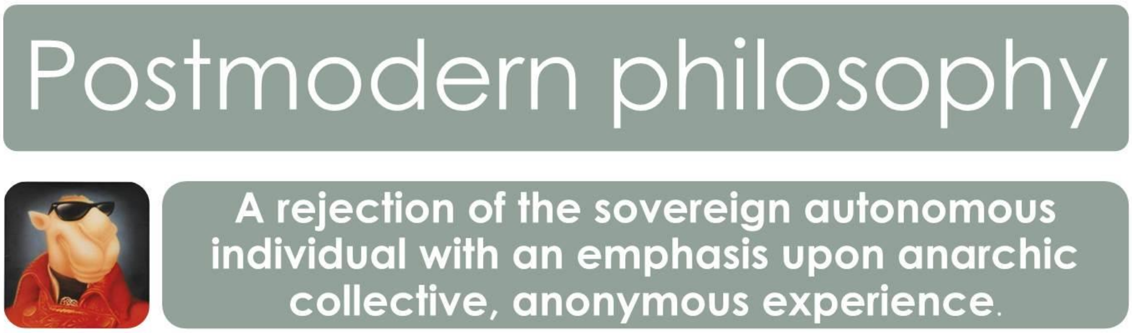
Alternative approach



A PPP should be a partnership. It is a long term arrangement which needs nurturing. By all means enforce risk allocation, but not to the detriment of the project – a tollroad is part of the road network, at water treatment plant is part of the water supply network and a hospital is part of the health system - regardless of who supplied the capital and how the operating services are delivered.

The Post Modern Board

Why Postmodern? There are millions of definitions of Postmodern Philosophy, so it is possible to choose the one that suits the current purposes. The one I have chosen is:-



So that is what I am bringing you - anarchic, collective anonymous experience which informs the conditions which must prevail to ensure that a board is able to concentrate on maximising the return to investors in all circumstances.

PPPs rarely run strictly to plan. My experience is that a crisis or two is almost a normal part of a project. That is when the real value of a board emerges; when the risks turn into realities, whether that be cost and time overruns, patronage shortfalls or environmental "excursions" or indeed, camels.

It is in these times when the Corporations Law is unrelenting in placing the responsibilities onto individual board members - not to mention WHS and Environmental Laws or one of the other 700 Australian statutes which place personal liability on directors. Whether you like it or not as an investor, this places the board at the centre of your defence of your investment or asset. In a crisis, a board must be proactive, trying to head off problems and it must increase its interaction with management, rather than leave the CEO to fend for himself. The board needs to drive the timing based on the often short time frames for default under Deeds and Banking documents. A major risk is that control will revert to lawyers and the opportunity of a sensible, commercial resolution becomes more remote. Of course, the board is your voice as an investor in the discussions which arise. As I mentioned before, the documents rarely mention camels or any of the other issues which emerge in these circumstances.

So my advice is that the board is your friend, and you must protect and nurture it:-

1. Protect it against insolvency.
2. Make operations payments senior to bank debt
3. Fund them for conflict or delay at the project start-up
4. Find an independent chairman
5. Avoid conflict of interest with the contractor in boardroom

Conclusion

The board is the only real link between the investor and the day to day issues of managing a PPP. Importantly, the value of the board does not diminish with the alleged de-risking of the project. The project needs to stay de-risked and that is the prime role of the board.

For the future, we seem to be slipping into adversarial positions rather than partnerships and this can erode both the short term effectiveness and the long term value of PPPs. So it is important for all parties to recognise the flexibility required to maintain a relationship for 30 years and apply that flexibility.

So how much is an SPV Board worth? I would say at least 10 camels, or 20 chickens, but with the market point established below, you may choose to make your own assessment.

SOMALI MILITANT GROUP AL SHABAB OFFER
10 CAMELS FOR OBAMA'S HEAD,
20 CHICKENS AND 20 ROOSERS FOR CLINTON'S

THE HUFFINGTON POST 11/6/ 2012

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