Financing Local Public Services

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Agenda

- Introduction: Local public services
- Financing options, cost recovery and the tariff dilemma
- The importance and types of regulation
- The borrowers and the owneship dilemma
- A mix of public and private finance
- Corporate finance and rating levels
- Project finance / PPP and the risk allocation in a Concession
- Two examples:
  - Project Finance for Waste-to-Energy Plant in Turin
  - Finance for small and medium sized water companies in the Veneto region
- Conclusions

Local Public Services

Sectors

- Electricity distribution
- Gas distribution
- Local public transport
- Water and wastewater
- Solid waste collection

Different levels of capital intensity, cost recovery through tariffs, need for public money

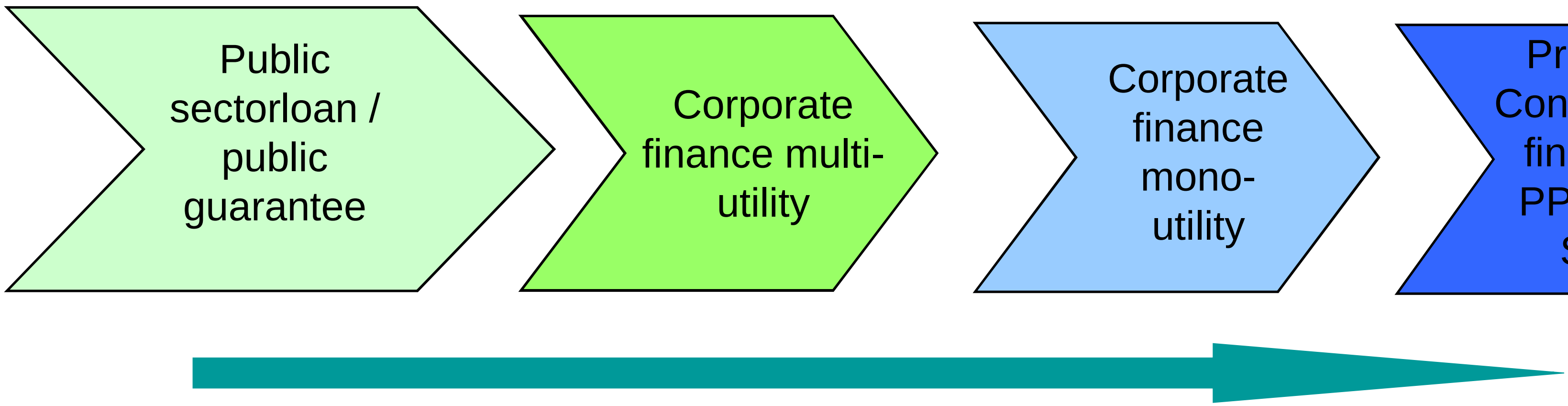
Key issues requiring regulation

- Natural monopoly , often concession based
- Service coverage / accessibility / social affordability issues
- Environmental externalities, public good nature

Financing options

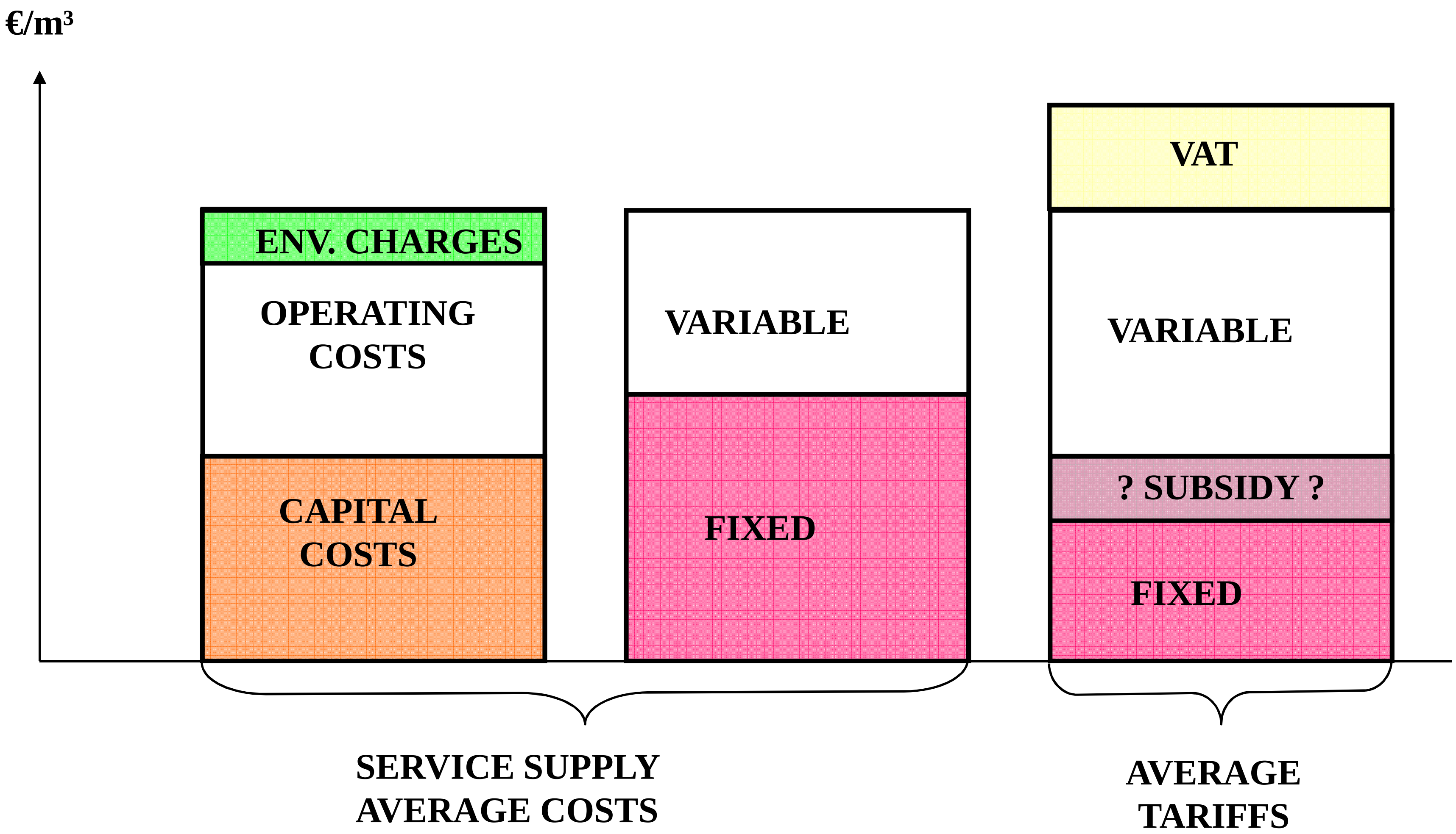
1. Taxes
2. Public Transfers
3. Tariffs, which allow to raise Debt + Equity (private funds)

Type of Loans

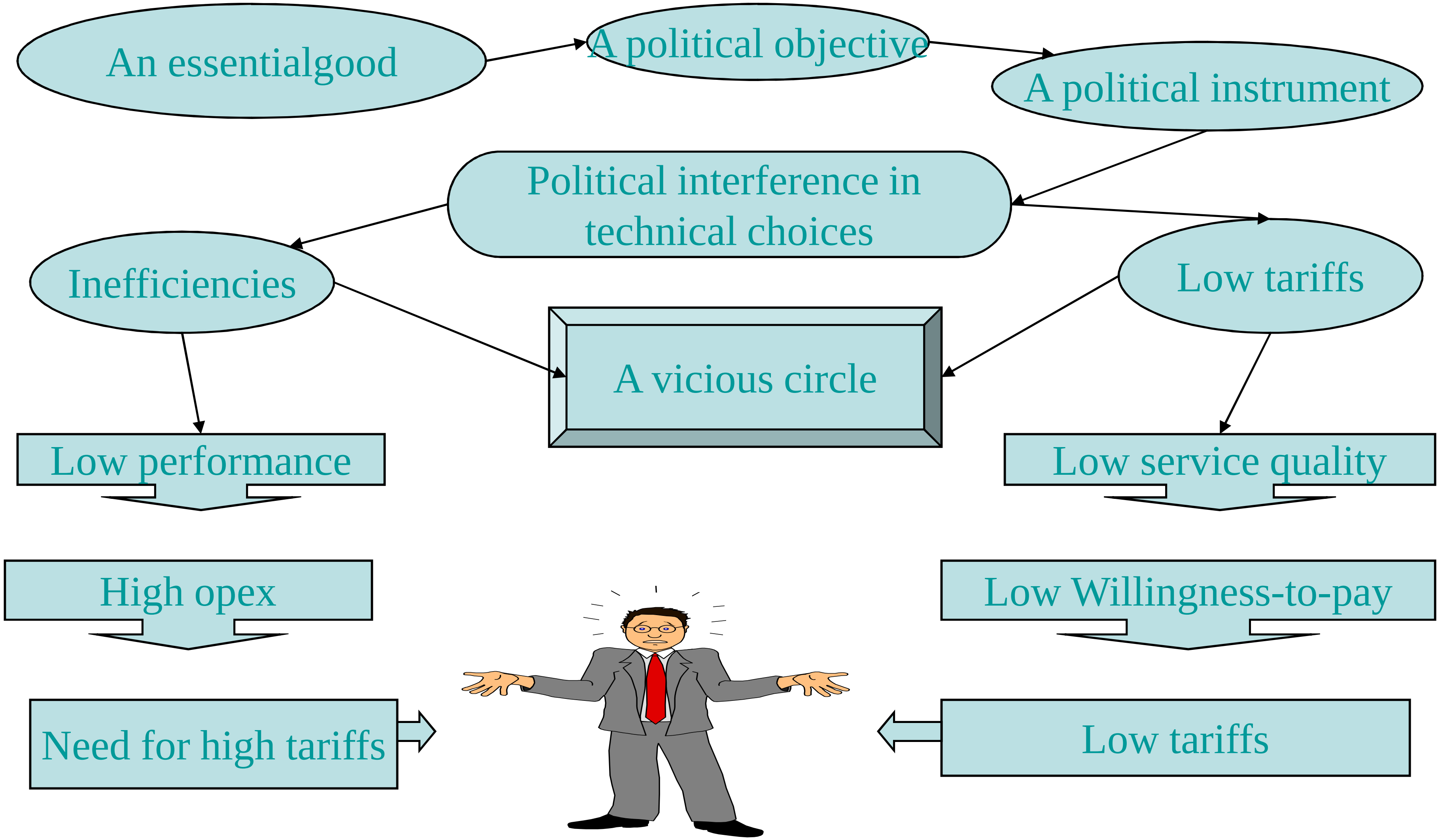


Increase risks / pricing of private funds (WACC)

Cost recovery through tariffs



The tariff dilemma



The importance of regulation

Regulation is crucial in « natural monopolies » to protect consumers but also to stimulate private investments in the sector. The cost of regulation is likely to be small compared to its benefits (i.e. through a lower cost of capital).

Some key issues

- National regulatory agency or local regulation?
- Regulation through a regulatory agency and/or based on contracts/concessions?
- Costplus vs. Price cap?
- Input or output-based?
- Level of annual depreciation allowed and terminal value?
- Degree of informationalasymmetry?

Types of regulation: EU water sector

Regulation	**Regulatedmonopoly « UK model »**	**Delegatedoperation « French model »**	**Local public enterprise « German model »**
Ownership	Private	Public	Public
Operation	Private	Leasing / Service contracts	Privatelaw public companies
Private sector risks	Investment + Operations	Market (part) + Operations	Not applicable
Public sector risks	Regulatortakesmarketrisk	Investment risk (e.g. Agences de l'Eau)	Full costrecovery

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

The borrowers

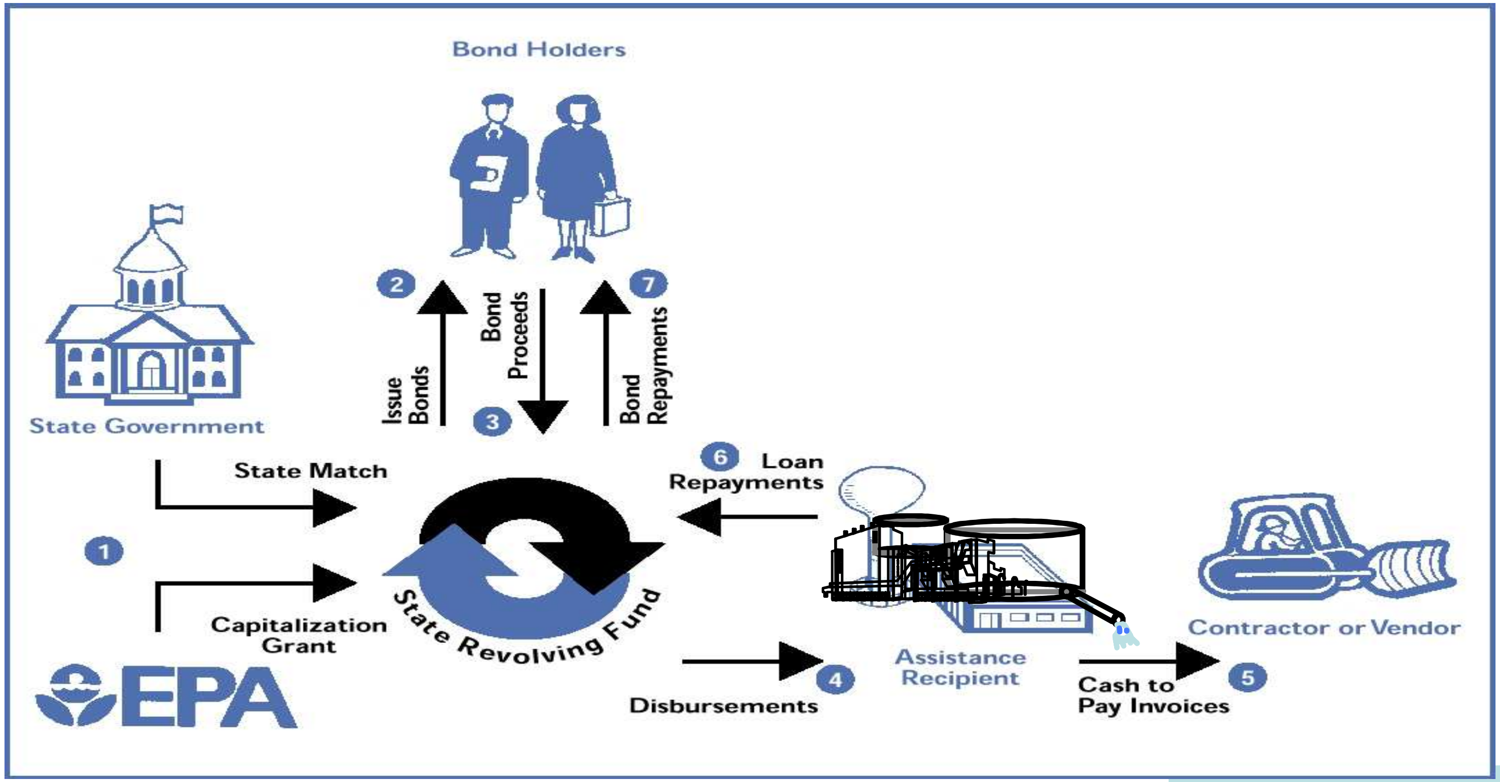
Identify typeof borrower

- Publicsector loan
- Corporateloan (publicorprivate company)
- SpecialPurposeVehicle (SPV):Projectfinanceloan (greenfieldor brownfield)

Keycreditworthiness criteria:

- Theclarityandstabilityoftheregulatory framework
- Multi-or mono-utility (economiesof scope)
- Size (economiesof scale/density)
- Trackrecord/ experience
- Theprojectedincomeandcashflowstatementsandbalance sheet

A mix of public and private finance: example USA



Source: EPA/ Michael Curley, 2004

Public grants are used to fund a State Revolving Fund
and private bond emissions are added

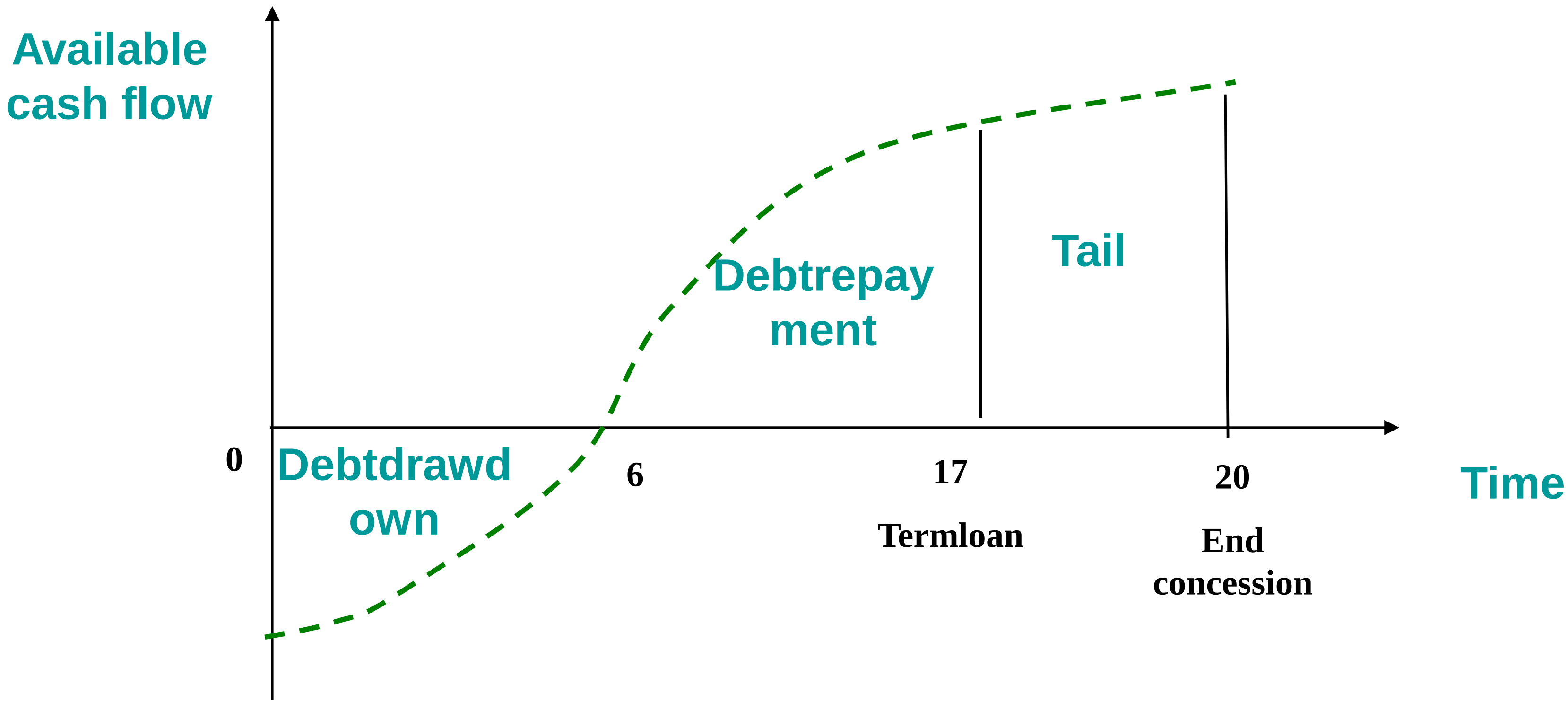
Corporate finance: Rating levels

- 40% Regulatory Environment & Asset Ownership Model
- 10% Efficiency and Execution risk (scale capital programme)
- 10% Stability of Business Model and Financial Structure
- 40% Key credit metrics

Financial ratios	**A**	**Baa (invest. grade)**	**Ba**
FFO Interest cover >	4.5-7.0x	2.5-4.5x	1.8-2.5x
Net Debt / Regulated Asset Base <	40-55%	55-70%	70-85%
FFO / Net Debt >	15-25%	10-15%	6-10%
RCF/Capex>	1.5-2.5x	1.0-1.5x	0.5-1.0x

Project finance: Cash flow based

Example: Long availabilityperiod(6 years) and 3 yeartail



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

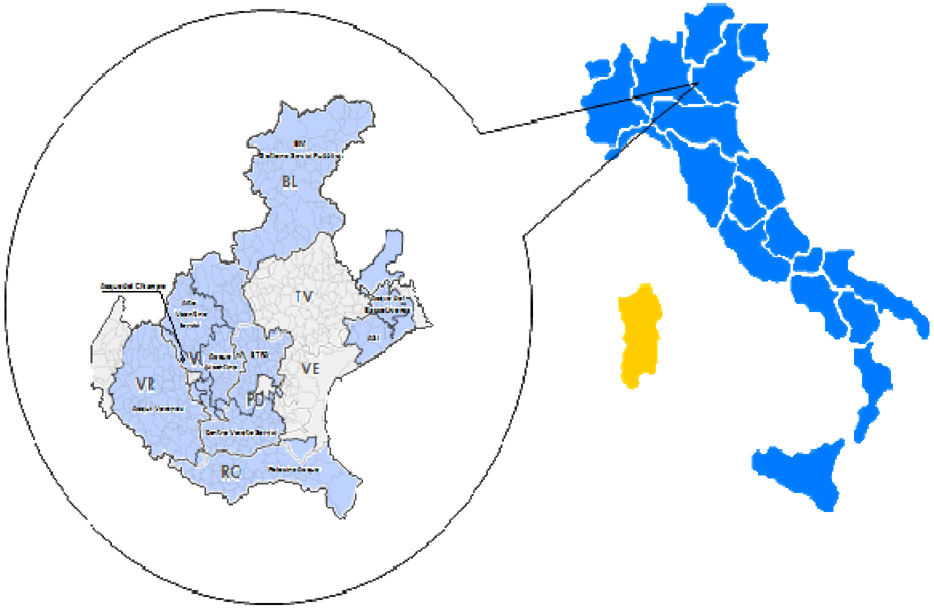
- List of events / risks in a Concession that allow financial re-balancing: is it a closed or open list?
- How is the economic and financial balance defined / ensured in case of the above events: mechanism / timing?
- Do parties share the same financial model / financial ratios?
- What happens in cases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

Example1: Project Finance of Waste-to-Energy Plant in Turin

ey factors of Project Finance operation

- High level of expertise 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 contractwith balanced/fair risk allocation
- Agreement on financial model and financial rebalancing mechanism
- Preparation ex-ante of waste conferral and energy sale contracts
- Support bymain shareholder (city of Turin) for events beyond the control of project promoter/banks

Example2: Finance forsmall/medium sized water companies in Veneto



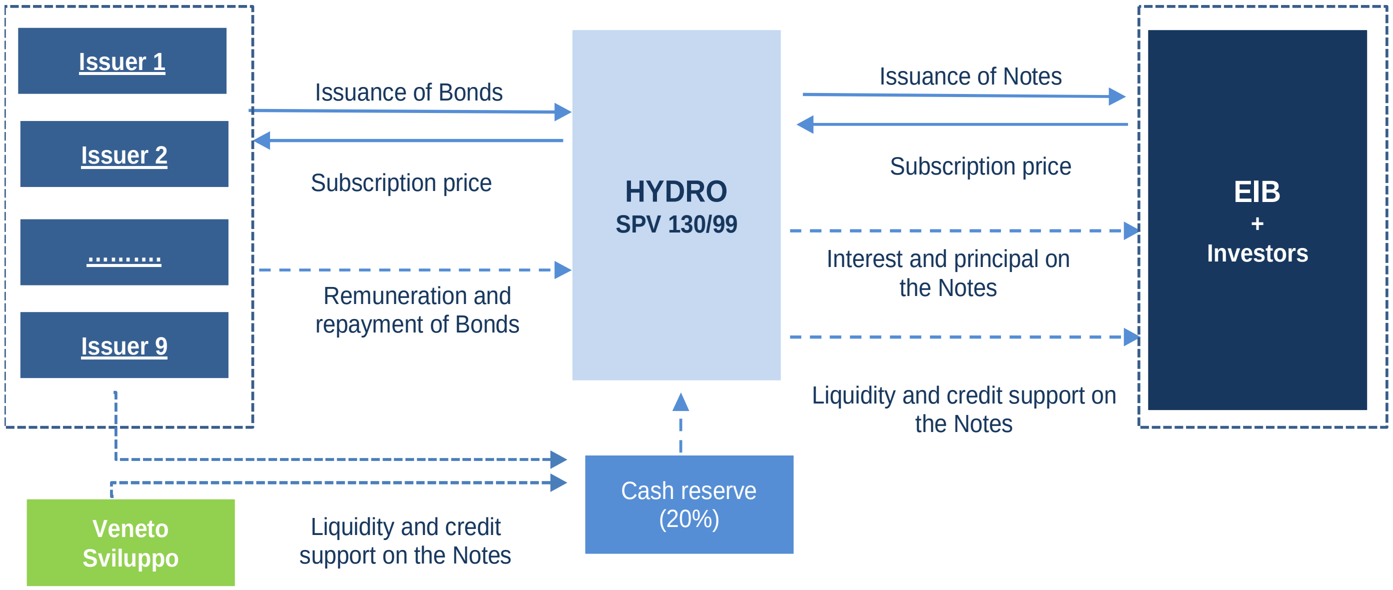
- Acque Vicentine
- Acque del Chiampo
- Alto Vicentino Servizi
- Centro Veneto Servizi
- ETRA
- Azienda Servizi Integrati
- BIM Belluno
- Basso Livenza

- Region of Veneto
- > 2 mresidents

<u>Problem</u>:

Difficulties of these companies in accessing financing on an individual basis for long maturitiesgiven the companies size and individual rating

Example2: Financial economiesof scale bycombiningmini-bonds



Key factors

- Portfolio diversification
- 20% first loss available up-front
- Involvement of Veneto region

Conclusions

- Regulation is a crucial aspect for financing local public services: a clear and stable regulatory framework reduces the WACC and increases the possible amount of private funds (leverage).

- Public Finance and Corporate Finance operations are more straightforward than PPPs. Public finance could have a lower cost depending on the rating level, but implies higher public debt and possibly a sub-optimal allocation of risks and incentives.

- PPPs should be chosen only after an evaluation of alternative options (“public sector comparator”). They require a strong public sector, a clear risk allocation and the control of life-cycle costs.

- Public funds/ transfers can be used to keep tariffs affordable and/or to leverage private funds, e.g. by covering certain risks that are not taken by private parties and/or a first loss portion.

Questions?