PARA BELLUM ADVISORS

PROJECT FINANCE · OPERATING PHASE

Floating Rate Basis Risk – Operating Project Debt

SCENARIO TYPE	Project Finance – Operating Phase
ASSET CLASS	Transport Infrastructure (Toll Roads, Regulated Utilities, Availability-Based Assets)
RISK FOCUS	Interest rate basis mismatch between debt resets and hedge benchmarks
PRIMARY OFFER	Hedge Rebuild™
RELEVANT SERVICES	Hedge Rebuild™ · Basis risk analysis and redesign · Hedge effectiveness review · Counterparty novation

THE SITUATION

The financing closed five to eight years ago. A mature operating asset – toll road, regulated utility, availability-based infrastructure. Long-dated floating-rate project debt referencing 3-month BBSW. Vanilla receive-floating / pay-fixed interest rate swaps against the same benchmark.

At the time, the structure was orthodox. Lenders were aligned. Documentation was clean. Interest rate risk was considered dealt with at financial close and left to run.

The assets performed broadly as expected. Traffic or usage tracks forecast. DSCR ratios are healthy. There is no financial stress and no obvious reason to revisit decisions made years earlier.

The embedded assumption is simple and rarely articulated: the benchmark underpinning the debt and the hedge will remain aligned for the life of the asset. That assumption holds – until it doesn't.

HOW THE TRAP FORMS

The trigger is rarely a market shock. It usually starts as an administrative change – a lender consolidates loan books; a facility amendment is proposed. A modest margin reduction is offered in exchange for moving from 3-month to 1-month BBSW resets.

The change is positioned as neutral or slightly beneficial. Lower margins. More frequent resets. No change to notional. No change to hedge documentation. Treasury signs off. External structuring input is rarely sought because nothing obviously financial has changed.

Then the rate cycle turns. Short-dated benchmarks reprice faster than term averages. The loan resets higher and sooner. The hedge continues to reference a slower-moving index. What was assumed to be fixed-rate exposure has quietly become structurally floating.

Over successive quarters, leakage compounds. Cash interest drifts away from the profile modelled at close. Hedge effectiveness weakens. The project is fully hedged on paper. Cashflows do not behave that way.

WHAT TYPICALLY BREAKS

Economic exposure is underestimated

Initial internal analysis looks backward at realised basis differences and concludes the cost is manageable. What it misses is the forward curve – in volatile rate environments, divergence is already embedded in market pricing and persists for as long as the structure remains misaligned.

The existing hedge is more valuable than realised

Legacy swaps executed years earlier often sit at fixed rates no longer achievable. Breaking or replacing them crystallises value destruction through settlement payments, loss of favourable fixed rates, and adverse accounting consequences.

Hedge accounting fails under strain

Once reference indices diverge, effectiveness testing becomes increasingly difficult to support. The result is earnings volatility disconnected from operational performance and growing tension between finance teams, auditors, and boards.

Standard bank response transfers value away

The default solution – unwind and replace with a new aligned hedge – transfers embedded value to the bank, locks in materially higher fixed rates, and introduces new fees. It resolves the index mismatch while worsening the economics.

THE STRUCTURAL INSIGHT

The starting point is not the hedge. It is the constraint set: the existing swap book contains meaningful embedded value; the debt structure cannot be destabilised; management can no longer tolerate unexplained volatility.

The first step is diagnostic. The debt and hedge stack must be decomposed properly – which exposures are contractual versus behavioural, where benchmark risk genuinely sits, how much variance is structural rather than transient noise. Until those are isolated, redesigning the hedge is premature.

The second principle is preservation. Legacy swaps are often the most valuable component of the structure. The objective is adaptation, not replacement – reshaping how the hedge interacts with the liability without forfeiting embedded value.

In practice, this usually involves layering rather than tearing down. Targeted basis overlays can convert the effective benchmark of the existing fixed position without touching its core economics. Making basis exposure explicit is itself a structural improvement – once isolated, it becomes measurable, bounded, and governable.

INTENDED OUTCOMES

- Visibility restored – what previously appeared as unexplained leakage becomes an identifiable, bounded component of the capital structure.
- Interest expense stabilised – the asset once again behaves like an operating project with largely neutralised rate exposure rather than one that appears partially speculative.
- Embedded value preserved – improvements in alignment do not come at the cost of crystallising losses or surrendering favourable economics locked in years earlier.
- Governance friction removed – basis risk ceases to be a recurring source of tension between treasury, asset management, and senior decision-makers.
- Optionality regained – refinancing, extensions, or asset sales can be approached on the project's terms rather than the market's.

WHERE THIS APPLIES

Most relevant where operational assets carry medium-to-long-dated floating debt; hedges reference different benchmarks or reset mechanics; refinancing or asset sale optionality matters; and small mechanical differences can compound over long periods.

Generally, less relevant where debt and hedges are benchmark-matched and reset-aligned, assets are short-dated or approaching maturity, or interest costs are immaterial to overall value drivers.

TYPICAL ENGAGEMENT PATH

Hedge Rebuild™ – Basis risk analysis and hedge realignment. Secondary: Basis overlay design, counterparty novation, hedge effectiveness review, documentation continuity. Scope confirmed following a focused diagnostic review.

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Illustrative scenario based on common operating-phase project finance patterns. Details have been anonymised. Outcomes depend on hedge structure, counterparty documentation, market conditions, and accounting constraints. Not investment advice.