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 counterpart risk for financing
- 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 a Waste-to-Energy Plant in Turin
  - Corporate Finance for small and medium sized water companies in the Veneto region
- Conclusions

Local Public Services

<u>Sectors</u>

- Electricity and gas distribution
- Water and wastewater
- Solid waste services
- Local public transport

Different levels of fixed capital intensity, of cost recovery through tariffs, of competition

<u>Key issues requiring regulation</u>

- Natural monopoly
- Service coverage / social affordability issues
- Need for well studied local investment plans
- Environmental externalities, public good nature

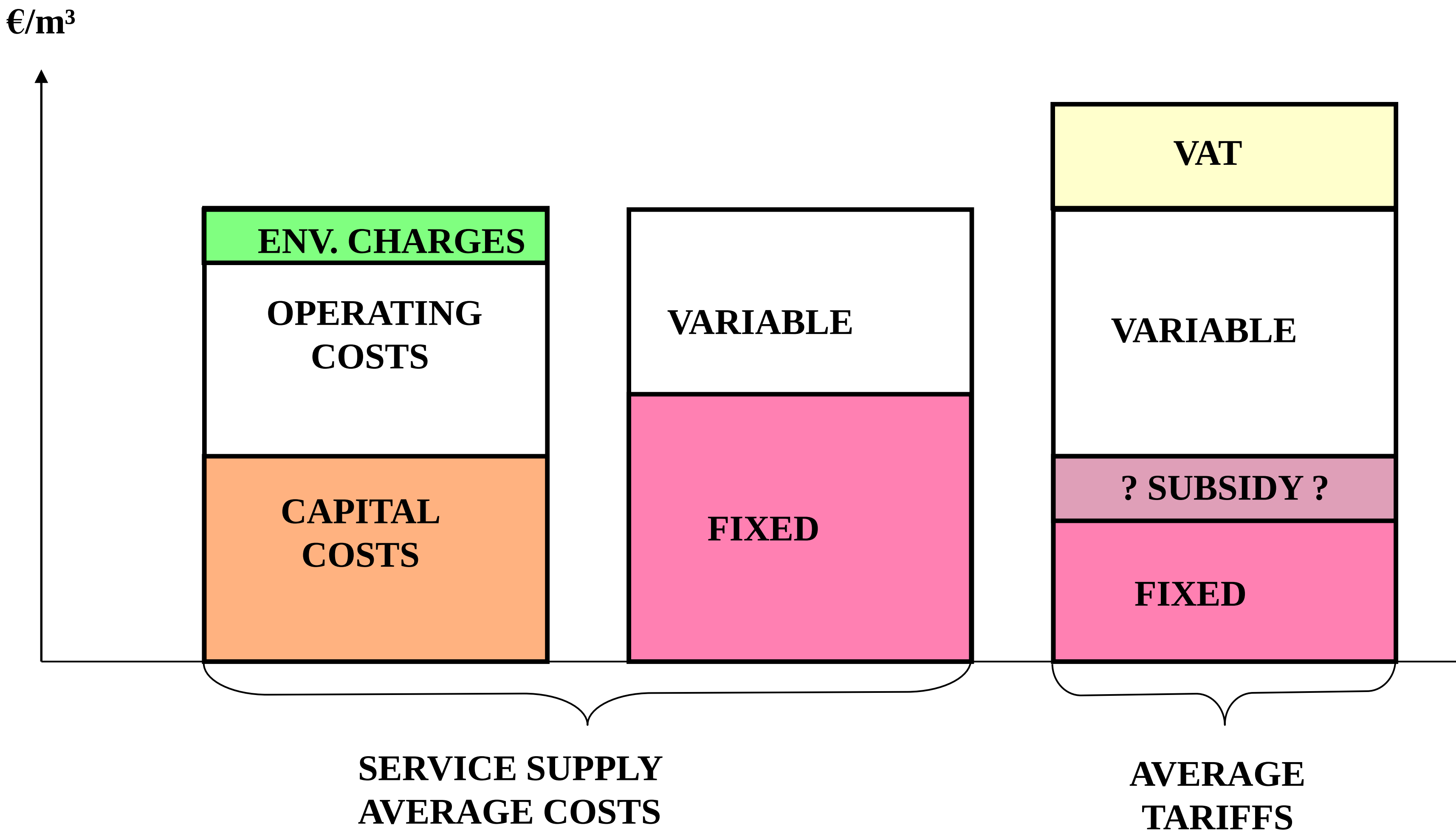
Financing options (3 Ts)

1. Taxes (general public money)
2. Transfers (dedicated public money)
3. Tariffs / user fees (which allow to raise private funds, e.g. bank loans or equity)

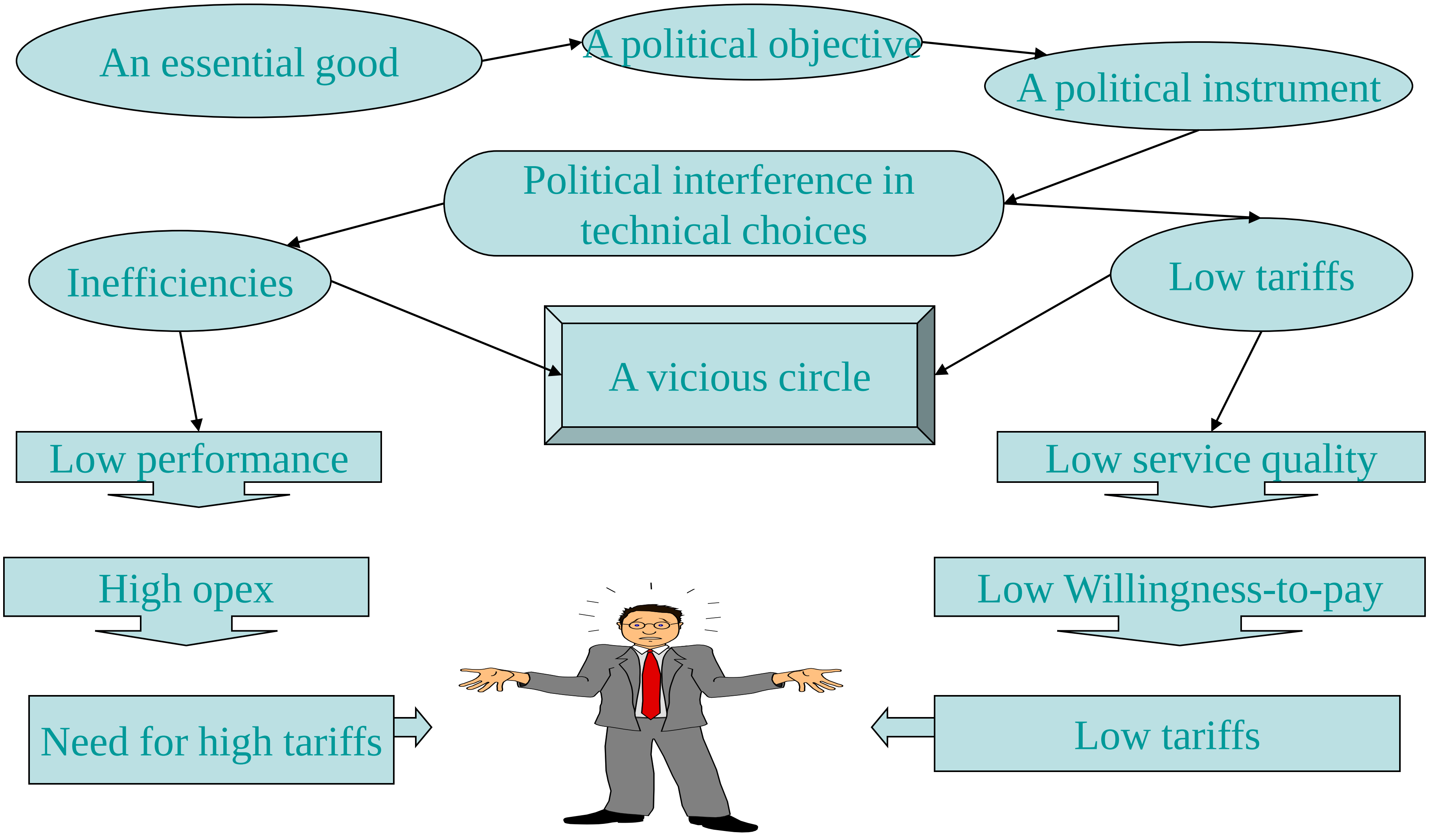
For banks the projected cash flows and/or available guarantees to cover the debt service over time are key (look at downside)

Equity investors look at dividends from cash flows and at value of shares for resale (look at upside)

Cost recovery through Tariffs



The tariff dilemma



The importance of regulation

Regulation is crucial in « natural monopolies » to protect consumers. Regulatory stability is important to raise private funding. In capital intensive sectors, the cost of regulation is likely to be small compared to its benefits (i.e. through a lower cost of capital).

Some key issues

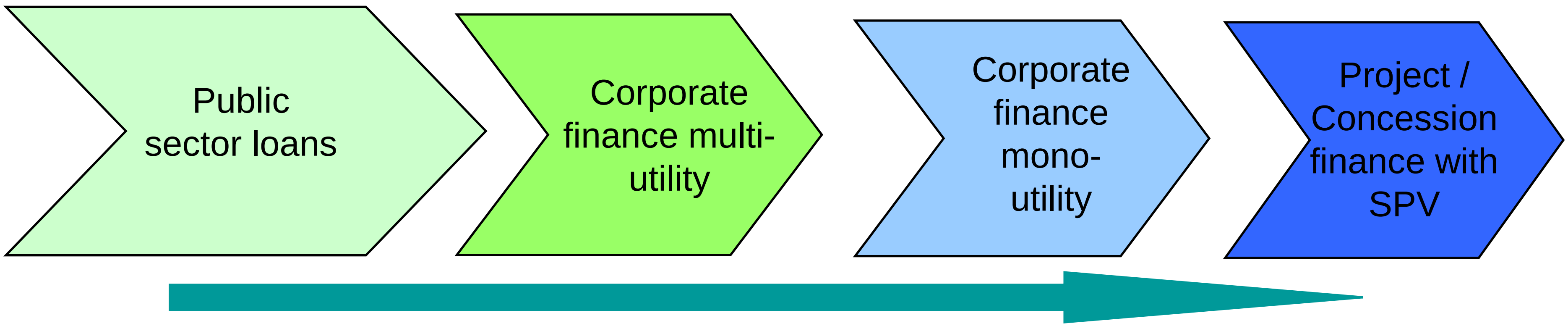
- Regulation through a national regulatory agency and/or based on local contracts/concessions?
- Cost-plus vs. Price cap? Input vs. output based?
- Length of the regulatory period?
- Public or private operators: the risk allocation between the regulator and the regulated company?
- Concession termination provisions

Public Private Participation: the EU water sector

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

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

Counterparty risk for financing

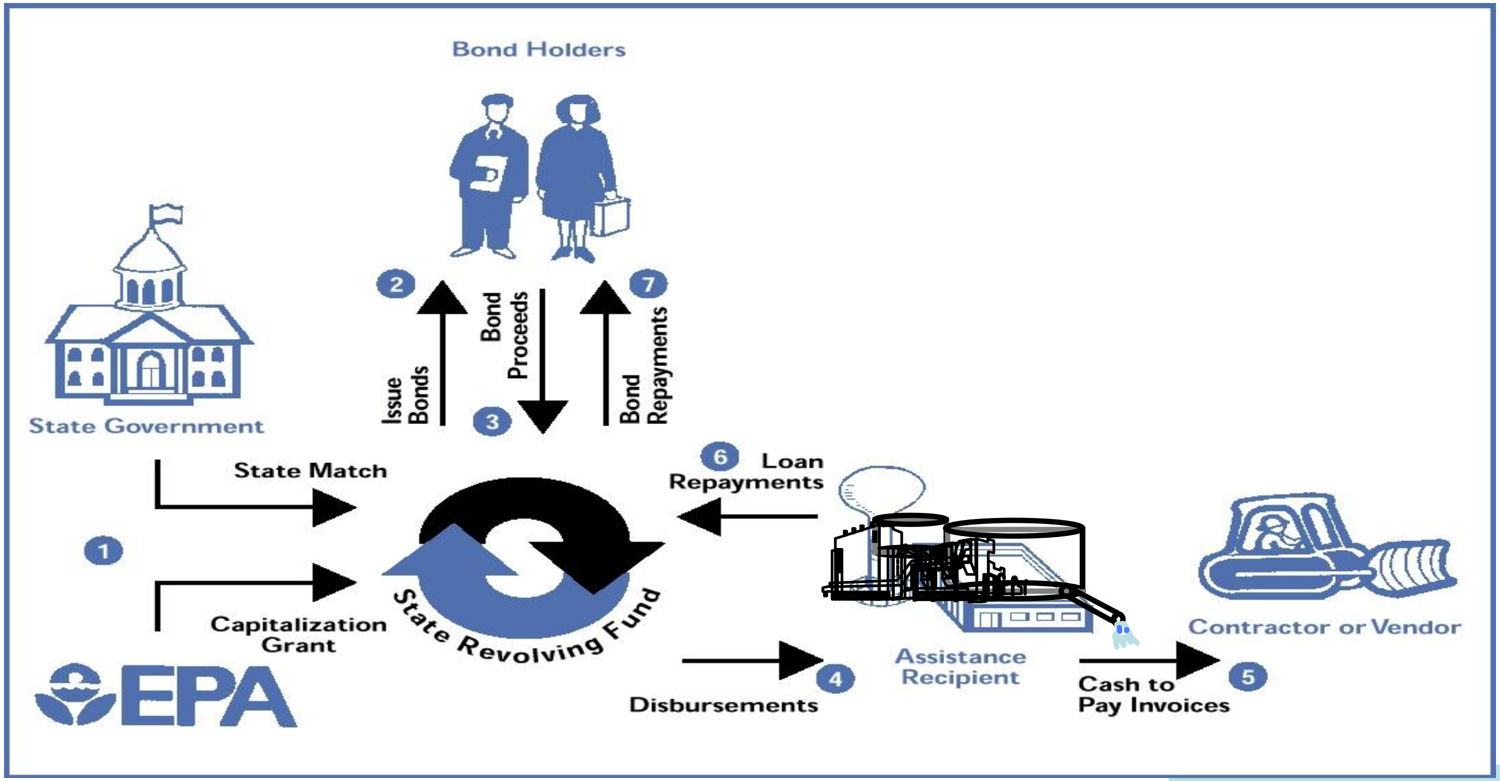


Increase risks / risk pricing (WACC)

Key factors

- The clarity and stability of the regulatory framework
- Diversification: multi- or mono-utility (economies of scope)?
- Level of equity / size (economies of scale/density)
- Track record / experience: solid project choice and design
- The remaining life of the concession
- The projected financial statements (cash flow)

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

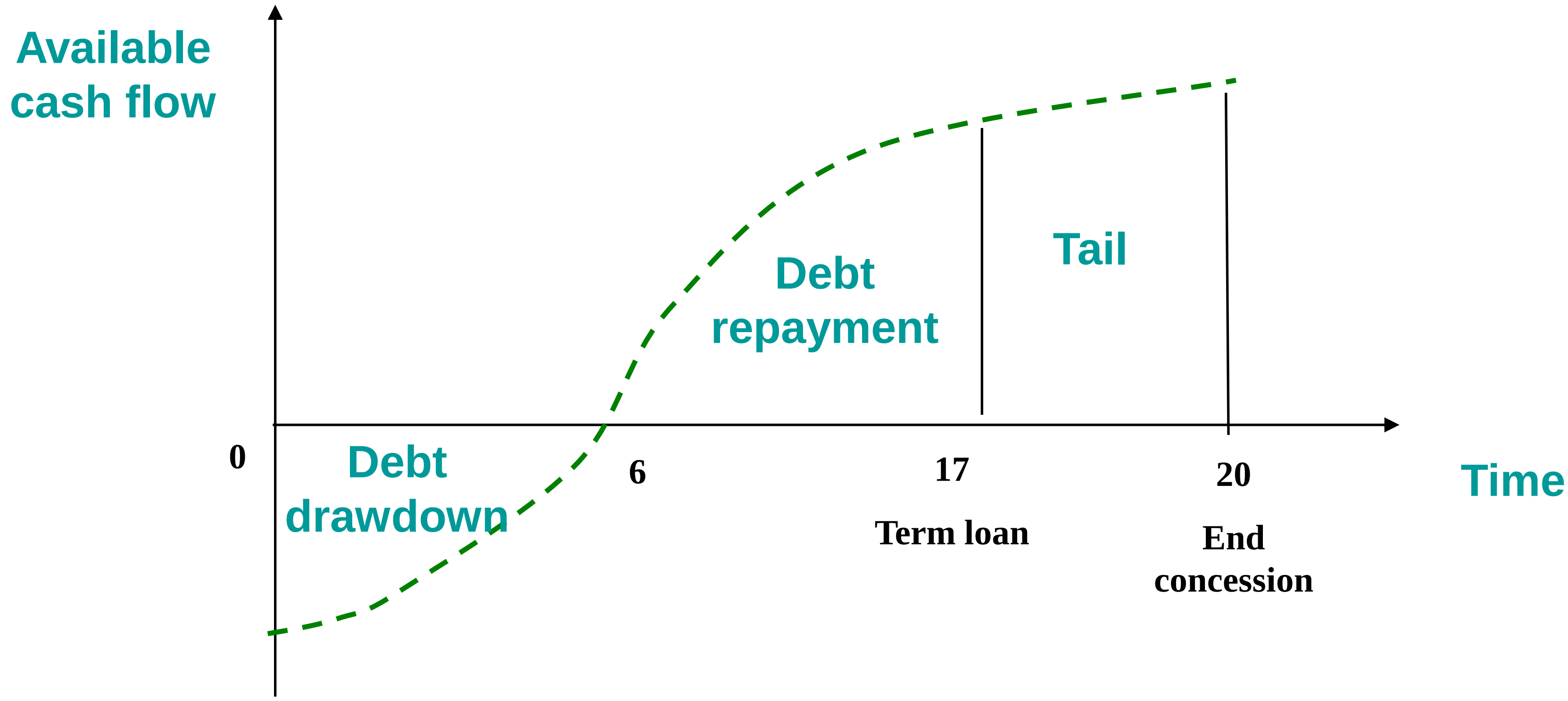
Corporate finance: Balance sheet and Rating based

- 40% Regulatory Environment & Asset Ownership Model
- 10% Efficiency and Execution risk
- 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%

PPP/Project finance: Cash flow based…every step you take

Example: Long term (20 years) and availability period (6 years) l



Advantages: Tailor-made, high leverage, long term

Needed: Certain size, water-tight documentation, good risk allocation,

Debt coverage ratios: DSCR> 1.2x , LLCR > 1.3x

The risk allocation in a Concession

Some key questions

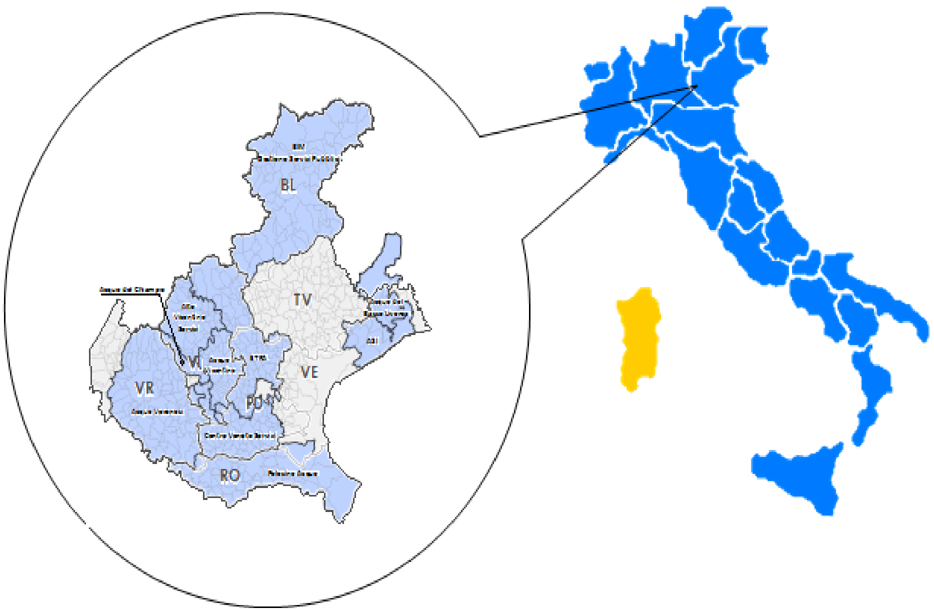
- How is the economic and financial balance defined?
- List of events / risks in a Concession that allow financial re-balancing: is it a closed or open list?
- Do parties share the same financial model?
- What happens in case of early termination of the Concession?
- Who is in charge of paying the termination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

Example 1: Project Finance of Waste-to-Energy Plant in Turin

Key factors of Project Finance operation

- High level of expertise of public project promoter: 100% public company
- Permits and public participation issues were solved: technically the project was 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 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

Example 2: Finance for small/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

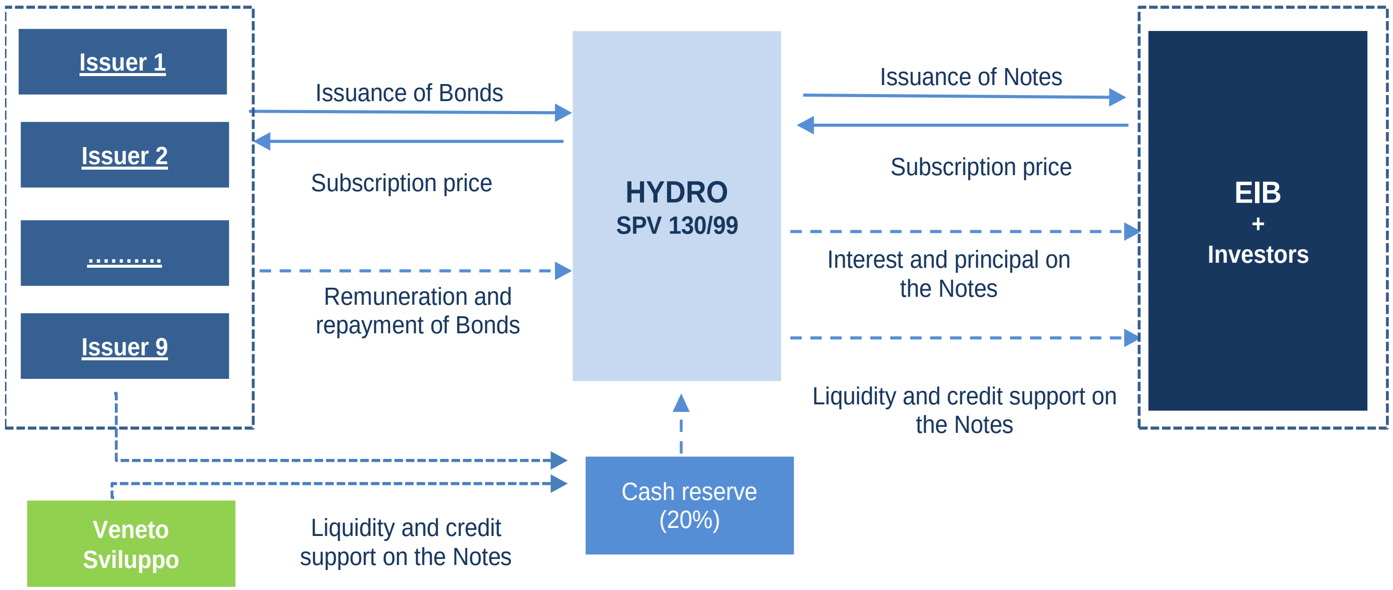
- Region of Veneto

- > 2 m residents

<u>Problem</u>:

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

Example 2: Financial economies of scale by combining mini-bonds



Key factors

- Portfolio diversification
- Two levels of financial ratios in financial documents
- 20% first loss available up-front
- Involvement of Veneto region (rated BBB+) with guarantee

Conclusions

- Regulation is a crucial aspect for financing local public services: a clear and stable regulatory framework reduces the WACC and increases the amount of private funds (leverage).
- Public 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” and “value for money”). They require a strong public sector, a good project preparation, a clear risk allocation and the control of life-cycle costs.
- Public funds can be used to leverage private funds, e.g. by covering certain risks that are not taken by private parties and/or a first loss portion.

Questions?