

Financing Local Public Services

Turin, 13th of September 2013
Lars Anwandter

Agenda

- Local public services
- Financing options
- The importance of regulation
- The borrowers
- Public finance
- Corporate finance
- Project finance / PPP

Local Public Services

Sectors

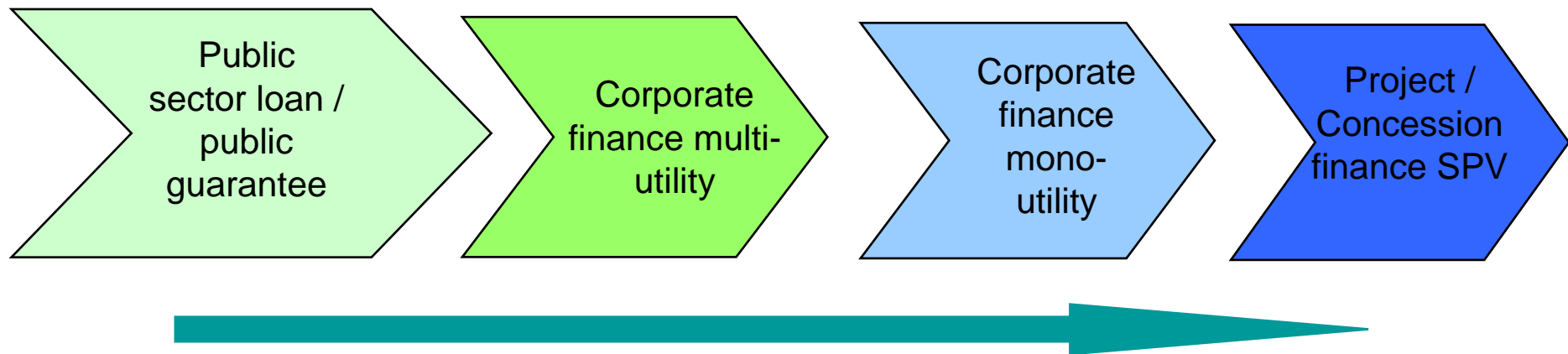
- Water and wastewater: capital intensive, political influence
- Solid waste collection: less capital intensive, local
- Electricity distribution: good cost recovery
- Gas distribution: good cost recovery
- Local public transport: need for high subsidies, demand and construction risk (e.g. Tramway of Mestre and of Florence)

Some key issues

- Natural monopoly , concession based
- Full service coverage, accessibility
- Social affordability issues
- Environmental sustainability, externalities, public good nature
- Economies of scale / of density

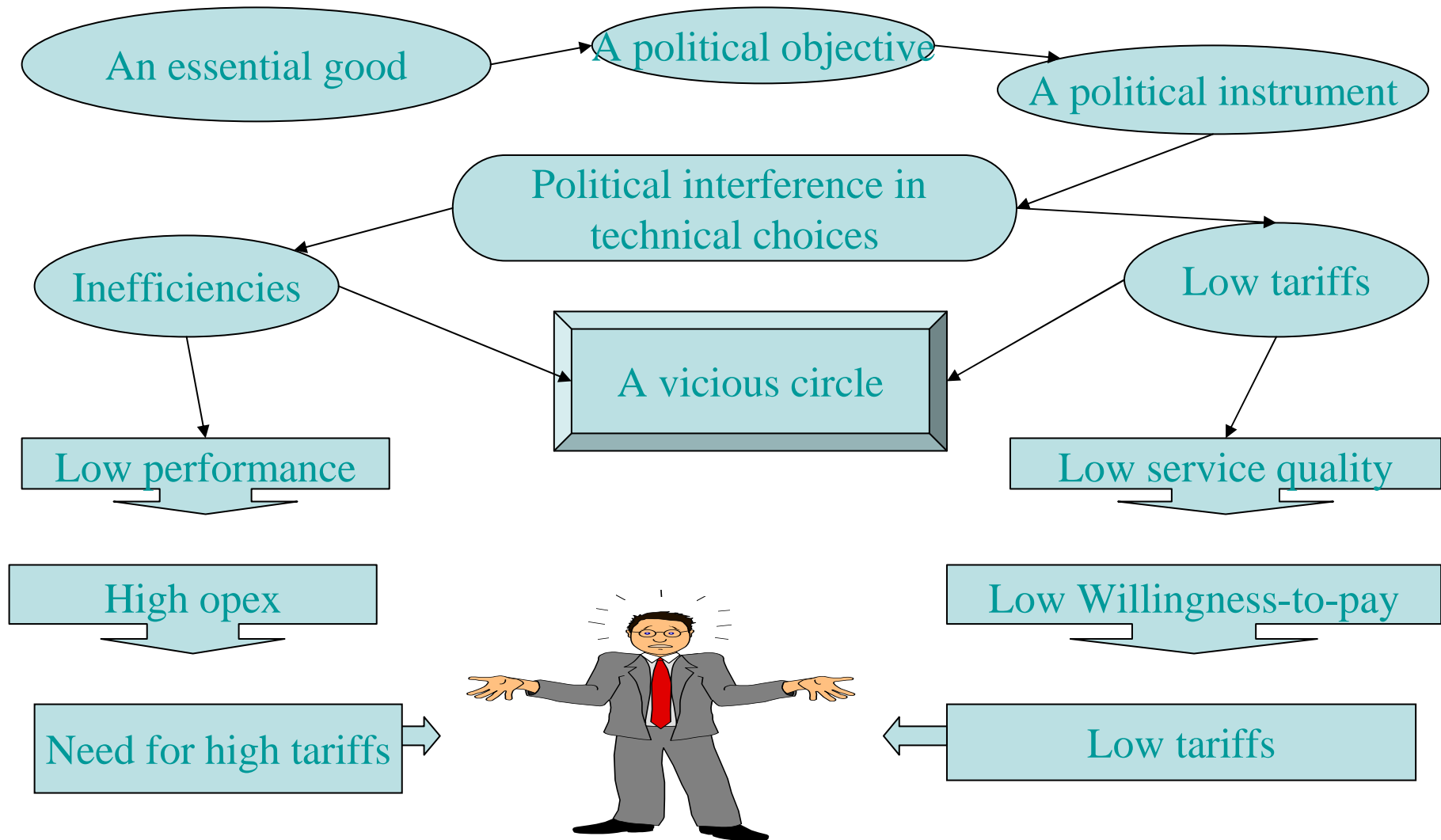
Financing options

1. Taxes
2. Trainers
3. Tariffs: Debt + Equity resulting in WACC

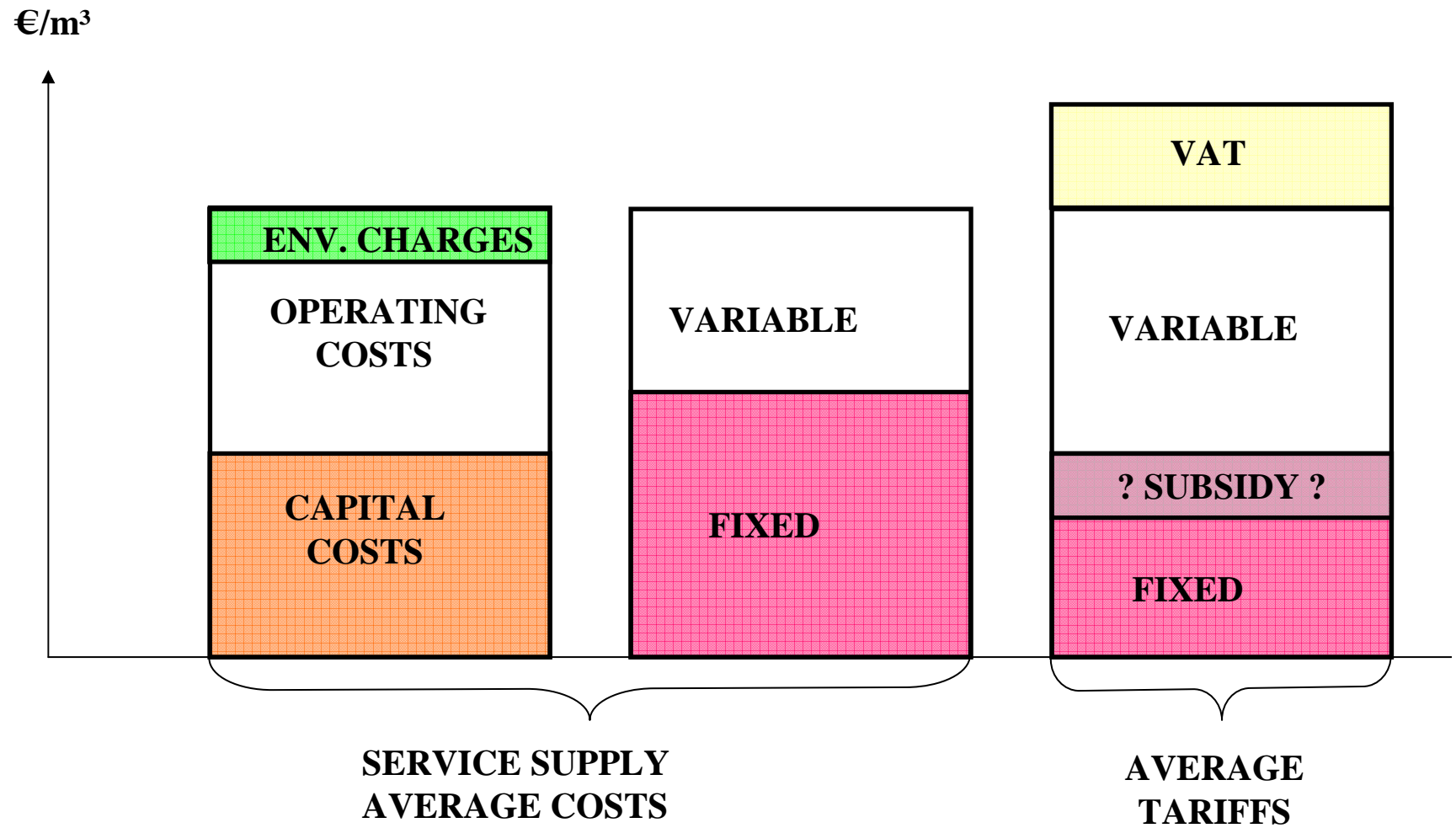


Increase risks / pricing

The tariff dilemma

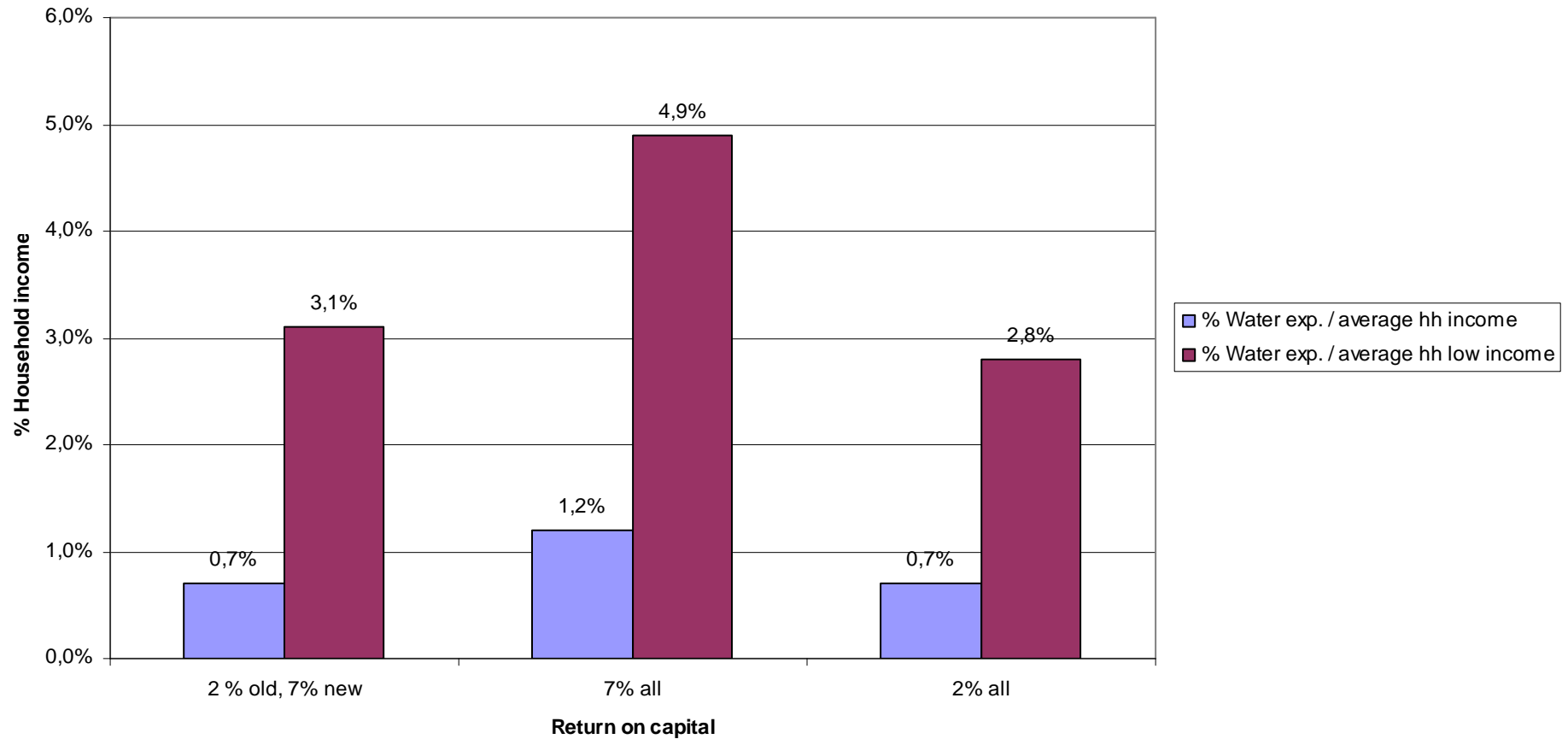


Cost recovery



The impact of capital on user charges

Effect of Return on capital on water tariffs (Lombardy region)



Source: Prof. Massarutto, « La legge Galli alla prova dei fatti »

The importance of regulation

Regulation is crucial in « natural monopolies » to protect consumers and stimulate efficiency among service providers. The cost of regulation is likely to be small compared to its benefits (e.g. lower cost of capital).

Some key issues

- Autonomous regulation or dependent from government?
- National regulatory agency or regulation by contract / concession ?
- Cost-plus vs. Price cap?
- Level of depreciation and degree of return on capital?
- Degree of informational asymmetry?

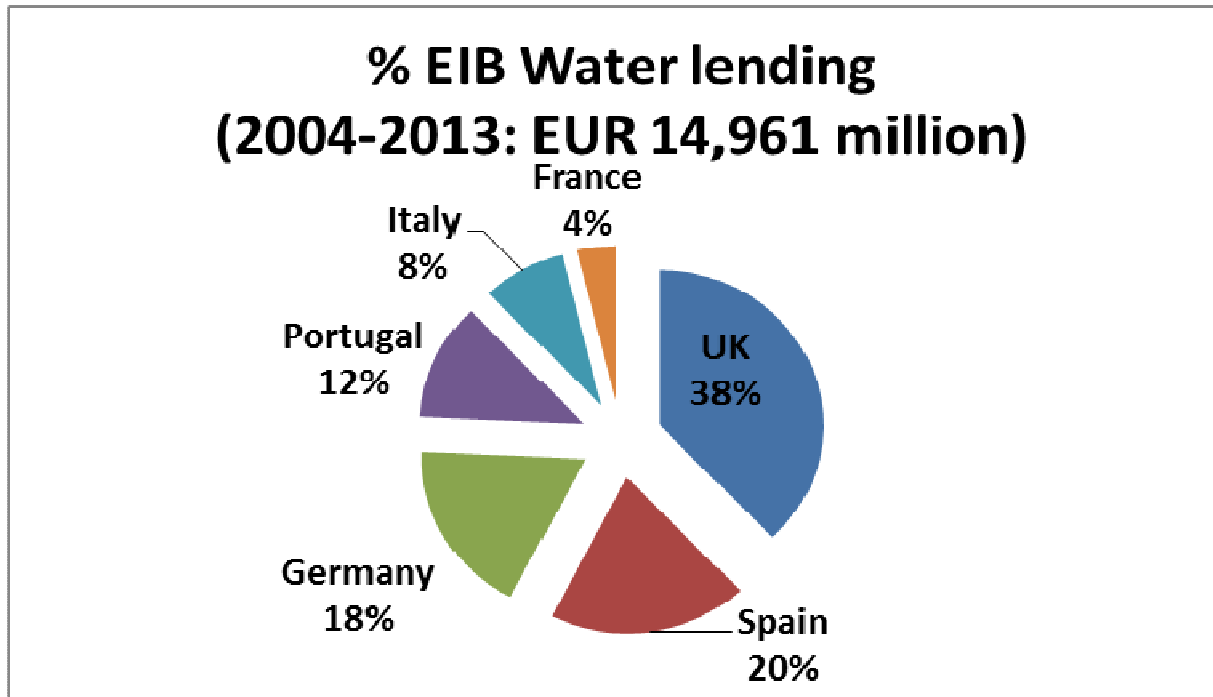
The types of regulation

Regulation	Regulated monopoly « UK model »	Delegated operation « French model »	Local public enterprise « German model »
Ownership	Private	Public	Public
Operation	Private	Leasing / Service contracts	Private law public companies
Private sector risks	Investment + Operations	Market (part) + Operations	Not applicable
Public sector risks	Regulator takes market risk	Investment risk (e.g. Agences de l'Eau)	Full cost recovery

Source: Prof. Massarutto, « La legge Galli alla prova dei fatti »

A clear risk allocation among public and private counterparts is crucial

The results of good regulation



- UK: regulation with good track record, private corporate companies
- Spain: corporate and public lending
- Germany: public companies, high tariff levels (e.g. Berlin)
- Portugal: solid regulation, high level of concentration, public sector guarantees

The ownership dilemma

Key questions

- Does public vs. private ownership of assets matter?
- Are private companies more efficient?
- Do private companies invest more?
- How can competition be introduced: competition for the market vs. in the market? Could competitive benchmarking / yardstick competition be useful?
- What are advantages and disadvantages of separating public asset ownership from private operation?

The borrowers

Key creditworthiness criteria:

- The clarity and stability of the regulatory framework
- Multi- or mono-utility (economies of scope)
- Size (economies of scale/density)
- Track record / experience
- Rating level or non-rated



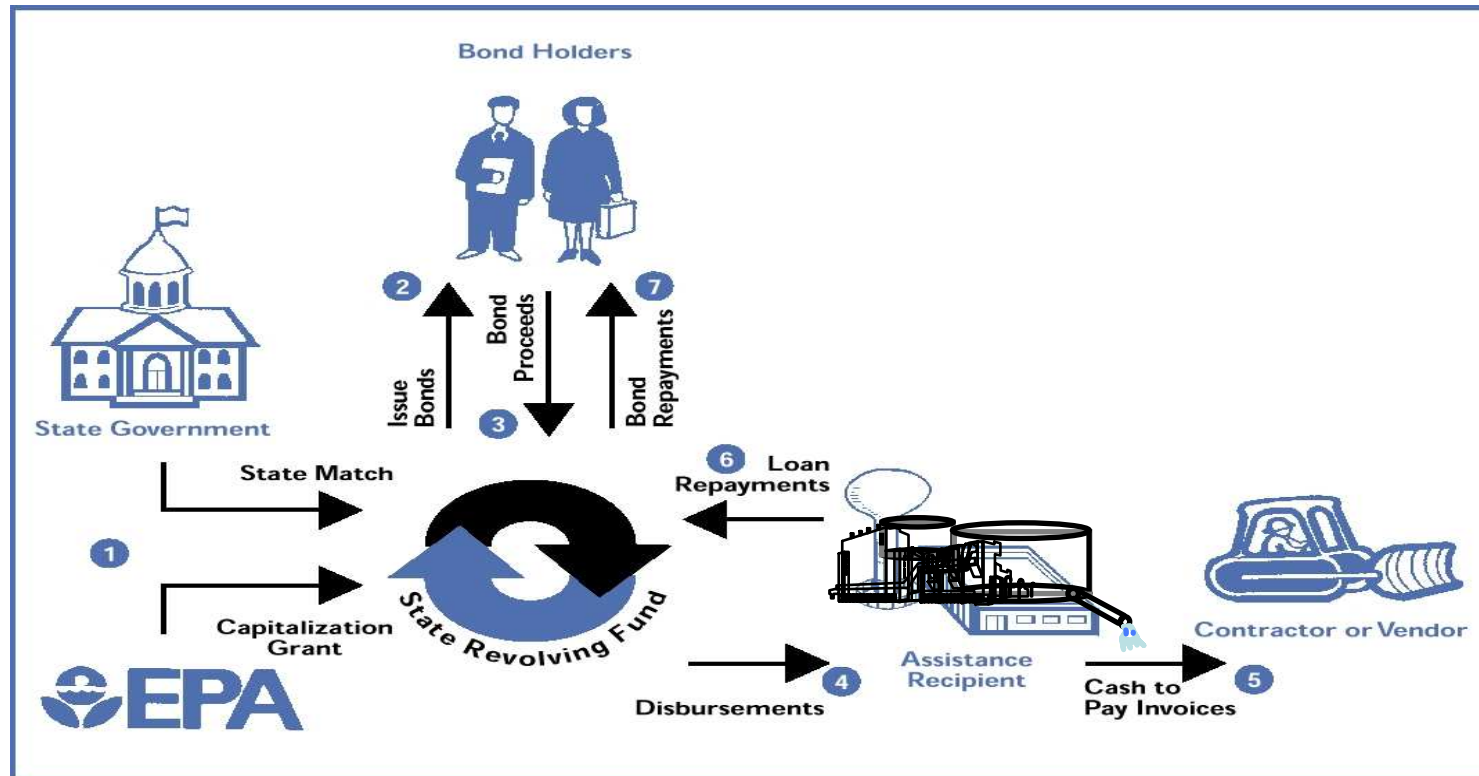
Public vs. Private ownership should not matter

A predictable and stable cash flow (from water or other businesses) is key

Examples of water sector operations in Italy

Operations	Loan	Public	Bank	Corporate	Project Finance
Nuove Acque Arezzo (2004)	44 milioni		X		X
Smat Torino (2007&2008)	210 milioni		X	X	
Irisacqua (2007)	50 milioni		X		X
Enia (2008)	100 milioni			X	
Acea Idrico Roma (2008)	200 milioni			X	
Acq. Veneto Centrale (2009)	88 milioni	X			
Idrico Toscana (2010)	51 milioni	X			
Trento Trattamento (2012)	60 milioni	X			
Acquedotto Pugliese (2012)	150 milioni	X		X	

Public financing mechanism: example USA



Source: EPA/ Michael Curley, 2004

Leverage public funds through bond emissions

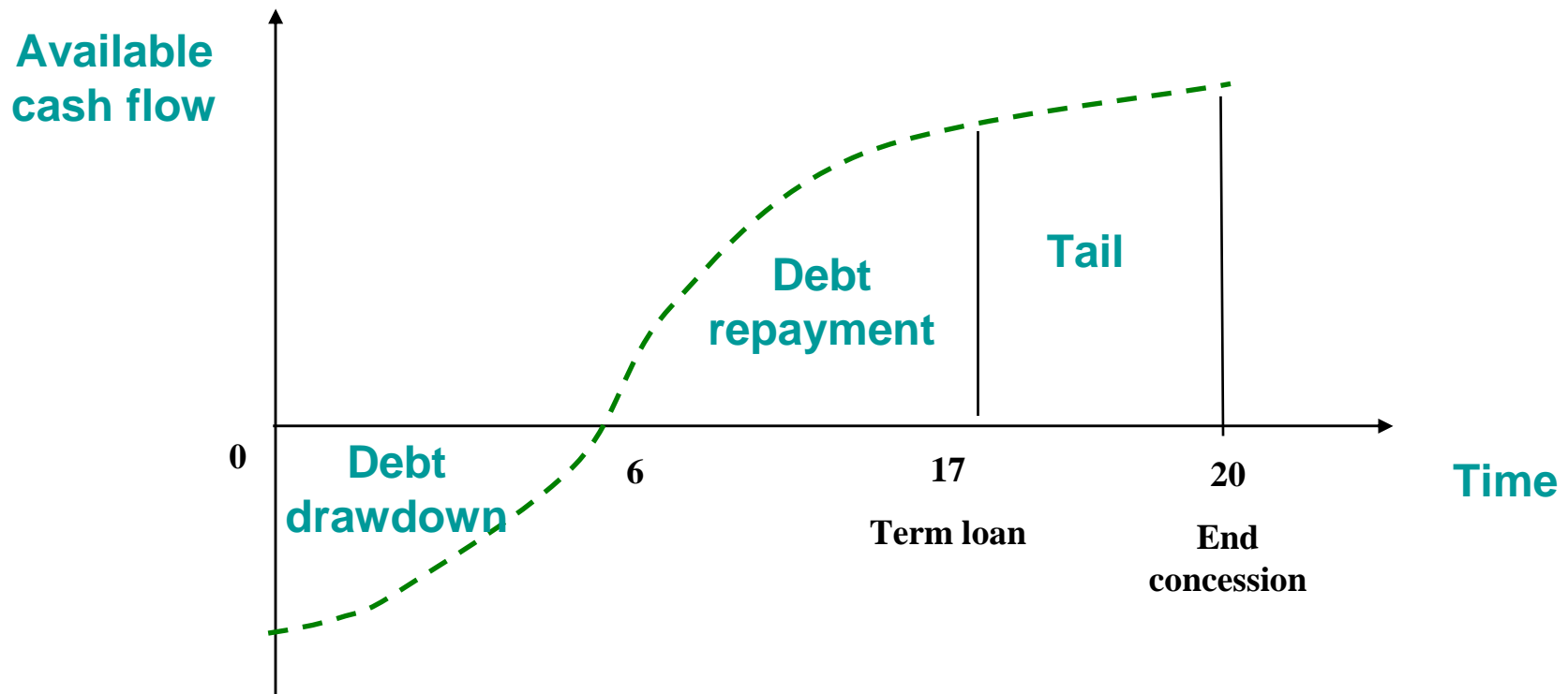
Corporate finance: Rating levels

Financial ratios	BBB- (example)
EBITDA / interest expenses >	4.5x
Debt / EBITDA <	4.0x
Debt / Equity <	1.6x

In addition to the regulatory framework, the **financial ratios** are key rating parameters, as well as the **debt structure and average life**

Project finance: Cash flow based

Example: Long availability period (6 years) and 3 year tail



Advantages: Tailor-made, high leverage, long term

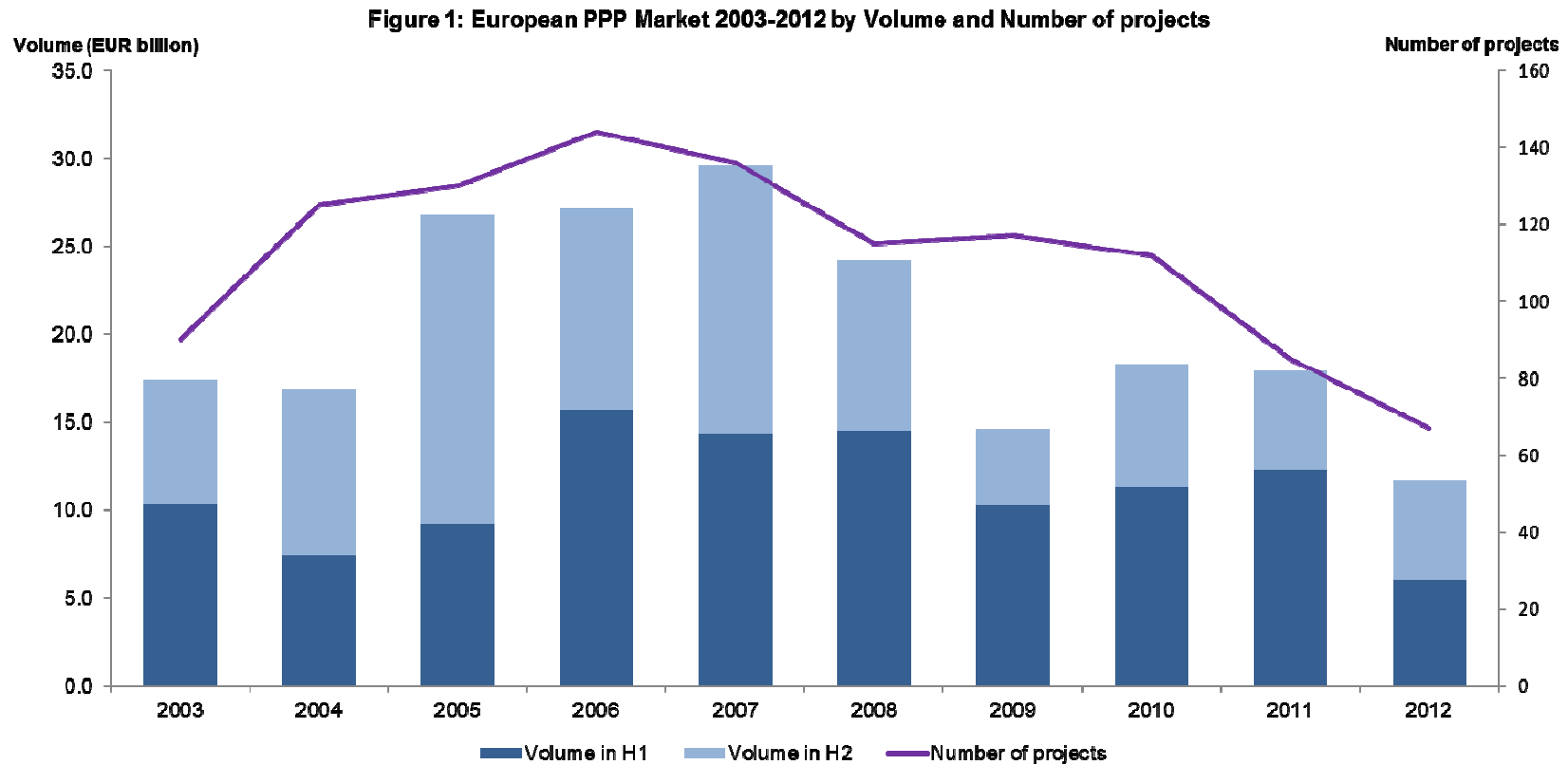
Needed: Certain size, water-tight documentation, risk allocation, DSCR, LLCR

The risk allocation in a Concession

Key questions

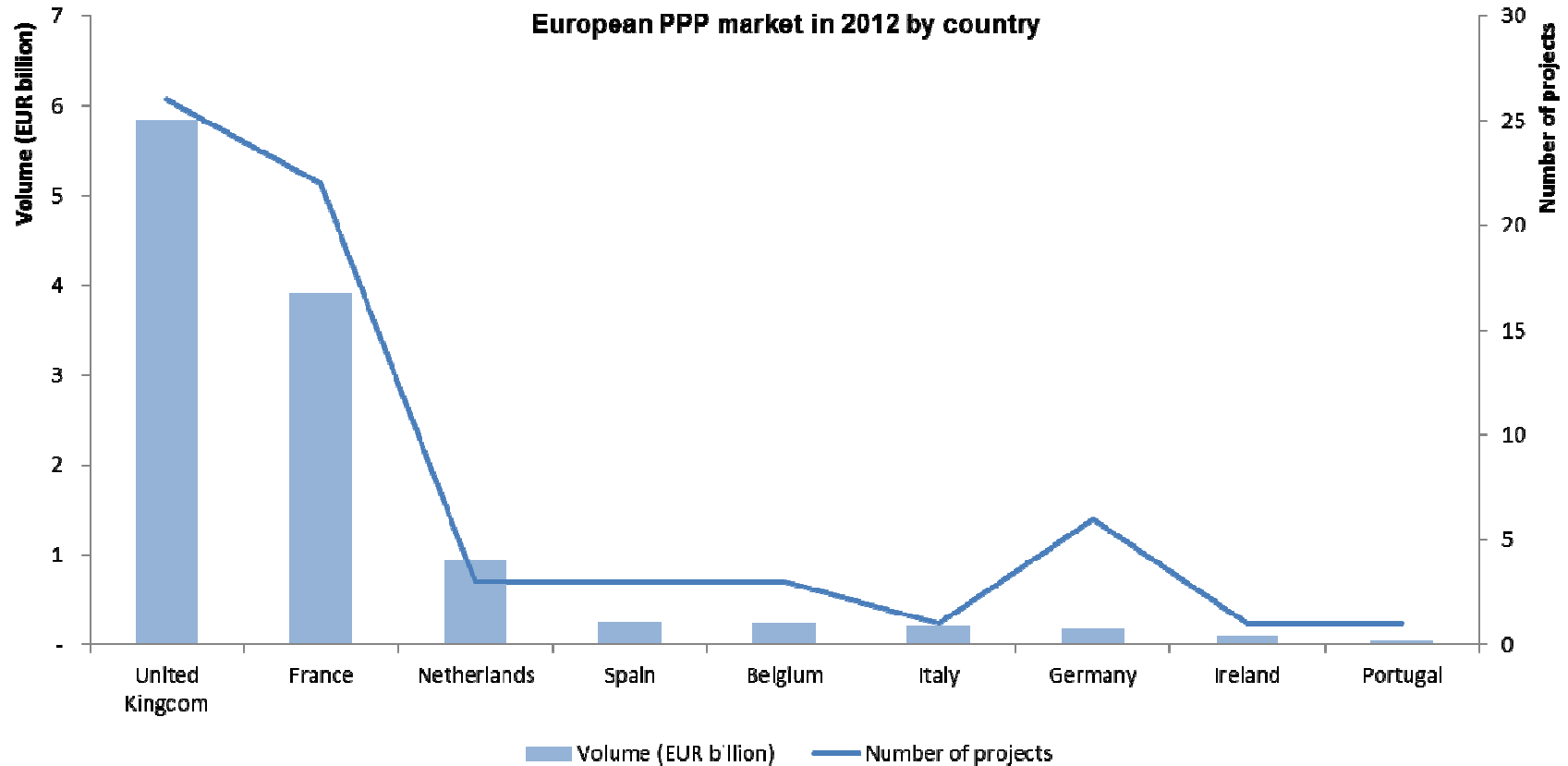
- List of events / risks in a Concession that allow financial re-balancing: is it a closed or open list?
- How is the economic and financial balance defined / ensured in case of the above events: mechanism / timing?
- Do parties share the same financial model / financial ratios?
- What happens in cases of force majeure?
- What happens in case of early termination of the Concession?
- Who is in charge of paying the termination indemnity?

The EU PPP Market



67 PPPs reached financial *closing* in 2012, for a value of EUR 11,7 Bn (the lowest level over the past 10 years).

PPP by country



Only one large PPP (cost > EUR 50 m) in Italy for EUR 212 m.
There is a high mortality rate of PPPs.

Mestre Hospital PPP



- Concession of 29 years to build and operate a hospital with 630 beds (total cost EUR 230 m, senior loan EUR 130 m)
- 18 months to reach financial close (32 months after the concession award)

Mestre Hospital

- **Project finance**, greenfield, availability based, 100% private SPV
- The EIB took **operating risk post-construction**
- **Economic and financial balance**: a model concession was developed with the national PPP Unit
- Conceding party risk: **ASL=Region**

Lessons learned from Mestre

- **«Value-for-money»**: importance of regional planning
- **Earlier involvement of banks**: a lot of time was needed to clarify risk allocation
- **Ensure risk pass-through and management**: detailed service contracts and management of interface risks
- **Evaluate start-up of operations and life cycle costs**: transfer plan from old hospital and define replacement needs of machinery (MRA)
- **Financial sensitivities**: cap on penalties to ensure stable cash flows
- **Termination**: step-in rights and amount of termination payments due

Financing of waste sector

Some issues

- Does an overall local waste management plan exist and how is it being implemented?
- Separate financing of capital intensive part (e.g. waste-to-energy plant) from labour intensive part (e.g. waste collection)?
- Corporate or project finance operation?
- Where does cash come from: retail, industry, energy?
- How is tariff structured and how are tariff collection rates?
- Are environmental permits in place?
- Have environmental compensations been defined?

Financing of Waste-to-Energy Plant in Turin

Key factors of Project Finance operation

- High level of expertise and professionalism of **project promoter**: 100% public company
- Permits and public participation issues were solved: technically the project was very well defined and accepted by the population
- Project promoter was assisted by **financial advisor**
- Cooperation **by regulatory authority** (local regulator)
- Clear and detailed **concession contract** with balanced/fair risk allocation
- Agreement on **financial model and financial rebalancing** mechanism
- Preparation ex-ante of **waste conferral** and **energy sale** contracts
- Support by **main shareholder (city of Turin)** for events beyond the control of project promoter/banks

Conclusions

- **Regulation is a crucial aspect in financing public services, good regulation reduces WACC and increases leverage**
- **Public and Corporate Finance operations are more straightforward; Public finance has lower cost**
- **PPPs require strong public sector and good judicial system**
- **Private equity requires stability and high returns (mainly brownfield)**
- **Public funds/ transfers can be used to keep tariffs affordable**
- **Revolving public funds may be used to leverage private funds, e.g. by covering certain risks that are not taken by private parties**

Questions?

