

# PPP Practice Note: Expectations and Guidance for Refinancing Events

## 1. The Infrastructure Commission

The New Zealand Infrastructure Commission, Te Waihangā (Te Waihangā), was established on 25 September 2019. Te Waihangā will help improve how New Zealand coordinates and plans its infrastructure, makes the most of the infrastructure it already has, and ensures that investment in infrastructure delivers what New Zealand needs.

One of Te Waihangā's core functions is to prepare research and best practice guidance on major infrastructure procurement and delivery, to provide guidance on specific issues, beyond the more general procurement guidance already available from other agencies.

As part of this function, Te Waihangā is responsible for maintaining and developing the New Zealand Public Private Partnership (PPP) Model. This function was previously undertaken by the former PPP Unit in the New Zealand Treasury (the Treasury). As part of this role, Te Waihangā is responsible for:

- developing PPP policy and processes;
- assisting agencies with PPP procurement;
- maintaining the Standard Form PPP Project Agreement;
- engaging with potential private sector participants; and
- monitoring the implementation of PPP projects.

## 2. Purpose

The guidance in this document is in the form of a Practice Note, which is relevant only to those agencies that are sponsors and contract managers of a PPP project (**agencies**).

The purpose of this Practice Note is to assist Agencies by providing an overview of the Refinancing process for PPPs and set out the expectations and role of Te Waihangā and Treasury during a Refinancing event. The Practice Note covers the following topics:

- What constitutes a Refinancing event;
- Crown consent requirements;
- The Refinancing process and parties involved; and
- Standard form positions on the calculation and sharing of Refinancing Gains.

This Practice Note forms part of a suite of guidance documents issued by Te Waihangā relevant to the planning and delivery of major infrastructure projects in New Zealand, including PPPs. It should be read in conjunction with other Te Waihangā guidance.

Unless otherwise stated, this Practice Note has been developed with reference to the Standard Form PPP Project Agreement v3 and associated Schedules. Advice should be sought as to the relevance of this guidance should a different version of the model form be in use. During a

Refinancing event, Agencies will need to refer to their specific Project Agreement to ensure the correct commercial and legal treatment has been applied. Capitalised terms in this guidance, unless otherwise defined, have the meaning given to those terms in the Standard Form PPP Project Agreement.

### 3. What constitutes a Refinancing event?

Refinancing events are events that occur post Financial Close that result in a change to, or the exercise of any rights under, the Senior Financing Agreements and/or the entry into or breakage of any swap arrangement.

Refinancing events can take many different forms, including but not limited to:

- A reduction of debt margins;
- The extension or expiry of debt tenor;
- A change in reserve account requirements (such as the Debt Service Reserve Account);
- A change in gearing (i.e. the ratio of debt to equity) of the SPV;
- A change in payment terms or other finance terms (e.g. covenants);
- A change in lenders or debt providers; and/or
- A change to the guarantee structure.

Where a Refinancing event has the effect of increasing or accelerating Distributions to investors or reducing their commitments to the Project, these effects are individually and collectively referred to as Refinancing Gains.<sup>1</sup> Calculation and payment of a Refinancing Gain is discussed in Section 7 below.

Due to the complexity surrounding most Refinancing events, Agencies should engage with their respective Commercial and Legal Advisors, Te Waihangā and Treasury to ensure the risks and/or potential benefits of a Refinancing event are fully assessed before providing consent (except in the case of an Exempt Refinancing).

### 4. Crown Consent

The PPP Project Agreement requires the Contractor to seek Crown Consent to any proposed Refinancing (with the exception of any Exempt Refinancing, which a Contractor may undertake without the prior consent of the Crown). Crown consent must not be unreasonably withheld and must be obtained in writing prior to any Refinancing event taking place.

***Procedurally, Crown Consent is provided by the relevant Agency (as the contractual counterparty to the PPP Project Agreement). However, Agencies are expected to consult with Te Waihangā and the Treasury to confirm that Crown Consent should be provided by the Agency.***

The timeline to provide consent typically range from 5-20 Business Days. Failure by an Agency to respond to a Refinancing request within the prescribed timelines stipulated in each Project Agreement may result in 'deemed consent' and limit an Agency's ability to make future claims against the Contractor.

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<sup>1</sup> The definition of Refinancing Gain has been developed through reference to international precedent.

There are limited circumstances where the Crown will have grounds to withhold its consent. These situations include (but are not limited to):

- where the proposed Refinancing event involves an Unsuitable Third Party;
- when there is a material change in the Termination Liabilities of the Crown;
- where the terms and conditions of a proposed Refinancing event (taken as a whole) are not in accordance with market practice at the time; and/or
- where a Refinancing event may reduce incentives for the Contractor to achieve contracted service standards.

Withholding consent can have serious implications for both the Crown and Contractor and this right should only be exercised in exceptional circumstances. ***An Agency should only consider withholding consent after consulting with its Legal and Commercial Advisors and in consultation with Te Waihanga.***

## 5. Refinancing process

### How is a Refinancing initiated?

Any Refinancing event (other than Exempt Refinancing) will be initiated by the Contractor by providing notice to the Agency of their intention to Refinance. The Contractor will provide the Agency with documentation, stipulated in each Project Agreement, necessary to assess the Refinancing event.<sup>2</sup>

Agencies should seek early engagement with the Contractor in relation to any upcoming Refinancing event and encourage the Contractor to advise its intentions as early as possible. Doing so will help to alleviate the time pressure associated with the provision of consent.

### Who is involved in a Refinancing?

There are several parties involved in a Refinancing event outside of the Contractor and Agency, including Commercial and Legal Advisors, Senior Lenders, an Independent Model Auditor, the Crown Swap Counterparty and Te Waihanga. Refer to Appendix A for further details on the role each party plays in a Refinancing event.

## 6. Te Waihanga consent expectations for certain Refinancing events

Additional scrutiny will be required for proposed Refinancing events that include any change to:

- The Senior Debt repayment profile;
- Re-gearing; or
- A change in Senior Lender(s) to a non-Qualifying Lender(s).

***Agencies should consult with Te Waihanga (who will in turn consult with Treasury) where any proposed Refinancing includes one or more of the above situations given the potential impact on the Crown's Termination Liabilities and/or change to the risk profile of a Project.***

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<sup>2</sup> Clause 51.3 of the Standard Form Public Private Partnership (PPP) Project Agreement

## Change in the Senior Debt repayment profile

Base Interest Rate risk typically sits with the Contractor for the first five years (managed through hedging with senior debt providers or their affiliates) and then with the Agency for the remainder of the contract term. Agencies hedge this risk through a forward starting interest rate swap with a Crown Swap Counterparty, which is set based on the Senior Debt repayment profile at Financial Close.

Any change to the Senior Debt repayment profile post Financial Close may result in the Agency being under or over-hedged at various times throughout the life of the Project. An under-hedged position will put an Agency at risk of future market movements and may require additional unexpected payments to be made to the Contractor. Re-hedging through a new swap arrangement may be required. In this scenario, the Agency should discuss this with their Commercial Advisor, Te Waihanga, and Treasury.

## Re-gearing

Re-gearing can generate increased returns for investors, however, it may also result in an increase to the Crown's Termination Liabilities and/or change the underlying risk profile of the Contractor. Te Waihanga will accordingly expect that significant diligence is undertaken on any proposal that includes re-gearing.

Any financial gains that result due to the re-gearing of a Project should be shared between the Crown and the Contractor as set out in section 7 below.

## Change to Senior Lender(s) outside the Qualifying Lender list

The Crown has a vested interest in the identity of Senior Lenders to a Project. The Crown should carefully review any proposed new Lender that is not classified as a Qualifying Lender. Consent to a new Senior Lender cannot be unreasonably withheld and will follow an assessment of the new lender's risk profile and reputation.

Debt Assignments, which may take the form of syndications, sub-participations or transfers to a Qualifying Lender are considered Qualifying Bank Transactions under the definition of an Exempt Refinancing and allow Senior Lenders to manage their assets without seeking consent from the Crown. Financial gains resulting from a Qualifying Bank Transaction are excluded from the Refinancing Gain calculations.

Note that the Qualifying Lender lists were set at the time the relevant projects were documented and should not be taken as an up to date or complete list of the financiers that may in fact be appropriate Senior Lenders to a Project.

## 7. Calculating, Sharing and Payment of Refinancing Gains

The Crown is entitled to receive 50% of any Refinancing Gain resulting from any Qualifying Refinancing.<sup>3</sup> The Crown will receive its share by way of an adjustment to the scheduled Unitary

<sup>3</sup> 50% reflects the default position in the Standard Form Public Private Partnership (PPP) Project Agreement but may vary in each Project.

Payment in accordance with the Project's Payment Mechanism. Agencies do not share in any Refinancing losses.

## Use of the Base Case Financial Model ("BCFM")

The Contractor is required to use the BCFM when demonstrating the impact of a proposed Refinancing event. The BCFM is used for, amongst other things, calculation of the periodic unitary payments. The Contractor is required to update the BCFM to take into account certain changes (e.g. Refinancing and other matters altering the unitary charge).

The use of an alternative financial model, such as an operational model used to record actual performance, is not suitable for the purposes of assessing the impact of a Refinancing event as it is not easily compared with the Base Case as agreed at Financial Close (or the most recent Refinancing). Any such model should not be accepted by Agencies.

Clause 5.4 of the Standard Form PPP Project Agreement requires that an adjusted BCFM be audited before it becomes the agreed Base Case for contractual purposes. ***Te Waihanga expects that the model auditor will be an independent third party.***

## Calculation of a Refinancing Gain

A Refinancing Gain is calculated as an amount equal to the greater of zero and  $(A - B) - C$  where:

- A = the Net Present Value of the Distributions projected to be made over the remaining term of the Project Agreement following the Refinancing, using the Base Case as updated to take into account the effect of that Refinancing;
- B = the Net Present Value of the Distributions projected to be made over the remaining term of the Project Agreement following the Refinancing, using the Base Case without updates to take into account the effect of that Refinancing; and
- C = any adjustment required to raise the Pre-Refinancing Equity IRR to the Threshold Equity IRR.

The discount rate used to calculate the present value of the remaining Distributions in each case is the Threshold Equity IRR. This rate represents the return that investors expect to receive on their investment and is a rate that will have been competitively bid during the original PPP procurement process.

Alternative rates such as Senior Debt interest rates and the Equity IRR are not considered appropriate as they may lead to artificial reductions in Refinancing Gains.

When calculating the Refinancing Gain, Agencies should confirm that all assumptions and calculations (including actual performance and macro-economic) used in calculating the pre-Refinancing and post-Refinancing Distributions are identical.

## Payment of Refinancing Gain

Refinancing Gains can be earned upfront (e.g. through a release of funds held in a reserve account) or over time (e.g. through a reduction in bank margins) and will be received by the Agency through an adjustment to the periodic Unitary Payment.<sup>4</sup> An Agency's share of a Refinancing Gain can be received:

- a) Through a single Unitary Payment reduction (i.e. Upfront); or

<sup>4</sup> Clause 53.1 of the Standard Form Public Private Partnership (PPP) Project Agreement.

- b) Spread across a number of Unitary Payments (i.e. Overtime).<sup>5</sup>

When electing the appropriate method to receive its share of a Refinancing Gain, an Agency must consider the impact the reduction in Unitary Payment will have on the SPV and its ability to continue to meet its financial obligations.

***Te Waihanga's policy position is that any Refinancing Gain that is earned upfront (e.g. through a release of a reserve account) should be received upfront and any Refinancing Gain that is earned over time (e.g. through a reduction in debt margins) should be received over time.***

The profile of any Refinancing Gain that is received over time should be fixed at the time of Refinancing and should not be altered at subsequent Refinancing events. This provides a level of certainty to both the Contractor and the Agency. Agencies should consult with Te Waihanga where a proposed Refinancing includes the SPV taking on additional Senior Debt to pay a Refinancing Gain that would otherwise accrue over time, as this introduces additional risk to the Project.

Where an Agency's share of a Refinancing Gain is received over time, the Agency should receive compensation on the deferred portion of the Refinancing Gain. The rate at which the Agency is compensated should correlate to the prevailing Senior Debt interest rate at the time of the Refinancing event. This differs from the discount rate applied to calculate the present value of future Distributions as the Agency has a fixed claim for a 'lump sum' payment or a committed reduction in the Unitary Payment and is, therefore, at less risk when compared to the Contractor.

## 8. Other key considerations

### Impact on Crown's Termination Liability exposure

It is likely that a Refinancing event will result in a change to the Senior Debt profile in the BCFM as actual refinancing dates will not align with modelled refinancing dates. This change, whilst often immaterial, along with any other proposed changes to the BCFM, may lead to a change in the Crown's liability on various termination events. The Agency's Commercial Advisors will quantify the change in Termination Liabilities. Treasury should be notified of any material changes to Termination Liabilities as soon as possible.

The Refinancing general provisions within the Standard Form PPP Project Agreement state that no change to Financing Agreements (this may include termination/amendments/replacement of the existing agreements, or the entry into new agreements) shall have the effect of increasing the Crown's Liabilities on termination.<sup>6</sup> That is, unless the Crown has provided prior consent or if such liabilities are already payable by the Crown as defined in the model schedules.

The extent to which Termination Liabilities increase and/or decrease as a result of a Refinancing event will be specific to the type and structure of the Refinancing undertaken. The Agency will need to assess whether an increase to Termination Liabilities is acceptable under the proposed Refinancing. This may include a value for money exercise comparing the increase in liabilities with the Crown's share of any Refinancing Gain.

<sup>5</sup> The Standard Form Public Private Partnership (PPP) Project Agreement does not specify the timing in which an Agency will receive its share of a Refinancing Gain.

<sup>6</sup> Clause 51.3(d) of the Standard Form Public Private Partnership (PPP) Project Agreement.

Appendix C identifies the Termination Liabilities included within the Standard Form PPP Project Agreement.

### **Additional interest rate swap considerations**

Agencies should closely monitor changes to the Senior Financing Agreements that result in a misalignment to any interest rate hedging agreement. Misalignment may result in increased costs/exposure for an Agency and should only be accepted in exceptional circumstances. An example of this is when an interest rate floor is added to Senior Financing Agreements, but no corresponding floor is included in an Agency's interest rate hedging agreement with its respective swap counterparty. In this situation, if base interest rates were negative, the Agency will pay both the fixed and (negative) floating rate under the Crown swap without receiving a corresponding floating payment from the Contractor (payments are received from/paid to the Contractor through adjustments to the Unitary Payment).

# Appendix A - Refinancing roles

| Party                          | Role in Refinancing                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|--------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Contractor</b>              | The Contractor will initiate a proposed Refinancing by notifying the Agency of its intent to Refinance (except in the case of an Exempt Refinancing).                                                                                                                                                                                                                                                                                                                                                        |
| <b>Agency</b>                  | Upon receipt of a request to Refinance, the Agency will undertake the procedures required to either grant or refuse consent to the Refinancing.                                                                                                                                                                                                                                                                                                                                                              |
| <b>Senior Lenders</b>          | The Contractor will engage Senior Lenders to secure terms for the refinanced debt, these terms will be displayed in the updated/new Senior Financing Agreements.                                                                                                                                                                                                                                                                                                                                             |
| <b>Te Waihangā</b>             | Te Waihangā is responsible for maintaining and developing the New Zealand PPP model. As a part of this role, it is responsible for, amongst other things, developing PPP policy and processes, and monitoring the implementation of PPP projects. As noted in Section 2.3 of Te Waihangā's PPP Practice note on consultation requirements for operational PPPs, Agencies are required to consult Te Waihangā when any event occurs that is likely to result in changes to the BCFM such as in a Refinancing. |
| <b>Treasury</b>                | Treasury's Investment Management and Asset Performance team's responsibilities include establishing and maintaining policy around investment and asset management and managing risks to the Crown's balance sheet. As required, Te Waihangā will consult with Treasury during a Refinancing event, in particular when there is a material change to Termination Liabilities.                                                                                                                                 |
| <b>Crown Swap Counterparty</b> | The Agency is likely to have an interest rate swap in place to hedge base interest rate risk. Following a Refinancing, the Senior Debt profile is likely to change resulting in a mismatch between Senior Debt outstanding and the notional amount under the existing swap arrangement. Depending on the magnitude of the mismatch, the Agency may wish to re-hedge their position through the entry into a new incremental swap with the Crown Swap Counterparty.                                           |
| <b>Commercial Advisors</b>     | Both the Contractor and Agency are likely to engage Commercial Advisors to provide commercial support during the Refinancing process. This is likely to include assessment of the terms of the proposed Refinancing, review of any changes to the BCFM and the gainshare calculations (if any), and negotiation of any points of contention.                                                                                                                                                                 |

***Legal Advisors***

Legal Advisors are engaged by both the Contractor and Agency to provide support in confirming the consistent application of contractual conditions under the Project Agreement and other supporting legal documentation. They will also be required to review any changes to the existing legal documentation (or the entry into any new arrangements such as new Senior Financing Agreements). They will also be a part of negotiating any contentious terms.

***Independent  
Model Auditor***

As noted in Clause 5.4 of the Standard Form Project Agreement, any changes to the BCFM must be audited before it becomes the agreed Base Case for contractual purposes. The Independent Model Auditor will review, and subsequently attest to, the mechanical accuracy of any changes made to the BCFM as a result of the proposed Refinancing. Note: The Independent Model Auditor is appointed by the Contractor (although their report should be co-addressed to the Agency as well) and does not review the commerciality of any proposed Refinancing and should not be considered a substitute for Commercial Advisors.

## Appendix B: Termination Liabilities

### Termination Event

### Termination Liability

#### ***Termination for Convenience***

If the Crown decides to terminate the agreement for reasons other than those listed below, this is deemed a termination for convenience. Under such a termination, the Compensation Sum payable by the Crown is the **net aggregate** of the: **Base Senior Debt Termination Amount, Adjusted Estimated Value of the equity** (provided that such amount is not less than zero), **redundancy payments** for employees of the Contractor as a result of the termination, and **subcontractor breakage costs**.

#### ***Termination on Contractor Default***

Under a termination for Contractor Default, the Compensation Sum is equal to **either**: The **Adjusted Estimated Value of the Contract** or the **Adjusted Highest Compliant Tender Price**.

#### ***Termination on Uninsurable Event or Uninsurability***

Under a termination on uninsurable event, and where termination occurs after Service Commencement, the Compensation Sum is equal to the **greater of**: the **Adjusted Estimated Value of the Contract** or the **Base Senior Debt Termination Amount**.