THE FUTURE OF INFRASTRUCTURE FINANCING AND BIDDING PROCESSES

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KEY POINT

Fundamentally, the appetite for infrastructure projects with secure, stable cash flows, remains strong but it is increasingly difficult for competing bidders to raise finance.

INTRODUCTION

There have been a number of significant developments in the infrastructure financing market over the last 12 months. It is timely to consider how that market is changing and potential future developments.

DEBT FINANCE MARKET

The global financial crisis is having a significant impact of the financing of infrastructure projects. Credit rating downgrades for monoline insurers, because of their exposure to highly structured collateralised debt obligations (CDOs) and the like, have caused the credit wrapped bond market to temporarily shut up shop. In addition, banks have become increasingly concerned about the availability and cost of finance, and are reducing the amounts which they are prepared to provide to any single project, and the tenor/period for which it will be provided. The lack of liquidity has also caused lending margins charged by banks to increase.

The lack of credit has lead to a preference for 'club and hold' arrangements, with banks clubbing together and each bank committing to the amount of debt it ultimately wishes to hold; rather than 'underwrite and syndicate' arrangements, where a single bank or small group of banks underwrites the total amount of debt required on the basis that they will be able to quickly syndicate or sell down to others the portion that they do not wish to hold on their own balance sheet. While the use of club deals provides a potential solution to the credit problem, it creates other problems given the need to agree commercial terms with a large group of banks and to accept the risk profile required by the most risk averse bank in the club. In addition, for mega projects which require each bidder to provide fully committed finance as part of its bid, the need for each bidder to pull together a large club of banks can mean that there are not enough banks to go around the interested bidders.

Volatility and uncertainty in debt finance markets has also made it difficult to obtain firm commitments from banks which remain valid for the duration of the often lengthy bid evaluation periods on major projects. Market flex/disruption provisions, which give lenders the right to increase margins before financial close, have become commonplace.

The higher cost of debt is making it more difficult (but not impossible) for privately financed delivery models to demonstrate better value for money than publicly funded alternatives.

DELIVERY MODELS

Given current financial market trends, we may see some major infrastructure projects which might otherwise have been delivered as privately financed projects instead delivered under publicly funded models such as Design & Construct (D&C), Design Construct & Maintain (DCM), Alliances and Managing Contractor.

The urgency with which the Federal Government wishes to spend stimulus money allocated to infrastructure projects may also see a preference for delivery models which allow scope definition and design development to proceed in parallel with construction, such as Alliances and Managing Contractor.

We are also likely to see privately financed PPP models evolve in response to current market conditions.

Of course, any increase in the risk profile of government under the PPP model can reduce the value for money benefits associated with the model, so care will need to be taken to ensure that any evolved PPP models continue to provide taxpayers with good value for money outcomes.

BIDDING PRACTICES

The tighter debt finance market, combined with the emergence of mega projects, also provides an incentive for government to revisit standard bidding practices and consider alternative approaches. Some trends which may emerge include:

- a preference for short lists of only two bidders to reduce the amount of debt to be underwritten at the detailed proposal stage, reduce overall bidding costs, and encourage greater investment in bidding by the short listed bidders;
- requesting and evaluating technical aspects of detailed proposals ahead of submission of financing proposals. This enables a shorter bid validity period for which financiers are requested to hold the terms of finance packages;
- greater interaction in the bidding process—reducing the time required to evaluate detailed proposals and finalise negotiations, and enabling shorter bid validity periods;
- separate competitive tender for debt finance following the appointment of a preferred bidder. This approach creates greater competition for the preferred bidder's debt package by avoiding the need for each bidder to secure exclusive financiers. On the flip side, it provides less certainty for government at the time it appoints its preferred bidder; and
- bid cost minimisation strategies.

BIDDING COSTS

Bidders' concerns about the expenditure incurred throughout the contract negotiation phase when government maintains two preferred bidders are exacerbated in a tight market. However, government ultimately bears these costs as they are built into the corporate overheads which the private sector looks to recover on successful bids. Strategies for reducing the costs incurred by bidders during the tender phase may include:

- greater provision of initial design work by government—to avoid the need for each bidder to separately develop its own design from scratch, given that only the successful bidder's design work is utilised for the project;
- reduction in the due diligence which each bidder must undertake by means of government commissioning the geotechnical and other site reports for the benefit of all bidders;
- deferral of requirements for bidders to provide project documentation such as project plans and insurance policy terms until the appointment of preferred bidders;
- greater standardisation of bidding and contractual documents (which will be assisted by the work being progressed by Infrastructure Australia); and
- reimbursement by government of some of the value derived from running ‘two to the wire’, in appropriate circumstances.

CONCLUDING REMARKS

The infrastructure financing market is in a state of rapid change and uncertainty. Fundamentally, it seems the appetite for infrastructure projects with secure, stable cash flows, remains strong. However, recent liquidity issues in the debt market has made it increasingly difficult for competing bidders to raise finance for such projects.

The market is responding to these difficult market conditions and will continue to do so. A key challenge in this process will be to ensure that measures adopted to overcome the current difficulties are not in the future seen to undermine government's ability to achieve good value for money outcomes.

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