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THE FUTURE OF PROJECT FINANCE:
THE CRISIS IN PERSPECTIVE

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CHAPTER 13 ROADS TO THE FUTURE

PFI spoke to consultant and author Robert Bain about his view of the future outlook for the global toll road sector.

PFI: The toll road sector appears to be having a rough time at present.

RB: On one level, yes. The recent M80 transaction in Scotland certainly demonstrates how difficult it is to get roads to financial close in the current climate of credit rationing. The EIB stepped up to the plate in a major way, but the financing of toll roads just now is difficult, as is refinancing – whether because of near-term maturities, long-term accreting swap overlays or non-performing variable rate debt. And of course toll roads get hit with a 'double whammy' with the recession dampening the traffic numbers. But why should we be surprised at that? Traffic consultants are quick – and correct – to point to links between economic growth and traffic growth when they are trying to sell roads to market participants, but appear to be more reticent to acknowledge that, during a downturn, the numbers will flounder. All you have to do is look at a country like Portugal over the past couple of years where a continuously sluggish economy has resulted in continuously poor traffic performance. Nothing new there. The truth of the matter is that straight-line graphs of toll road traffic forecasts showing year-on-year growth should be treated very cautiously. At best, traffic models deal in long-term trends. They simply cannot capture variance. Anyone who is structuring deals needs to understand this. Deals that closely sculpt debt amortising schedules to traffic forecasts while keeping liquidity levels to a minimum fail to reflect the reality of demand forecasting today and the predictive performance of traffic models. And thinly capitalised SPVs are not exactly flush with financial flexibility. I keep hearing about underperforming toll roads but in many ways toll roads are performing exactly as you would expect. They're only underperforming if you had unrealistic expectations about them from the outset. Of course, from a credit point of view, there is actually some good news emerging from the current situation.

PFI: What do you mean exactly?

RB: Well, I don't deny that the situation today is not good: wide spreads, a closed bond market, a preference for club deals, low bank hold levels, no monoline insurance, liquidity is expensive and construction LCs are difficult to procure. But when I started at S&P in 2002 toll road transactions were pricing at around 125bp. When I left, in 2007, the spread had narrowed to almost 50bp, and monoline fees to backstop project credit had also declined markedly. How can that be right when the underlying project risks – mainly traffic risk – had remained unchanged? Something had to break. Now we're seeing the market correction. Okay, spreads have probably widened too far on the rebound but look at other developments. Shorter tenors, less leverage and tighter covenants – these are all positives for lenders. We seem to be getting back to some credit fundamentals: manageable debt burdens, sensible cash reserves, appropriate dividend distribution traps, and I'm glad to see the back of accreting debt which crystallised the future debt burden well in advance of uncertain traffic and revenue performance. Lenders were trying to mitigate project risk through exotic financial engineering. Hopefully we'll now see the emphasis shift to back to understanding project risk and sensible transaction structuring. However, my own pet subject at the moment is disclosure. Too often banks have been relaxed

about disclosure requirements just to get the deal done. No problem when things are going well but try to get basic project information when things are not so rosy and you will struggle. Project finance banks – those that remain – will emerge in a strong position and should assert their disclosure requirements from the outset. Even minor syndicate players should be supplied with appropriate information to enable them to monitor their exposure. I think – I hope – that future borrowers will be required to up their game in terms of disclosure. There's no excuse for not providing basic information about projects and project performance to lenders, and there's no excuse for lenders not to insist on this.

PFI: What about the future?

RB: Well, in the very short term you're going to see a lot more of the EIB.

PFI: You're working for the EIB these days.

RB: Yes, I'm retained by the bank on a part-time basis. It's certainly a busy place at the moment! I've just finished a review of the PPPs they're exposed to globally, focusing on the lessons the bank has learned from projects in operations. More than half of these are toll roads. I had full access to bank documentation and interviewed around 20 senior members of staff. I hope that they will publish the results of the review as there are a number of useful lessons – particularly for scheme promoters. But the EIB's increased PPP lending activity at the moment is only partly due to the fact that commercial lenders are shy. It coincides with an increased risk appetite at the bank. The EIB started life as a wholesale bank – part of the treasury play; a conservative public sector lender lending to sovereign and public sector entities. It evolved to lending against sovereign or bank guarantees, or in deals with monoline wraps with, in theory, no project risk exposure. Next came guarantees with releases post-construction; the guarantee being released once projects had passed into operations if certain conditions were met. Today, under its structured finance facility the Bank is prepared to go on-risk from the outset of a project; through construction and operations.

PFI: And the EIB's appetite for risk will increase further in the future?

RB: Certainly that's the indication. It's wary about traffic risk – and, having reviewed the Bank's monitoring reports, it has good cause. But there are good people there who understand traffic and toll roads, and are keen to lend to highway schemes – and other big infrastructure projects – that meet the Bank's criteria. I think we'll see new products being offered by the EIB in the future. It already has developed a guarantee instrument for trans-European transport network projects called the LGTT, it might look at other guarantee instruments, may develop some mezzanine products and, ultimately, may participate in equity funds and funding.

PFI: What else for the future?

RB: In terms of toll roads, the world is divided into very different markets. Let's take some western countries; long established players in terms of PPP-style highway concessions. Here we're seeing clear evidence of what the Department for Transport calls 'silting-up', when concessionaires are being reimbursed, not through user

charges, but by procuring agencies based on asset availability or performance or shadow tolls. Estimates suggest that the M25 DBFO scheme will bring the UK Highways Agency's PPP-related obligations up to nearly 40% of its budget – for 17% of its road network. It simply won't be able to afford any more roads using the existing model. In Spain, for the first time there are signs of PPPs impacting on public sector ratings. S&P recently assigned a negative outlook to the Autonomous Community of Madrid (AA+) because servicing PPP debt now accounts for 60–75% of its spending – leading to low expenditure flexibility and increasing budgetary rigidity. And the situation is Portugal has been widely publicised in terms of the county's need to shift from shadow tolls to user-paid tolls to ease pressure on government finances. Personally I'd like to see more traditional road tolling and less reliance on government-supported roads. It's about sending the right messages to road users in terms of the cost of the infrastructure they use; allowing properly-informed drivers to make sensible decisions about where, when and how to travel.

Canada has been an interesting place in terms of toll road deals in the past, although the political support for PPPs – or 'P3s' – differed considerably from province to province. Now there appears to be broader buy-in to the concept and a wider realisation that, when applied correctly, this form of public sector procurement can represent real value for money. Canada should continue to be interesting; however, its neighbour to the south remains confused and confusing. The US gets all hung-up on protectionist issues about its infrastructure being run by foreign companies. What it doesn't get is that these are not so much foreign companies, but global companies operating in global industries employing local people. Until it accepts or, better, embraces that fact, investor-financed toll road development will remain piecemeal at best.

Then there are the western countries that are at the earlier stages of developing toll roads – Germany, for example. I'm off to Berlin shortly to learn more about the German plans but the last time I looked the intention was to use revenues from Toll Collect, the distance-based truck tolling programme, to support a number of highway concessions. From a credit perspective, this could be problematic. Is support for the concessions contingent on the performance of Toll Collect? Are Toll Collect revenues simply passed-through to highway concessionaires, or is there any potential for the revenue flow to be disrupted or impeded by government? In general, when toll roads depend on government support I'm happiest when the arrangements are clear and straightforward – and preferably ring-fenced; not complex and certainly not discretionary in any way.

Eastern Europe remains difficult for the toll road sector. I think we'll see a couple of deals but they'll probably have to rely on government guarantees to some extent and I'm not convinced about that model. In terms of value for money, PPP roads work best when there is genuine risk transfer and genuine private capital on the line – not when there is some great big government guarantee underpinning the financing. Australia is certainly interesting from a spectator's perspective, although I'm not too sure that I'd like to be exposed to too many Australian toll roads. The sector seems to be dogged by hopelessly optimistic traffic forecasts and – unsurprisingly – underperforming assets.
For me, Latin America continues to offer considerable potential – but not for the uninformed or faint-hearted. I'll be interested to watch Ascendi, the Moto-Engil/BES investment vehicle, and its forays into Latin America – particularly Brazil. And having

worked in Mexico I know that there are very strong public sector capabilities looking to take the toll road sector there to its next stage of development.

PFI: Anything else in the short to medium term that will impact the toll road sector?

RB: Well, the big issue is tolling technologies and their applications. Electronic toll collection has been around for years. The individual system components are mature. Getting them working together is not always straightforward – that's interface risk – but generally the basic systems work. However, the use of electronic tolls means that road operators can become much more sophisticated in terms of pricing. Changing the price simply involves a bit of source code. This introduces us to time-of-day pricing and fully dynamic pricing – pricing that changes based on the level of asset use. The Americans refer to 'managed lanes' – roads or carved-out lanes where price is used to maintain a certain level of service. As traffic volumes increase, price goes up and extra demand gets choked off. The challenge here will be demand forecasting – predicting the consumer response – and past performance with far more straightforward tolling applications has been pitiful to date.

PFI: What about the longer-term outlook for the toll road sector?

RB: Do you mean, will we be driving cars on roads in 50 years' time? Who knows – but one thing's for sure: the autonomous mobility and opportunities which the automobile provides means that it will be around for some time. If there are cars, we need roads and if there's an increasing number of cars or they're being used more, we'll need more roads. How are we going to pay for this infrastructure – that is the key question. Yes, we're seeing a reduction in traffic on many roads across the world at present. Polls of people's responses to the current recession suggest that eliminating discretionary trip-making is one of the most common ways of saving money. Yet people love – and, importantly, report that they need – their cars. A recent survey in the US revealed that nearly 90% of people viewed their car as a necessity, placing it at the top of America's list of everyday necessities. Are other countries that different? I don't think so. Will other countries follow the same development path? Very likely.

I think that the big change that will come will not be about cars – it will be about fuel. This is when things start getting interesting. Beyond toll roads, the concept of road pricing makes clear sense and has done so for some time. Many people agree but precious little has been done. Why is that? It's because nothing needs to be done and the status quo – the present system of charging motorists – suits some people very well. The UK Treasury collects £45bn from road users each year through fuel tax, excise duty, VAT and company car tax – yet the government's budget for roads is less than £9bn. That's a nice earner. Fuel tax and the VAT on fuel alone generate over £30bn. However, if developments in fuel cell technology mean that alternative motive technologies become realistic options – spurred on by a strong desire to become less gasoline dependent – that healthy source of government income will start to look shaky. This could be the time when something needs to be done and road pricing – in the form of urban congestion charging, motorway tolls or both – will have its day. To a certain extent this is already happening in the US. As vehicles have become increasingly fuel efficient, gas taxes revenues have simply failed to keep up with road investment needs. Road pricing is coming in from the cold and is

seriously being discussed by senior politicians. And with the prospect of national road pricing schemes, where will that leave the toll road sector?

PFI: Where will it leave the toll road sector?

RB: Well, we will face the challenge of trying to establish national charging systems for road use with small sections of the network already owned and operated by different private sector parties. That won't work. I don't know what will happen but there is one thing I'd make sure: in any toll road concession agreement I would make very sure that there are clear clauses that speak to lender compensation in the event that the current system of charging for road use is subject to a dramatic overhaul. This is certainly not inconceivable given the typical road concession terms of 25 or 30 years – sometimes longer.

PFI: Thank you.

Rob's recent book, Toll Road Traffic & Revenue Forecasts: An Interpreter's Guide is available online from Amazon and Barnes & Noble. The personal views and opinions expressed in this interview are those of the author alone and do not represent the official policy or position of the European Investment Bank.

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