



Freshfields Bruckhaus Deringer



---

# Financing PPPs with project bonds in Germany

An analysis of procurement issues

July 2013

## **Authors**

### **Freshfields Bruckhaus Deringer**

Daniel Reichert-Facilides

E [daniel.reichertfacilides@freshfields.com](mailto:daniel.reichertfacilides@freshfields.com)

Roland M Stein

E [roland.stein@freshfields.com](mailto:roland.stein@freshfields.com)

## **Supported by**

Nick Bliss

E [nicholas.bliss@freshfields.com](mailto:nicholas.bliss@freshfields.com)

Sally Roe

E [sally.roe@freshfields.com](mailto:sally.roe@freshfields.com)

### **The EPEC team**

[epec@eib.org](mailto:epec@eib.org)

[www.eib.org/epec](http://www.eib.org/epec)

Introduction .....	2
Section 1 Context .....	3
1.1 German procurement law .....	3
Types of procedure .....	3
Prior information notice ('Vorinformation') .....	3
Prequalification and short listing ('Teilnahmewettbewerb') .....	3
Invitation to negotiate ('Vergabeunterlage') .....	3
Content of bids .....	4
Evaluation .....	4
Award .....	4
1.2 Financing process .....	4
(a) Raising a bank loan .....	4
(b) Placing a public bond issue .....	5
(c) Private placement .....	7
Section 2 Analysis and solutions .....	8
2.1 Timeline .....	8
2.2 Procurement law issues .....	10
(a) Transparency of qualification criteria .....	10
(b) Pricing subject to placement .....	10
Option one – committed pricing formula .....	11
Option two – pass-through of actual pricing .....	12
(c) Evaluation of bond pricing proposals .....	12
Option one – committed pricing formula .....	13
Option two – pass-through of actual pricing .....	13
(d) Evaluation of transaction certainty .....	13
Option one – committed pricing formula .....	14
Option two – pass-through of actual pricing .....	14
(e) Comparative evaluation of bond and bank loan financings .....	14
Option one – separate proposals .....	14
Option two – combined proposals .....	15
Terms of use for this publication .....	16

This memorandum is a joint publication co-written and researched by the European PPP Expertise Centre and Freshfields Bruckhaus Deringer LLP. It is mainly directed at public authorities, with the purpose of outlining issues that procuring authorities will face from a German procurement law perspective in the context of making bond financing available to public private partnerships.<sup>1</sup>

On 21 December 2012 the European Investment Bank published its outline guide to Project Bonds Credit Enhancement and the Project Bond Initiative (the *Outline Guide*).<sup>2</sup> In Germany, public private partnerships (PPPs) have to date almost exclusively been financed with bank loans. Opening the market for infrastructure debt financing to bond issues constitutes a major change. Based on past experience, German bidders and procuring authorities view bank loans as the standard solution, and procurement processes have been set up to accommodate the operational requirements of banks. While bond financing is expected to benefit infrastructure projects by offering longer tenors, higher overall funding capacity and often lower interest rates, a bond placement differs significantly from raising bank debt and is generally subject to more rigid market standards for process and documentation.

In a paper dated October 2012,<sup>3</sup> the European PPP Expertise Centre (EPEC) identified the main challenges which a procuring authority typically will face when structuring a procurement process for a PPP in a way to enable the project to access the bond market. This paper will address these issues from a German procurement law perspective. The challenges identified by EPEC largely result from the different processes involved in raising bank and bond debt. Section 1 of this paper therefore briefly contrasts and puts these processes into the context of a procurement process. The section also briefly explains the relevant requirements of German procurement law for the benefit of readers unfamiliar with the German legal framework.

On this basis, Section 2 then provides the legal analysis and potential solutions for the structuring of a procurement law process to support a project bond financing.

## Executive summary

- German procurement law permits project bond financing for a PPP. In particular, the negotiated procedure and the competitive dialogue give German procuring authorities a wide margin of discretion to accommodate the particularities of a project bond financing.
- The main legal challenge will be to develop an evaluation matrix whereby the procuring authority will be able to identify the most economically advantageous financing solution. Additionally, the matrix would have to take into account the lower deal certainty of a bond financing prior to actual placement when compared to a committed bank loan – unless the bond is fully underwritten at first bid submission, which is unlikely. As a separate item, the different contractual terms of the proposed financing solutions may also have to be evaluated.
- Defining and calibrating a rational evaluation matrix will require capital markets expertise typically provided by an external financial adviser.
- Requiring bidders to submit combined bank loan and bond proposals with an option for the procuring authority to choose, up to the time of actual execution, either funding route, will reduce the risk of challenges to the evaluation methodology under German procurement law and provide a fall-back if the bond placement should fail.

<sup>1</sup> Please note terms of use at the end of this paper.

<sup>2</sup> [http://ec.europa.eu/economy\\_finance/financial\\_operations/investment/europe\\_2020/index\\_en.htm](http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/index_en.htm)

<sup>3</sup> Financing PPPs with project bonds – Issues for procuring authorities, October 2012, <http://www.eib.org/products/project-bonds/index.htm>

# Section 1

## Context

### 1.1 German procurement law

The procurement law framework for PPPs in German infrastructure projects is set out in the Act against Restraints of Competition (*GWB*), the Procurement Regulation (*VgV*) and the Procurement Guidelines for Construction Works (*VOB/A*).<sup>4</sup> While all of these are based on European Union law, notably the Public Procurement Directive,<sup>5</sup> they also reflect traditional German procurement concepts and a rapidly growing body of national case law that has developed over the last 20 years.

#### Types of procedure

Due to the complexities of PPPs, procuring authorities in Germany usually opt for a negotiated procedure when structuring the procurement process. The competitive dialogue procedure is available as an alternative, but has been used far less frequently in Germany to date. Whilst the competitive dialogue procedure offers additional flexibility where it is difficult for the procuring authority to define the scope of a project comprehensively at the outset, it is unlikely to be more helpful in overcoming the specific challenges associated with a bond placement than the negotiated procedure.

The following legal requirements, which apply to both the negotiated procedure and the competitive dialogue, are likely to have an impact on the procurement process of a PPP incorporating a bond financing.

#### Prior information notice ('Vorinformation')

Although a prior information notice is not a requirement of German procurement law (except when statutory minimum periods are shortened in a manner which is impractical for a PPP), the procuring authority will nevertheless typically release such a notice to raise market awareness of an upcoming project.

#### Prequalification and short listing ('Teilnahmewettbewerb')

If the procuring authority intends to limit the number of qualifying bidders, which is customary in PPP procurement processes, it must mention all aspects that may be relevant for the short listing in the contract notice to be published in the European public procurement journal *Tenders Electronic Daily (TED)*, and set out the details in the prequalification questionnaire ('Teilnahmeunterlage').<sup>6</sup> In addition, the procuring authority must set out the project's main financing conditions in section III.1.2. of the standard TED publication for works contracts.

#### Invitation to negotiate ('Vergabeunterlage')

The object and procurement strategy for the PPP must be reflected in the tender documents to ensure *effective competition*,<sup>7</sup> *transparency of procedure*,<sup>8</sup> *equal treatment of bidders*,<sup>9</sup> and *selection of the most economically advantageous bid*.<sup>10</sup> In particular, the invitation to negotiate must define:

- the scope of work, stating the requirements of the procuring authority in an unequivocal<sup>11</sup> and product neutral<sup>12</sup> fashion, which at the same time must not impose undue risk on the bidders;<sup>13</sup>

<sup>4</sup> Trans-European energy and communication networks, which are also eligible for the Pilot Phase of the Project Bond Initiative, are not realised as PPPs in Germany and are, therefore, not addressed in this paper.

<sup>5</sup> Directive 2004/18/EC of the European Parliament and the Council of 31 March 2004 on the co-ordination of procedures for the award of public works contracts, public supply contracts and public service contracts.

<sup>6</sup> §§ 6 (2) no. 4 lit. a) and 12 (2) EG VOB/A.

<sup>7</sup> § 97 (1) GWB.

<sup>8</sup> § 97 (1) GWB.

<sup>9</sup> § 97 (2) GWB.

<sup>10</sup> § 97 (5) GWB.

<sup>11</sup> § 7 (1) no. 1 EG VOB/A.

<sup>12</sup> OLG Koblenz 10.6.2010 – 1 Verg 3/10; OLG München 5.11.2009 – Verg 15/09.

<sup>13</sup> § 7 (1) no. 3 EG VOB/A.

- the contract terms, some of which may differ depending on how the bidders intend to meet the substantive requirements of the tender;<sup>14</sup>
- which prices, statements and evidence must be included in the bid;<sup>15</sup> and
- the criteria for evaluation of each bid component and the weighting of the different components.<sup>16</sup>

### Content of bids

The bids must contain all prices, statements and evidence required in the tender documents.<sup>17</sup>

### Evaluation

The evaluation methodology – ie the evaluation criteria, the scoring ranges and the weighting factors – must not be changed after the issue of the tender documents, and needs to be consistently applied throughout the procurement process.<sup>18</sup>

### Award

The contract will be awarded based on the most economically advantageous bid.<sup>19</sup> The procurement procedure must be cancelled prior to awarding the contract if none of the bids comply with the requirements in the tender documents.<sup>20</sup>

Other procurement law issues may arise depending on the circumstances of the individual project. Accordingly, a comprehensive procurement law analysis must be conducted on a case-by-case basis before a contract notice is published in the TED, and must be reflected in the tender documents.

## 1.2 Financing process

Whilst debt origination may vary to some extent, depending on market developments and project requirements, the main challenges of a bond financing for a PPP stem from the different fundraising processes when compared to those inherent in raising a bank loan.

### (a) Raising a bank loan

The process of raising a project finance loan in the German market largely conforms to London (UK) market practice. Accordingly, each bidder will mandate a group of banks on the basis of an agreed term sheet confirming indicative pricing and commitment levels prior to submitting its initial bid in the procurement procedure.

Since the agreed term sheet commits the banks to extend a bank loan to the project company if the term sheet conditions are met, it often requires preliminary internal approval by the credit committee of that bank. Moreover, the bank needs to take into account opportunity costs, ie profits lost since the allocated funds are not available for alternative long-term lending, especially if the contract is not ultimately awarded to that bidder. In light of the amounts committed and the typical time-span of six to twelve months between the issue of the commitment letter and the award of the project and financial close, these opportunity costs must be factored into the pricing of the loan and will consequently increase the overall cost of the project.

<sup>14</sup> § 8 (1) no. 2 EG VOB/A.

<sup>15</sup> §§ 13 (6) and 13 (1) no. 3 and 4 EG VOB/A; BGH 10.9.2009 – VII ZR 255/08.

<sup>16</sup> § 16 (7) EG VOB/A.

<sup>17</sup> § 13 (1) no. 3 and 4 EG VOB/A.

<sup>18</sup> § 16 (7) EG VOB/A.

<sup>19</sup> § 97 (5) GWB.

<sup>20</sup> § 17 (1) 1 EG VOB/A.

As the drafting and negotiation of the finance documentation requires the commitment of significant advisory and management resources and cost, this process will usually only be started once the bidder has been appointed as one of the preferred bidders.<sup>21</sup> The finance documentation will reflect the common understanding that the lenders will be closely involved in the project throughout the term of the loan agreement by means of an elaborate system of monitoring rights, covenants and events of default. The bidder's perspective is that these detailed terms will be balanced by an expectation that lenders who are familiar with the project will be amenable to waiver requests as long as the project is sustainable on a forward looking basis.

Since the bank loan agreement will constitute the main source of funding for the project, the bidder will typically try to co-ordinate the signing of the transaction documents – including those with the procuring authority – and the fulfilment of conditions for the first utilisation under the bank loan agreement, so that all contractual obligations under the project contract with the procuring authority and the other project documents on the one hand, and under the bank loan agreement and the other finance documents on the other hand, become effective on the same date. As part of this process, the interest rate of the bank loan, typically expressed as EURIBOR plus a margin, will be hedged by means of an interest rate swap. On the same date, the pricing of the project contract will be adjusted on the basis of the same or a similar swap rate, eg ISDAFIX.

Once financial close has occurred, the mandated lead arrangers (*MLAs*) will seek to transfer part of their commitments to other banks through a syndication process. The bidder will typically undertake to support this process in its mandate letter with the bank group, subject to pre-agreed final hold amounts which are meant to ensure the ongoing involvement of the *MLAs*. This is considered important because the relationship of the *MLAs* with the bidder and their in-depth understanding of the transaction is expected to be of value if the project faces an event of default at a later time.

In summary, the process of raising a project loan in the German banking market is to a large extent driven by the relationships between the *MLAs* and the bidder. These relationships are helpful in obtaining early commitments and addressing difficulties after financial close has occurred. Bank loans do, however, come at a relatively high price, reflecting high opportunity costs resulting from a long-term commitment when compared with the higher liquidity of a project bond, in particular if the bond is publicly traded on a securities exchange.

#### **(b) Placing a public bond issue**

In contrast to a project loan, public bond financing essentially relies on the liquidity of capital markets for rated debt instruments issued on fairly standard terms. In a typical scenario, it is hoped that this will deliver lower interest rates and longer tenors than are available in the project finance banking market. However, the project company will firstly have to accept the presence of placement risk until financial close, and, secondly, more standardised terms for the debt being raised.

<sup>21</sup> Note that German procurement law requires the appointment of two preferred bidders whenever possible, § 3(6) no. 2 last sentence EG VOB/A.

To initiate a bond offering, the successful bidder(s) will first appoint an investment bank as lead manager. The task of the lead manager is to arrange and provide the underwriting for the bond, but it usually does not provide financing itself. Accordingly, any support letter issued by the lead manager for the purposes of the procurement process will typically be on a best efforts basis only and will not require the commitment of actual funds, as would be expected from a lead arranger of a project loan.

As is the case with the term sheet underlying the mandate of a lead arranger in a bank loan financing, the initial mandate letter of the lead manager will outline the proposed bond terms. However, the focus of the term sheet will be less on contractual requirements and more on market considerations, in particular, the target bond investor market (eg European insurance companies), the marketing strategy (eg early market soundings), target rating (eg A- by Standard & Poor's), target price (ie a target spread over the reference government bond interest rate), listing location, identity of fiscal agent and paying agent, and fee structure.

Although the lead manager may approach potential bond investors at an early stage, any pricing indication at this stage will be subject to rating requirements and market developments. As a general rule, bond investors will not allocate funds on the basis of long-term relationships or project analysis, but will seize opportunities within the matrix of asset classes, yield and ratings. The target pricing for a project bond will therefore be determined by reference to the interest rate for a long-term government bond of similar tenor (as the 'reference rate') and a pricing grid reflecting typical risk premiums (ie spreads over the reference rate) for a range of potential ratings.

In preparation for the bond marketing process, the lead manager will approach one or two of the main rating agencies to obtain an indicative rating for the bond to be issued by the project company, on the assumption that all project contracts have been executed. The assessment of the rating agencies will typically be based on the financial model for the project, an explanation of the transaction structure reflecting the risk allocation to which the project company is subject, the term sheet for the project bond and due diligence reports from legal, technical, insurance and any other relevant advisers. The rating agencies are also likely to require the bond to be issued by a special purpose company. The process from first contacting the rating agencies to obtaining an indicative rating is likely to take between six and eight weeks.

Once (an) indicative rating(s) has, or have, been obtained, the drafting of the bond documentation begins. Besides the contractual credit and security agreements, the documentation will comprise the bond prospectus, which provides detailed information on all aspects of the proposed issue for potential investors. Based on the draft prospectus, the lead manager will market the bond to potential investors in a road show and finalise the pricing, which can now be based on the current interest level – or yield – for bonds with the same rating in the same or a similar asset class. The indicative rating will be confirmed as final once all documents are in agreed form, and issue of the final rating will constitute a condition precedent to financial close.

Financial close usually takes place a week after signing. At this point, the issuer will receive the funds and the issuer's debt obligation arises with the actual bond issue. Following the issue of the bonds and receipt of funds, the project company will also enter into a guaranteed investment agreement or a similar treasury

management arrangement. The purpose of such an arrangement is to obtain agreed rates of return on deposits, thereby hedging interest rate risk on funds that are not immediately applied to project costs and minimising 'negative cost of carry', ie the differential between interest owed under the bonds and the interest received on a time deposit until funds are actually applied to project costs.

If the bond is to be listed on a public exchange, the successful bidder(s) will need to appoint a listing agent (usually the investment bank appointed as lead manager) who will act as the liaison point between the issuer and the relevant exchange. Each exchange has its own listing rules and the issuer will have to comply with the rules of the relevant exchange. Such rules will include the degree of disclosure about the project in the prospectus, risk issues, public display of project and credit documents, a listing fee, ongoing reporting obligations and so on.

### (c) Private placement

The private placement of a bond offers the prospect of striking a meaningful compromise between the respective advantages and disadvantages of a bank loan and a public bond issue (ie with the bonds being listed on a public exchange). Subject to the limitations resulting from banking and capital markets regulation, the bond issuance process can largely be structured to meet the requirements of the individual project and the target investor base. The more tailor-made private placement process does, however, come at the price of lower liquidity when compared with a public bond issue, and this tends to result in higher interest rates. Moreover, early commitments and underwriting will still be difficult to obtain from typical bond investors even in a private placement process. With these qualifications, and in the German market, a private placement may be easier to implement than public bond issues.



## Section 2

### Analysis and solutions

#### 2.1 Timeline

To allow bidders to pursue a bond proposal as an alternative to a bank loan financing, the tender documents should reflect the following indicative timeline:

#### Bank solution

Mandate commercial banks as lead arrangers  
Indicative term sheet and bid submission

#### Private placement bond solution

Mandate investment bank as lead manager  
Information memorandum

#### Public bond solution

Mandate investment bank as lead manager  
Outline of bond terms and lead manager support letter

<i>0 month</i>	<i>0 + 1 month</i>	<i>0 + 2 months</i>	<i>0 + 4 months</i>	<i>0 + 8 months</i>
<p>Prior information notice Contract notice (TED)</p>	<p>Prequalification submissions</p>	<p>Prequalification decision</p>	<p>Invitation to negotiate</p>	<p>Initial bid submission</p>
<p><b>Commentary</b> Transparency of prequalification requirements – see 2.2(a) overleaf</p>			<p><b>Commentary</b> ITN must stipulate evaluation criteria – see 2.2(c)–(e) overleaf</p>	
			<p><b>Commentary</b> Pricing subject to placement – see 2.2(b) overleaf</p>	

		Credit committee approval		Develop credit documents Financial close and syndication
		Pricing and committed underwriting		Financial close and issue bonds; enter into Guaranteed Investment Contracts (GICs) and/or other treasury management arrangements
Rating agency soundings, if applicable			Commence Rating Agency Submissions, if applicable	Develop bond documents Complete rating process and indicative pricing Financial close and issue bonds; enter into GICs and/or other treasury management arrangements; admission to listing if applicable
<b>0 + 10 months</b>	<b>0 + 12 months</b>	<b>0 + 14 months</b>	<b>0 + 22 months</b>	<b>0 + 25 months</b>
Evaluation and clarification	Downselect bidders	BAFO submission	Evaluation and appointment of preferred bidders Notification of unsuccessful bidders Contract award	Signing of project contract
<b>Commentary</b> Evaluation of price adjustment mechanisms, deliverability and bond-or-loan alternative – see 2.2(c)–(e) overleaf			<b>Commentary</b> Evaluation of price adjustment mechanisms, deliverability and bond-or-loan alternative – see 2.2(c)–(e) overleaf	<b>Commentary</b> Placement risk – see 2.2(e)( 2) overleaf

It should be noted that completion of a bond process will typically require more time than a project bank loan financing and that, at the outset of a bond financing process, any bond lead manager may be hesitant to offer firm commitments as to the deliverability of a bond financing. These are commercial issues which the procuring authority must take into account when evaluating the potential economic benefits of a bond financing as part of a procurement strategy.

## 2.2 Procurement law issues

A procuring authority inviting proposals for a bond financing in a German public private partnership will, *inter alia*, have to consider the following procurement law issues, which are likely to arise due to: (1) the requirements of bond investors regarding a bidder's creditworthiness, (2) the later commitment of bond investors when compared to bank commitments under a conventional bank loan, and (3) the differences in contractual terms between the two forms of financing. Since these aspects apply equally to publicly listed bonds and private placement – at least in principle – the two alternative bond routes are considered together for the remainder of this paper.

### (a) Transparency of qualification criteria

Depending on the strength and nature of their banking relationships, not all potential bidders who can raise bank loans for a PPP may be able to arrange bond financing. In particular small and medium enterprise bidders without prior capital markets experience will find it difficult to cope with the administrative requirements of the rating and placement process and may face unfavourable pricing terms. Hence, if the procuring authority intends to take bond financing capability into account in the prequalification process, it must identify the ability to deliver a bond financing as a prequalification criterion in the contract notice published in the TED.

### (b) Pricing subject to placement

Since a project bond will be issued and priced after the initial bid submission, the financing proposal will have to be subject to later price changes at the bond issue stage, unless the bidder assumes full placement risk (which is highly unlikely). Requiring the bidders to absorb pricing changes to the cost of debt (the project bonds) caused by capital market fluctuations over a period of several months might even constitute an undue risk. This could lead to a breach of German procurement law, which generally prohibits the procuring authority from burdening the successful bidder with unquantifiable risks, particularly for works contracts.

German procurement law generally allows for price adjustment clauses as a means to address significant but uncertain changes in underlying factors.<sup>22</sup> Accordingly, indexation of *financing offers for bank loans* in PPPs by means of a reference rate is generally accepted. It has, however, been held that indexation must be proposed *by the procuring authority* in order to ensure comparability.<sup>23</sup> However, mathematical formulae proposed *by the bidders* may be used instead if the procuring authority has sufficient expertise to analyse them.<sup>24</sup> Moreover, risk sharing between the bidder and the procuring authority is encouraged if pricing is subject to market-driven changes after initial bid submission.<sup>25</sup>

<sup>22</sup> § 9 (9) EG VOB/A.

<sup>23</sup> VK Düsseldorf 7.6.2001 – VK 13/2001 – B.

<sup>24</sup> Bekanntmachung der Grundsätze zur Anwendung von Preisvorbehalten bei öffentlichen Aufträgen vom 5. Mai 1972, Abschnitt I.2.f), VHB 2008, Anhang 4.

<sup>25</sup> Bekanntmachung, Abschnitt I.2.d); this specific recommendation can be understood as an exception to the general principle of § 7 (1) no. 3 EG VOB/A pursuant to which the bidder must not be required to assume atypical risks beyond his control.

### Example 1

**Indexation prescribed by the procuring authority:** In some German PPP projects, the tender documents prescribed a debt pricing formula allowing bidders to adjust the price for the financing of the project according to movements in the ISDAFIX2 with an assumed average loan life of eg 10 years, between a prescribed date prior to initial bid and financial close. With a project life of 20 years, this reference rate resulted in a partial assumption of interest rate risk by the public sector if the bidder entered into an interest rate swap at financial close. However, the reference rate would only be an approximation because the loan would never be repaid as a bullet halfway through the project. Even if the tender documents assumed a certain repayment profile, there would still be a strong element of risk for the bidders because bidders remained free to structure their debt financing differently, not all repayment dates would be quoted on ISDAFIX, and actual swap rates could differ in any event.

### Example 2

**Pricing formulae proposed by bidders:** More recently, there has been a tendency to merely prescribe the quotation dates and permit each bidder to use its own interest adjustment formula and reference rates, as long as these are transparent and the quotes are available from public sources. As a result, a greater degree of interest rate movement risk (but also potential savings) has been transferred to the procuring authority. However, even with these procedures an element of risk for the bidders remains because actual swap rates will typically still differ from published mid market rates.

In both scenarios, the margin reflecting the bank debt arrangers' assessment of the credit risk associated with the project and the bidders, will have been committed prior to initial bid submission, subject only to major issues resulting from the due diligence process or from delays to the procurement process.

Against this background, the following solutions may be proposed to accommodate **a bond placement process:**

### Option one – committed pricing formula

In a project bond solution, German government bond yields may serve as a **reference rate** comparable to the ISDAFIX for bank loan financings. Bidders will, however, require further adjustment mechanisms to reflect the fact that bond investors are still unknown when the initial bid is submitted. This is different to a bank solution, where the arrangers will already have committed to a certain margin, reflecting both the project and the credit of the bidders, at the time of initial bid submission. In contrast, bond investors will benchmark the pricing of the project bond against similar investment opportunities only after a rating has been obtained, ie shortly before financial close.

Against this background, a suitable adjustment mechanism for a project bond might be achieved by referring to the average yield of a **defined basket of reference securities**, which would consist of German government bonds and corporate bonds with a similar overall risk profile, such as debt issued by construction companies, property asset managers or logistics providers, as applicable.

### Example

A basket of reference securities for a project bond issued for a German road or accommodation project could consist, for example, of the equally weighted average bond yields of three specific German federal government bonds with terms of 10, 20 and 30 years and three specific bonds issued by construction companies who have in the past participated as bidders in similar projects.

Only debt issued by the bidders themselves would have to be precluded as a reference to preserve the objective character of the formula.

### Example

To avoid a situation where the pricing formula would make reference to a bond issued by a bidder, one or two other corporate bonds issued by similar major construction companies could be added to the basket as fall-backs for the evaluation of bids submitted by the issuers of the primary reference bonds.

If such a basket formula methodology is adopted, the bidders will have to assume the downside of higher actual pricing by providing additional equity but will benefit from a successful placement at a lower interest rate.

#### *Example*

In the downside scenario, the winning bidder may have submitted a bid stipulating a margin of 3 per cent over the reference basket yield. If the actual interest rate for the project bond at placement exceeds the reference basket yield (eg 3.1 per cent), the bidder would have to absorb these additional costs through a lower return on capital. Conversely, a placement at 2.9 per cent above the reference basket yield would increase the equity return.

While bidders will be very reluctant to assume any significant pricing risk on the bond financing, the possibility of a bidder defining the ‘basket’ itself might make this approach acceptable to market participants.

#### *Example*

To reflect the structure and risk profile of the proposed project bond more closely, the bidder might prefer a different weighting of the government bonds, or refer to the corporate bond issued by competitor in its home market rather than to one issued by the typical bidders for a German PPP project.

In a procurement law analysis, the risk-sharing element implicit in the use of a committed pricing formula and the similarity to the established practice for bank loan financing will generally make the use of a committed pricing formula the preferred option.

#### Option two – pass-through of actual pricing

Alternatively, the tender documents may provide that the *actual pricing of the bond* will be passed through to the procuring authority under the project contract which is let to the bidder. This approach will be preferable from the bidders’ point of view because pricing risk is borne fully by the public sector. It is, however, at some risk of challenge under German procurement law because the credit rating of the bidders will have a significant impact upon the actual pricing of the bond. In addition, passing through a still unknown financing cost could cause a conflict with the procurement law principle of transparency.

Against this background, this option (pass-through of actual pricing) appears to be problematic under German procurement law. The procuring authority could try to minimise the procurement challenge risk by having the bond offered as an option to a committed bank loan financing. The committed bank loan would serve as fall-back if the procuring authority considers the actual bond pricing to be unsatisfactory.

#### (c) Evaluation of bond pricing proposals

Whichever approach is taken to price adjustments in a bond financing, it must be reflected in the evaluation methodology stipulated in the tender documents. Developing a rational methodology for any such evaluation requires significant expertise in capital markets transactions, for which the procuring authority will typically have to rely on external advice. With this caveat, the following methods could be adopted:

### Option one – committed pricing formula

If the tender documents prescribe a uniform committed pricing formula,<sup>26</sup> the bond price element of different bids can be evaluated using current market data. In this scenario, future market changes will have the same impact on all bids.

#### Example

If a uniform basket is prescribed, the procuring authority would obtain bond yields for each relevant quotation date and calculate the price adjustment for each bid on the basis of the chosen formula. Since the basket is the same for all bidders, there is no risk that future changes in the respective yields will have an impact on the relative pricing of the bids. Accordingly, no bidder could argue that it had been prematurely excluded from the procurement process due to later changes in bond yields.

The evaluation will require greater financial expertise if bidders are permitted to propose their own formulae. This will be particularly so if they propose their own basket of reference securities: in this case, the pricing of the reference securities at financial close will have to be anticipated in the course of evaluation based on market projections.

#### Example

If each bidder is allowed to define its own basket, the relative pricing may be affected by future events pertaining to securities which have not been included by all bidders with the same weighting in their respective baskets. To identify the most economically advantageous bid prior to contract award, the procuring authority may, in addition to the application of current yield data, apply a factor reflecting different volatility levels applicable to the individual baskets in the evaluation formula.

Even if the tender documents permit wider flexibility in the development of a committed pricing formula by the bidder, a mathematical projection of the pricing to financial close but made at evaluation stage should be possible, thereby ensuring comparability as at evaluation.

### Option two – pass-through of actual pricing

If the financing proposal is subject to actual bond pricing, the procuring authority will largely be limited to a qualitative assessment. The bond will in this scenario be evaluated on the plausibility of the indicative pricing by reference to the proposed placement strategy. To ensure comparability, the evaluation would have to take into account all project-related aspects of the bids that may have an impact on the pricing, notably the target rating and the respective track records of the bidders and their financial advisers in the execution of similar debt capital markets transactions.

To guard against overly optimistic indicative bond pricing or optimism bias, the procuring authority may stipulate that bids containing a margin grid with different pricing ranges for different ratings be evaluated on the basis of the highest interest rate proposed in the lowest rating category. As a final safeguard against optimism bias and based on accepted principles of German procurement law,<sup>27</sup> the procuring authority may preclude any bids quoting an unrealistically low financing price.

#### (d) Evaluation of transaction certainty

Closely related to evaluation of the pricing proposal, but conceptually distinct, is the assessment of the ability of a bidder to actually implement the proposed placement strategy for the particular transaction.

<sup>26</sup> See above for examples, Section 2.2(b) Option one.

<sup>27</sup> § 16 EG (6) (1) VOB/A.

### Option one – committed pricing formula

If a bidder has committed itself to a pricing formula for the bond financing, uncertainty is limited to:

- the creditworthiness of the bidder and the limits of its equity commitment as a means of absorbing the differential between the result of the pricing calculation on financial close and the actual pricing of the bond. Again, the analysis is similar, albeit slightly more complex, than in a bank loan financing; and

#### *Example*

If the creditworthiness of the winning bidder significantly deteriorates between initial bid and financial close, banks may cancel their commitments on grounds of material adverse change.

- the factors affecting transaction certainty that are discussed under option two below, provided that overly optimistic pricing assumptions are less likely if the bidder is absorbing a significant portion of the pricing risk through the committed formula.

### Option two – pass-through of actual pricing

If bids are evaluated on the basis of indicative pricing, but subject to actual placement of the bond, the lack of certainty requires a rigorous transaction certainty analysis to discourage over-optimistic assumptions. Moreover, the fact that deliverability hinges on future factors such as the (indicative) rating and market conditions at the time of placement, means that these aspects will be given a higher weighting within the evaluation methodology than the indicative pricing element of evaluation.<sup>28</sup> In light of the high degree of experience required for such an assessment, the procuring authority will almost certainly have to rely on external advice from capital market experts to evaluate the degree of transaction certainty. Ideally, this assessment should be combined with a pricing proposal calculated pursuant to a mathematical formula, thus arriving at a trade off between deliverability and the cost of financing.

### (e) Comparative evaluation of bond and bank loan financings

The issues discussed in (a) through (d) above are inherent to a bond financing and will arise regardless as to whether the tender documents permit or require a bank loan financing as an alternative. However, the procuring authority will almost certainly want to allow bidders an unfettered choice between bond and bank financing to achieve an optimal combination of competitive pricing and transaction certainty. Since each bid must be evaluated on its own merits, a bond-or-bank process raises particular issues reflecting the different nature of the two instruments:

#### Option one – separate proposals

If the tender documents allow bidders a choice between bond and bank loan financing, the procuring authority will have to develop a transparent and rational methodology to compare and evaluate the two options on a bid-by-bid basis.

In essence, the methodology will have to evaluate and weigh (a) different interest levels (ie cost of the debt, being the interest rate/yield on the debt) against (b) different levels of transaction certainty, and (c) a qualitative assessment of different contractual terms. One of the main challenges faced in the process will be to avoid an unintended bias that can easily result from the description of the evaluation methodology in the tender documents. In particular, the weighting factor and scoring scale for transaction certainty may prejudice the result. Since the evaluation methodology cannot legally be changed over the course of the procurement process, there is very little scope to remedy such a defect once the tender documents have been published.

<sup>28</sup> OLG Dresden 6.4.2004 WVerG 1/04.

If the procuring authority opts for an evaluation methodology which compares transaction certainty against pricing, a bank financing would probably score higher for deliverability but lower for pricing. The situation for project bonds may well be the reverse. If the evaluation methodology is correctly calibrated, it should enable a fair comparison of bank and bond financing options for the particular project by reference to the cost/certainty/contractual terms criteria.

#### Option two – combined proposals

Rather than leaving the choice of a debt financing route to the bidders, the procuring authority may wish to have the option to choose between either a bank loan or bond financed solution following the appointment of the preferred bidders or to move to loan financing if the bond placement at a stipulated threshold pricing fails or appears likely to fail. An approach which would achieve this is to require each bid to include both a bank loan and a bond alternative and to evaluate both alternatives on a weighted basis. The successful bid would be that which is the most economically advantageous judged by the evaluation criteria and based on the weighted combination of the two financing solutions.

Even though there is no precedent, this requirement should be compliant with German procurement law if the weighting factor for the two solutions is stipulated in the tender documents. To avoid discrimination and manipulation, the procuring authority should make a realistic assessment of the probability that it will pursue a project bond solution or a bank solution (it is likely that this evaluation will require support from external advisers experienced in both bank financing and capital markets transactions) and should establish the respective weighting factors on this basis.

#### Example

Where the procuring authority considers that a project bond solution is on balance marginally more likely than a bank financing, it might give a weighting of 55 per cent to the project bond alternative and a weighting of 45 per cent to the bank loan solution.

By weighting the evaluation of the two alternatives in this way, the procuring authority ensures that the successful bid is that which offers the most economically advantageous combination of bond and bank alternatives to meet the realistic requirements of the procuring authority. The disadvantage of this approach is that, when viewed in isolation, neither the bond financed alternative nor the bank financed alternative may be the most economically advantageous for the procuring authority. The advantage of the approach, however, is that where both alternatives carry a weighting which is likely to be material in the evaluation, bidders are encouraged to submit realistic pricing and, thus, identify the most economic solution.

---

## Terms of use for this publication

The European PPP Expertise Centre (*EPEC*) is a joint initiative involving the European Investment Bank (*EIB*), the European Commission, Member States of the European Union, Candidate States and certain other States. For more information about EPEC and its membership, please visit [www.eib.org/epec](http://www.eib.org/epec).

Freshfields Bruckhaus Deringer LLP (*Freshfields*) is a leading international law firm, with over 2,500 lawyers, located across 28 offices, in 16 countries and 17 jurisdictions across the world. Freshfields is a full service law-firm, offering its clients advice on all areas of business law, including M&A, finance, dispute resolution, tax, antitrust and competition law, intellectual property, regulatory and public law, including public procurement law, and real estate. For more information about Freshfields, please visit [www.freshfields.com/en/global/](http://www.freshfields.com/en/global/).

This publication has been prepared to contribute to and stimulate discussions on PPPs as well as to foster the diffusion of best practices in this area.

The findings, analyses, interpretations and conclusions contained in this publication do not necessarily reflect the views or policies of Freshfields, the EIB, the European Commission or any other EPEC member. Neither Freshfields nor any EPEC member, including the EIB and the European Commission, accepts any responsibility regarding the accuracy of the information contained in this publication or any liability for any consequences arising from the use of this publication. Reliance on the information provided in this publication is therefore at the sole risk of the user.

Freshfields and EPEC authorise the users of this publication to access, download, display, reproduce and print its content subject to the following conditions: (i) when using the content of this document, users should attribute the source of the material and (ii) under no circumstances should there be commercial exploitation of this document or its content.



