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UK Guarantees: A Temporary Stimulus Initiative or a Potential New Model?

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The Government has unveiled a package of so called credit easing for major infrastructure projects which goes under the heading of UK Guarantees. UK Guarantees contain two elements, firstly a guarantee scheme to extend to around £40bn worth of projects and secondly a 12 month temporary lending programme from which an estimated £6bn worth of projects could benefit.

The UK Guarantees scheme will be open for a 2 year window to 31 December 2014 although it requires legislation to come into effect. The need for legislation is less to do with capacity of the Government to give such guarantees but rather to enable Parliament to vote for the necessary funds to cover the guarantees. This will be achieved through the Infrastructure (Financial Assistance) Bill. The Bill includes "housing" within the definition of "Infrastructure" and we all now know that housing will be the subject of a separate guarantee scheme.

This method of stimulating the economy is not new and follows similar packages to stimulate business under the National Loan Guarantee and Funding for Lending Schemes which have been launched within the last year. However, what is slightly different with UK Guarantees is that it is aimed at an industry which of its very nature is "lumpy" in profile and often complex in its individual projects. Therefore any such scheme cannot be "one size fits all" and must be tailored to individual projects.

The credit easing approach does not have the same adverse consequences on the Government's deficit reduction programme as pure Government borrowing for projects (the temporary lending scheme could have such an impact although it is assumed that such has already been accounted for and/or results from slippage in existing programmes). Instead of borrowing the Government will use the national balance sheet to effectively credit enhance (or de-risk) projects and thereby make infrastructure projects more attractive to lenders and most importantly institutional investors.

However, the guarantees will not be available for all infrastructure projects, only those which are major and satisfy 5 key criteria in that they are:

- nationally significant (either identified in the National Infrastructure Plan 2011 presumably as one of the 40 priority projects or programmes of national or economic significance);
- ready to start construction within 12 months of the guarantee being given (presumably this means financial close rather than "offered");
- financially credible (with equity committed and willing to accept appropriate re-structuring of the project to limit risks to the taxpayer. Presumably the guarantee will play a similar role to mezzanine finance);
- dependent upon the guarantee to proceed (and not otherwise financeable);
- good value to the taxpayer (when measuring risks against economic stimulus).

The nature of the qualification criteria will largely limit the guarantees to transport, utilities, energy, communications and waste (largely the sectors covered by the National Infrastructure Plan). PPPs may qualify if they satisfy the 5 key criteria but the issues around risk transfer and balance sheet impact may mean they will be an exception rather than the rule. Housing is the subject of a separate guarantees scheme with a cap of £10 bn. Other economically important projects proposed by local government, Core City deals and Local Enterprise Partnerships could come within the "safe harbour" exception under "nationally significant." The extent of the pipeline of potential projects which may use this facility remains to be seen.

So how might a guarantee scheme such as this work? Is this just a temporary measure or a longer term model? Is it the solution for getting institutional investors comfortable with this asset class?

The Government guarantee will be used to credit ease or de-risk individual projects. There are various types of guarantee which may be possible for example, debt guarantee, revenue guarantee or

construction support. Any creditor can benefit whether bank or bond finance. It is assumed most of the projects which may benefit will be structured on a concession basis yielding customer revenues or government revenue subsidy or a mix of the two. It is the potential uncertainty around revenues where the guarantees are likely to operate. Foremost of these risks to revenues are construction risks on "green field" projects (operational risks may also be an issue but more likely only in relation to the more operationally complex). There are other potential ways of addressing these risks through for example the provider of development finance taking the risk (perhaps for a fee) or credit enhancing the construction contractor. However, all of these approaches will have a cost attached.

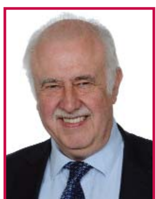
The guarantee on the other hand has less cost attached. It may be funded or unfunded. However it must be State Aid compliant. If it is funded then this means there must be a "commercial level" of return, and if unfunded then probably a fee for the guarantee. The letter is the way other guarantee schemes have worked such as the Local Authority Mortgage Scheme. It is likely that if funded the guarantee will take effect in a similar way to mezzanine debt or a "first loss" tranche of debt ranking behind the senior lender (or institutional investor). If unfunded then the guarantee would be given in relation to the debt (whether whole or part will depend on project specifics). If part the remainder of the debt would thereby be credit enhanced. The pricing of the guarantee is likely to reflect credit spreads in the market. Guarantees will be particularly attractive to institutional investors giving them comfort in relation to risks impacting on returns, more so because the scheme is unlikely to alleviate current bank problems with long term debt.

The guarantee approach will clearly impact upon recognised approaches to project risk. The public sector will clearly be accepting the first and major tranche of debt risk. The public sector therefore will need to undertake significant due diligence in respect of the project risks to minimise risk to public funds and to also ensure that the outcomes in the form of economic growth justify the risk capital. The public sector will also be concerned with the levels of equity in the project and the extent to which there is a significant equity buffer. What sort of "controls" might the public sector seek? The Government will wish to be substituted in respect of the rights of the guaranteed lenders and be the controlling creditor in relation to the guaranteed debt. Where a guarantee is given then clearly there will be less incentive for the senior lender or investor to "step in."

The temporary lending programme for PPP projects has resurrected IFUL (the Infrastructure Financing Company Limited). It will be no more than a temporary facility for 12 months and will involve the wholly Government owned company IFUL on lending Treasury funds. There will be no additional funds available as lending will be from current Department budgets. It will be a co-lending facility on commercial terms. The finance will need to be structured in co-lending terms so as to avoid State Aid arising and will therefore need to be pari passu. A methodology will need to be agreed between the Treasury and Senior lenders addressing the relationship between the funders. Co-lending could also come from local authorities through the prudential borrowing regime.

Whilst the stimulus package is to be welcomed the extent of "ready to go" projects remains to be seen. The structure of the guarantees may well be the initial answer for institutional investment until investors become comfortable with the asset class. However, more work still needs to be done on the demand side to look at a way of structuring projects so that institutional investment will work, and on the supply side to acquaint institutional investors with the nature of infrastructure projects and the risks involved.

Should you have any questions please contact



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