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Insights

WATCH OUT FOR BASIS RISK – PREPARING AND EXECUTING LIBOR TRANSITION IN UK PPP, INFRASTRUCTURE: GOVERNMENT PUBLISHES GUIDANCE

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SUMMARY

The Infrastructure Projects Authority ("**IPA**") recently published guidance on LIBOR transition and key considerations for both UK PFI/PPP contractors and their financiers in respect of active LIBOR transition.

Whilst this guidance is welcomed, we believe further guidance from the public sector on a number of key considerations would be helpful to promote a uniform approach to, and orderly transition from, LIBOR transition for UK PFI/PPP projects.

Since the guidance was published, the Financial Conduct Authority ("**FCA**") published (on Friday 5 March 2021) a statement announcing the dates of the future cessation or loss of representativeness of all 35 LIBOR settings currently published by ICE Benchmark Administration Limited ("**IBA**"). These LIBOR settings will be referenced in many commercial loans entered into as part of UK PFI/PPP projects. The FCA will consult on requiring IBA to continue publishing one-month, three-month and six-month sterling LIBOR on a non-representative, synthetic basis for a further period after the end of 2021. There will be uncertainty surrounding these synthetic sterling LIBOR until this consultation process has been concluded, so we expect lenders to be proactive with the management of their loan books in light of FCA's statement.

We have pioneered technology-based solutions to help with your organisation's LIBOR transition with BCLP's three-stage approach of Audit, Analyse and Execute – find out more here.
This suggested approach to your LIBOR-linked credit positions can equally apply to non-PPP/PFI infrastructure LIBOR credits.

Introduction

On 8 February 2021, the IPA published *PFI Guidance Note: Discontinuation of London Interbank Offered Rate* (the "**Guidance**"). This helpful guidance is timely as there are circa 700 transactions in the market, the significant majority of which are bank debt financed and LIBOR-linked, and asset managers will be looking to the public sector for indications as to its intended approach to LIBOR (London Interbank Offer Rate) transition (with the deadline currently set at the end of 2021).

Below we set out a brief overview of the contents of the Guidance and follow this with a discussion of the wider issues and key stakeholder considerations that may be relevant to parties to UK PFI/PPP contracts and their financiers.

Guidance overview

In general, the Guidance:

- describes in broad terms the background of the transition from (or 'discontinuation' of) LIBOR (and anticipated transition to SONIA (the Sterling Overnight Index Average)) as a component for interest rate calculations for UK PFI/PPP project debt finance (noting that the coupon/interest on debt for bond-financed projects is unlikely to be based on LIBOR), and for the purposes of related interest rate hedging;

- highlights the broad differences between LIBOR and SONIA (including that SONIA is a backwards-looking measure of overnight borrowing rate rather than a forward-looking term rate and is a (near proxy) risk-free rate which does not incorporate bank credit risk and liquidity premium elements);

- details that, whilst procuring authorities should be aware of the potential impact of LIBOR transition on their relevant projects (including interactions with certain project agreement clauses such as variations, refinancing and compensation on termination), these procuring authorities should not contribute to any costs incurred associated with LIBOR transition and should not mandate any particular cause of action in respect of LIBOR transition (so as to avoid any liability that may be associated with such a mandate causing a qualifying change in law);

- highlights the potential for the FCA to determine UK PFI/PPP contracts as 'tough legacy contracts', which would allow application of a benchmark 'synthetic LIBOR' to the relevant contracts (for a period of up to ten years according to FCA guidelines), and the considerations that would be involved in such a determination; and

- publicises a possible UK PFI/PPP market consultation on LIBOR transition in H1 2021.

Stakeholder considerations

The Bank of England's Working Group on Sterling Risk Free Rates ("**RFR WG**") has given recommendations on sterling LIBOR's transition to SONIA – compounded in arrears, five banking day lookback with no observation period shift, and both the LMA and ISDA are developing documentary approaches around these bases and to address the adoption of SONIA (please note: the current ISDA documentation anticipates a two banking day lookback with observation shift, but see further below regarding '*rate options*').

These are a useful guide and starting point, but the picture for UK PFI/PPPs and infrastructure is in reality potentially much more complex than a 'straightforward' administrative/legal task of switching out LIBOR and in SONIA (and setting up the agency and interest calculation systems necessary to operate SONIA-based loans). There are a number of material considerations for UK PFI/PPP contractors and their financiers, including key issues on which further government would be welcome.

Such key considerations include:

(1) refinancing: whether the public sector believes that LIBOR transition is likely to be considered a refinancing under the relevant project/development agreements (notwithstanding that the relevant contractual provisions should be reviewed on a case-by-case basis), and whether it will publish guidance on this point;

(2) compensation on termination: without a true counterfactual (with LIBOR likely to 'cease' to be published for these purposes, notwithstanding synthetic LIBOR publication considerations), what approach the public sector may take to determining whether the contractual amendments necessary to effect LIBOR transition would increase the relevant public authority's compensation liabilities on early termination; and

(3) non-finance document interest rate calculations: there may be LIBOR-derived calculations within project documents such as late payment calculations that may need to be amended, so reviewing the entire suite of project and subcontract documentation is recommended.

Other material considerations (setting aside the continued smooth operation of the project on the ground) include:

(a) credit adjustment spread: agreeing a commercially acceptable credit adjustment spread with its lenders (i.e. looking to minimise economic value shift): whilst SONIA is an overnight rate and would generally be expected to be lower than LIBOR, it is possible that (for example) the three month compounded SONIA rate is higher than the term LIBOR equivalent on any given date. The RFR WG has recommended the use of a historical five year median spread, but it is ultimately a matter of commercial negotiation (we have seen a variety of commercial practices here including stating a spot value, a rolling historical spread, a historical spread fixed on the agreement date and a spread based on forwards); and

(b) interest rate hedging, intercreditor considerations and timing: there is a risk of mismatch (i.e. basis risk) if LIBOR transition for the senior debt and relevant hedging does not occur at the same time – assuming the adoption of the same risk free rate (and, indeed, where calculation conventions and/or fallbacks are different between the senior debt and hedging – ISDA are now working on a number of 'rate options' which would include those more closely aligning with LMA precedent – the bilateral templates published by ISDA may also be useful in ensuring alignment between senior debt and hedging). These considerations may be particularly important if the senior lenders and their participations do not mirror hedging bank participations (i.e. there are third party hedging banks). Both UK PFI/PPP contractors and financiers should review their financing documents as to hedging programme requirements, existing fallbacks and the ability to close out or novate hedges in the event of mismatch (and the consequences of the same).

Conclusion

The Guidance is welcomed and, if nothing else, shows that the public sector is cognisant of LIBOR transition and how it will be a major hurdle for UK PFI/PPP contracts this year. Further guidance would surely help drive a sector-based approach and would be welcome if the sector is to transition from sterling LIBOR in good order before the end of 2021, especially in light of the recent FCA statement.

We have set out above what we view as some key legal issues – other key issues may be broadly commercial or financial (such as agreeing updated financial models and the continuing, accounting considerations and the appropriateness of compensation for break costs in SONIA-based loans), or specific to the transaction in question.

It is worth noting that there have already been delays announced to most tenors of USD LIBOR (the transition of key tenors being delayed to June 2023), but given the FCA statement, we do not see the same delays in sterling LIBOR transition. However, whilst it might be possible to "kick the can down the road" with synthetic sterling LIBOR, that may be subject to falling within the scope of the tough legacy regime (which is not yet clear). In any event there is no a prospect of cancellation. UK PFI/PPP contractors and their financiers alike should actively consider what steps they need to take to review their financing documents and agree commercial positions early to encourage an orderly transition.

Please do consider BCLP's technology led approach to LIBOR transition… Audit, Analyse and Execute – LIBOR transition is happening fast.

If you have any questions, please do get in touch with Mark Richards or Oran Gelb.

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