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SHARING INTEREST RATE RISK IN SOCIAL INFRASTRUCTURE PROJECTS

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Recent NSW social infrastructure projects have heralded a change in the government's approach to interest rate risk on social infrastructure projects post financial close. In earlier PPP projects, NSW required the private sector to manage interest rate risk during the term of the project. More recently, the state has been willing to accept some level of interest rate risk where this offers an improved value for money result.

No change has occurred to the policy where NSW will not accept the risk of changes in margins bid by PPP proponents.

WHY THE CHANGE?
There are two main reasons for the change.

First, the change harmonises the state's position on PPP interest rate risk with its $20 billion debt portfolio. NSW currently accepts and manages exposure to interest rate volatility. However, in the case of earlier PPP projects, NSW was effectively seeking funding on a fixed rate basis.

Ignoring arguments that the debt in PPPs does not represent government debt but that of the private sector, the recent change in NSW's approach to PPP interest rate risk seeks to ensure consistency in the state's management of its overall debt position.

Second, improved value for money outcomes. The concession terms for PPPs are generally longer than the maturities offered by debt markets. This requires private bidders to hedge debt exposures or raise loans in niche or less liquid markets. Borrowing offshore also raises the costly problem of currency risk management.

A paper released by NSW Treasury in February 2004 indicated that historically the average cost of borrowing for 10 years was 0.4% more than the cost for terms of 5 years. Accordingly, by providing more flexible options for the management of interest rate risk, NSW is encouraging the private sector to create financing solutions which might reduce the cost of private debt and deliver improved value for money from PPP transactions. This approach does not expose NSW to greater interest rate risk than presently exist with its existing debt portfolio.

THE OPTIONS FOR ALLOCATING INTEREST RATE RISK
There now appears to be three main options for allocating interest rate risk.

Option 1 – Nominal Fixed Rate Amount
This is the traditional approach adopted in the UK whereby the private sector accepts nominal interest rate risk and provision of hedged nominal finance over the term of the project.

Option 2 – CPI Linked Debt
Under this option the private sector will bear real interest rate risk but NSW will bear full CPI risk through indexation of the service fee component. This option recognises the increasing popularity of CPI indexed bonds in recent Australian infrastructure projects. This approach was adopted for the first of the NSW Public Schools PPP projects.

Option 3 – Floating Base Rate Debt
Under this option, NSW will accept interest rate risk against a benchmark reference rate such as the 90 or 180-day bank bill swap rate. However, consistent with NSW Treasury policy, the state will not accept interest rate risk during the construction phase of the project. NSW will also consider financial solutions which include the floating rate being set at time periods longer than 90 or 180 days. Some possible funding structures are:

- Rolling 5 year fixed rates
- Rolling 10 year fixed rates, or
- Combinations of the above.

HOW WILL NSW EVALUATE THE THREE OPTIONS?
To date NSW has evaluated the three options by converting each to a fixed nominal basis. The following table is a simplistic summary of how this would occur:

OPTION 1
No specific adjustment required
OPTION 2
Proposal will be adjusted assuming a forecast CPI rate. The assumed rate generally specified in the call documents
OPTION 3
Proposal will be converted to a fixed nominal basis on the assumption that the reference rate at each reset point will equal the applicable NSW Treasury Corporation bond yield less a forecast term premium. NSW Treasury Corporation bond yield will generally correspond to the weighted average of the terms of the debt tranches.

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