

The UK MoD's Skynet 5 restructuring

Edward Berry

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When the Ministry of Defense (MoD) closed the UK's Skynet 5 - the country's largest PFI project of all time - it was immediately apparent that it needed to be bigger yet. And that was what prompted its restructure

A value-for-money, cutting edge refinancing was exactly what the MoD needed to ensure that its decision to expand the £2.5bn Skynet 5 PFI scheme paid off - and it wasn't disappointed.

Soon after the close in 2003, the MoD entered into talks with the scheme's preferred bidder - Paradigm Secure Communications - about increasing the ministry's network of military satellites.

Changes to the commercial insurance market meant that under the framework of the original deal - which entailed the design, construction and maintenance of two satellites (Skynet 5A and 5B) - there were doubts over whether it was viable to insure the twin-satellite network.

In response to the MoD's request, Paradigm and EADS Astrium and a host of the industry's big players in the banking, legal and consultancy fields masterminded the £1.6bn (US\$2.8bn) Skynet 5 restructuring deal.

Innovation and flexibility - together with huge savings from insurance costs - formed the backbone of the scheme, which not only entailed the provision of a third satellite (Skynet 5C) but included the partial construction of a fourth (5D).

Background

The principal aim of Skynet 5 - which is currently being delivered on time and on budget - is to provide the MoD with global secure satellite communication services and replace its existing Skynet 4 Stage 2 system.

Skynet 5 has a capacity some 2.5 times greater than the existing system and will provide a range of services, including global mobile voice communications, video conferencing, multimedia-based communications and broadcast communications.

More importantly for the MoD, it will deliver the next generation of military satellite communications services to support UK peacekeeping and military operations.

Under the framework of the original deal, it was funded using a debt financing with bank syndication. The syndication for the £963m (US\$1.82bn) 12.5-year term bank debt was originally over-subscribed by more than 300 per cent and some 30 international banks participated in the deal arranged by BNP Paribas, CIBC and HSBC.

At the time, the programme marked a change of approach in the UK from traditional defence procurement methods to a services-based contract.

Defence procurement minister Lord Bach said that the PFI had allowed the project to make 'substantial savings' of around 4 per cent - £100m (US\$1.89bn) - of the whole life costs of a conventional acquisition, while providing the same capability and greater flexibility.

The majority of satellite construction is being done at the UK towns of Stevenage and Portsmouth, in Kent and Hampshire respectively. Skynet 5A is scheduled for launch in the second half of 2006 while 5B is slated for take off in 2007.

Restructuring rationale and project details

The restructuring of Skynet 5 was prompted by overpricing in the commercial satellite insurance market.

Uncertainties about the extent and cost of available insurance cover throughout the entire contract period - rumoured to be 15-20 per cent of the cost of building the technology - led to the MoD re-evaluating the optimum risk mitigation strategy, to increase robustness and achieve best VFM.

Rather than dig deep for the insurance - which was due to be paid this year - the MoD decided it would get greater VFM by building a third unit and partially constructing a reserve fourth satellite, thereby negating the need for insurance by providing one-and-a-half back-up satellites.

Freshfields partner Nick Bliss explains the rationale behind the project's restructuring: 'The fundamental premise on which the restructuring was based was the switch from financial insurance for various space-related risks to a physical assurance strategy - a spare satellite.'

'Through a resulting combination of Paradigm savings on insurance premia and an extension to the MoD service period, increased communication assurance is delivered to the project, to the MoD and to third party nation states and NATO.'

In order to maintain the assurance strategy of having three satellites in orbit, the fourth satellite would only be completed and launched in the event that any of the first three satellites fail once they were in orbit.

EADS - which used Arianespace for the first two launches - will use the firm to launch Skynet 5C in 2008 from the Guiana Space Centre, Europe's Spaceport in Kourou, French Guiana.

The Skynet 5 satellites will be built by EADS, weighing in at around 4,700kg at launch.

Paradigm - a subsidiary of EADS SPACE Services - signed an amendment with the MoD to extend the 15 year Skynet 5 deal from 2018 to 2020 on 19 December 2005.

Six firms will work alongside Paradigm to deliver the scheme including:

- EADS Astrium - prime contractor to Paradigm and manufacturer of satellites
- LogicaCMG - development and operation of the Skynet Management System
- Serco - network and facilities management services
- General Dynamics Decision Systems - will manage the new Iridium services and organise their integration and life cycle
- Cable & Wireless - will provide Paradigm with tailored communications solutions include satellite, VSAT (Very Small Aperture Terminal) and bandwidth services to fulfill the requirements of the Skynet 5 programme
- Cogent Defence & Security Networks - will supply secure end-to-end communication solutions
- Stratos - will provide secure, reliable Inmarsat services

The new agreement will not only provide the potential for other customers to benefit from increased coverage and

capacity but the three satellite constellation will mean better performance, more efficiency and longer services availability.

When comparing the common 15-year baseline periods of the old and new deals, the Ministry has incurred no extra cost increase.

An MoD spokesman said: 'We are getting an extended capability for the cost and that is important for our armed forces.'

'Furthermore, the extended constellation life allows us to defer the Skynet 5 replacement programme (Skynet 6), making it possible to use the money available for the replacement to pay for the two or three year extension.'

The transaction

Citigroup and Goldman Sachs acted as co-managers, bookrunners and underwriters on the restructuring of the £963m senior debt facility into a £1.34bn (US\$2.8bn) capital market transaction. Dexia and Eurohypo are participant banks.

The total project financing is £1.6bn (US\$2.8bn) and EADS and its subsidiaries have a 15 per cent equity share in the project worth £266m (US\$466m). The original £963m project finance facilities made available in October 2003 have been repaid.

The main aim of the two lead managers was to create a refinancing facility that optimized the cost of debt, through protecting investors from project risk and maintaining a degree of flexibility over the extended 17 year period.

An innovative refinancing package was established around a firm Master Trust structure which involves Paradigm settling on trust its rights to receive income from the MoD and selling part of its interest in the trust to an SPV issuer (Satellite Financing) in return for the proceeds of bonds.

This securitisation was structured to attract a zero risk-weighting for investors: the bonds - which were sold to public sector participants - are unrated, unwrapped and have a floating rate risk, which was fixed through a derivative structure.

Unlike the majority of bond financed PFI projects, the Skynet 5 refinancing avoids issuing all notes up front at the start of the scheme, instead favouring the release of notes in three separate tranches, in a measured but flexible way, allowing for changes in the timing of project milestones. Investors were also committed to taking down forward purchase bonds at the same price as the initial tranche.

The first tranche of floating rate bonds totaling £186m (US\$327m) was released immediately on reaching financial close.

The second and principal tranche of £979.5m (US\$1.7bn) forward purchase notes will be issued as and when relevant project milestones are reached, again protecting investor interests as delays in the scheme do not affect their investments.

Allen & Overy's David Lee explained that this trigger approach - which strays from the normal practice of issuing bonds on hard deadlines - breaks new ground in PFI, and could well be the basis for many transactions in the future.

There is added security for investors in the form of the MoD termination payment: the total amount of the forward purchase note tranches equal the amount of guaranteed termination compensation payable by the MoD on reaching landmarks.

The transaction has been structured so that the termination payment will, in all circumstances be sufficient to repay principal, accrued and unpaid interest and prepayment amounts on the notes. The payment cannot be reduced as a result of any failure or negligence by Paradigm or EADS.

As a result of this MoD safety net, there is a positive pricing impact on the notes - 6bps over one month Libor.

A final batch of forward purchase enhancement notes worth £178.4m (US\$313.3m) will be made available should the fourth satellite need completion and launch. The bonds will be cancelled if that situation does not arise.

Burges Salmon acted for the Ministry of Defence, A&O acted for Citigroup and Goldman Sachs. Freshfields acted for EADS NV and Lovells advised EADS Astrium. Deloitte and Morgan Stanley provided financial advice for the MoD.

Conclusion

By taking the bold decision to extend the UK's largest PFI by two years, the MoD has not only increased the capacity of its global secure satellite communication services in a cost-efficient manner, it has created a project that will provide it with increased assurance through reduced risk.

As an MoD spokesman rounded up: 'This restructuring is to make a good deal even better and demonstrates the proactive risk management approach that underpins Smart Acquisition. We mitigate risk, obtain extended capability and operational resilience; and the company gets continuity of work.'

The parties involved in pulling together this pathfinder project have every right to be pleased with themselves. It is a fine example of innovation in the world of project finance, effectively slashing the investors' risk exposure and tee-ing up a degree of back-up that can only be achieved by having a half completed replacement model sitting in the garage.

As with most pathfinders, it will be interesting to observe how many times in the coming years this structure will be wheeled out to get projects off the ground, though it remains to be seen whether they will attain the altitudes of the Skynet satellites.

Project at a glance

Project Name	Skynet 5 Restructuring
Location	The sky
Description	The restructuring of the £2.5bn Skynet PFI entails the provision of a third satellite and the partial construction of a reserve satellite
Sponsors	European Aeronautic defence and Space Company EADS and subsidiary Paradigm Secure Communications.
Operator	Paradigm Secure Communications.
EPC Contractor	EADS Astrium
EPC Sub Contract 1	LogicaCMG
EPC Sub Contract 2	Serco
EPC Sub Contract 3	General Dynamics Decision Systems
EPC Sub Contract 4	Cable & Wireless
EPC Sub Contract 5	Cogent Defence & Security Networks, Stratos
Project Duration (Including construction)	17 years
Construction Stage	3 years
Total project finance value	£1.6bn
Total equity	£266m
Total senior debt	£1.34bn
Senior debt breakdown	Three tranches to be released after certain project milestones : 1. £180m 2. £979.5m 3. £178.4m
Bond Pricing	6bps above one month libor
Debt:equity ratio	85:15
Mandated lead managers	Citigroup (Underwrote £670m) Goldman Sachs (Underwrote £670m)
Participant banks	Dexia, Eurohypo
Legal Adviser to sponsor	Freshfields Bruckhaus Deringer (EADS NV) Lovells (EADS Astrium)

Legal adviser to banks	Allen & Overy
Legal adviser to government	Burges Salmon
Financial adviser to government	Deloitte & Touche/ Morgan Stanley
Date of financial close	15 December 2005

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