CDP **ASTRID**

Equity for Infrastructure

Rome, 30th March 2011

Infrastructure Financing Issues in Italy

by ***Claudio De Vincenti***

University of Rome “La Sapienza”

Outline

- The public utility regulatory framework
- Consequences for infrastructure financing
- Corporate finance vs. project finance
- The scope for project finance in Italy
- The EC project bond initiative: pros and cons of Italy framework
- Some final suggestions

The public utility regulatory framework (1)

Sectors regulated by Independent Authorities:

- electricity and gas (AEEG); TLC (AGCOM)
- unbundling of infrastructure operator: ownership separation of TERNA; corporate separation of SNAM; corporate separation for local distribution operators both in electricity and gas; functional separation of network management in Telecom
- access regulation for infrastructure; competition in activities other than natural monopoly

Sectors without Independent Authorities:

- transport (railways, motorways, local transport), water, waste treatment
- infrastructure and services: corporate unbundling of RFI; in local utility sectors, opportunity to constitute a public network company which holds the ownership of infrastructure separately from the service operator
- prices and quality regulated by ministries or local government bodies

The public utility regulatory framework (2)

Concession regimes:

- concessions for electricity distribution granted to ENEL and local firms until 2030
- concessions for gas distribution should be awarded by competitive bidding (territorial areas in course of definition)
- competition in the market, based on a license regime, for freight and long distance passenger railway transport (in the initial stage at present); franchise auctions for regional railway transport (but several postponements)
- long duration of current motorway concessions, but first awards of some (new) concessions by competitive tendering procedures
- in local service sectors (local transport, water, waste treatment), concessions granted alternatively by franchise auctions, competitive bidding for capital shares in public-private firms, in-house providing; the last has been the more usual form until now, but the recent reform prescribes that in-house has to be the exception (subject to specific conditions); legislative uncertainty

The public utility regulatory framework (3)

Infrastructure operators' revenues:

- regulated access prices in electricity, gas and TLC sectors
- regulated access prices and public subsidies for RFI
- regulated prices (user payments) in motorway sector, in several cases supported by public contributions to investment
- regulated prices and subsidies in local transport sector, often supported by public contributions to investment; in some BOT experiences, availability payments by the local government body, which retains the task of collecting user payments
- regulated prices in the water sector and prices/taxes in the waste sector, sometimes supported by public contributions to investment; availability payments are granted to some operators in sewage disposal and waste processing

Consequences for infrastructure financing (1)

Sectors regulated by Independent Authorities (electricity, gas and TLC)

Main investment needs:

- enhancing electricity network connections with other European countries and among Italian macro-areas
- enhancing upstream pipelines for gas provision and storage facilities, building re-gasification plants
- overcoming the problem of digital divide and developing the NGN

Favourable conditions:

- certainty of regulatory framework and prices able to guarantee long term return on investment
- ownership separation of TERNA created an electricity network operator that is interested in developing the infrastructure
- the development of competition in activities other than natural monopoly ensures an increasing demand for infrastructure utilization

Main today problems:

- investments in gas infrastructures suffer from the vertical integration of SNAM with the dominant natural gas operator
- without a well defined agreement between Telecom and the other TLC operators, investments in the TLC Next Generation Network seem now substantially in stand-by

Consequences for infrastructure financing (2)

Sectors without Independent Authorities (transport, water and waste)

Main investment needs:

- enhancing railway connections with the other European countries, modernizing technology of network in order to reduce costs of transport companies, improving interoperability with other infrastructures for freight transport, developing AV and AC lines; renewing the rolling-stock of regional transport
- removing the main bottlenecks in the motorway network
- developing underground railways and renewing the bus endowment in the main cities
- improving quality of the water network and developing plants for sewage treatment and disposal
- filling the relevant gap in waste processing

Main today problems:

- inadequacy of the regulatory framework: regulation by ministries and local government bodies lacks commitment about rules and pricing and exhibits the risk of capture by the incumbent; bad design of tendering procedures (contractual clauses not sufficiently specified); financial and economic time-inconsistency of several infrastructural plans
- conflicts between central and local government bodies and between the last ones heavily prolong the time which is necessary to complete the approval procedures for investment projects and modify the costs after the award of contract
- widespread presence of in-house providing restrains the scope for firms' dimensional growth
- legislative uncertainty negatively affects long-term expectations

Corporate vs. project finance (1)

Often infrastructure projects:

- have lengthy pre-construction and construction periods (without revenues)
- transfer risk of construction and demand to the utility company through concession clauses
- require long-term financing

Corporate finance (CF):

- infrastructure investment is made directly by the utility company, which collects resources on the financial markets (equity and debt) on a full-recourse basis

Project finance (PF):

- the investment project is financed and implemented through an entity – the project company - set up for this purpose only
- the project company raises equity and debt to finance the construction and pays off the financing from the revenues that the project generates (market based payments from the end user or availability payments from the public body grantor); non-recourse finance and insulation of the project from the other activities of the participants in the project company
- integration between fund raising, construction, service providing

Corporate vs. project finance (2)

Advantages of PF:

- insulation from other activities of participants and non-recourse finance determine a better allocation of risks
- the project company is interested in reducing the construction period
- better incentives for investments that are very specific to the project
- high leverage may have discipline effects on the managers

Shortcomings of PF:

- high transaction costs (a number of non-standardized contracts is necessary in order to allocate risks)
- predetermination of price dynamics not only for the usual regulatory periods (4-5 years) but for the entire concession duration or, alternatively, predetermination of availability payments from the public government body
- long duration of the concession reduces the scope for competitive bidding of public services
- more in general, possible lock-in effects for the public administration

Corporate vs. project finance (3)

Hence, the advantages of PF overcome its shortcomings when:

- the dimension of the project justifies transaction costs
- construction is the key phase of the project and the service providing activity has a routine nature
- the construction risk is more important than the demand risk
- the project can be insulated from the other entrepreneurial activities related to the public service

Some examples:

- construction and operation of a sewage disposal plant
- construction and operation of a big water storage providing wholesale water to downstream water operators
- construction and operation of a waste processing plant
- urban underground railways (but it is questionable the better allocation of demand risk between the project company – end user payments - and the local government body- availability payments)

Otherwise:

- CF seems to fit better the nature of service activities that are characterized by entrepreneurial ability to manage variable demand and cost conditions
- anyway, the utility company can resort to PF in allocating construction and operation (with project insulation) of single plants providing services in the upstream and downstream phases

The scope for project finance in Italy

The recent trends:

- increasing value of PF award contracts from 414 million in 2002 to 5.058 million in 2009 (source: Osservatorio nazionale PPP)
- the main grantors: local government bodies and local utility companies, health sector, ANAS
- too many procedures for small projects

The main obstacles for PF (but also for investment in CF):

- inadequacy of the regulatory framework in sectors without IA (lack of commitment, bad design of tendering procedures, time-inconsistency of infrastructural plans)
- long periods to conclude the approval procedures for investment projects and changes in costs after the award of contract
- legislative uncertainty that negatively affects long-term expectations (obstacle for CF)

The EC project bond initiative (1)

The consultation paper of the 28th February

The problem:

- one way to raise the attractiveness of bonds issued by project companies has been the insurance from monoline insurers
- financial crisis struck monolines and caused a halt in this practice

The EC proposal:

- a EU/EIB risk sharing mechanism for credit enhancement of the projects
- the EU backed EIB support would consist of a debt service guarantee (or of an additional layer of debt at the subordinated level) in the form of a contingent credit line provided to the project company
- once drawn, the facility would be subordinated to the project bonds
- the EU will define the project eligibility framework, while the EIB will carry out the due diligence of the project, price the guarantee and monitor the project
- EU and EIB would share the risk of the losses of the project portfolio

The EC project bond initiative (2)

Italy pros:

- the presence of a long term investor with a public sector mandate (CDP), which can support EIB in the credit enhancement of the projects
- a possible role in issuing PB for public network companies which hold the ownership of local infrastructures?

Italy cons:

- essentially the same that hinder the usual corporate and project financing: inadequacy of the regulatory framework in sectors without IA, long and controversial procedures for investment projects
- insufficient compliance of some local government bodies with contractual obligations
- Italian legislation binds the possibility for the project company of issuing bonds

Some final suggestions

In the short-term:

- publish competitive biddings only on the basis of executive projects that already passed all the steps necessary to obtain the consensus of involved public administrations and citizens (see ASTRID proposal for infrastructure planning and localization procedures)
- improve the time-consistency of economic and financial plans relative to the projects
- introduce a rigorous incentive/penalty mechanism related to company's performances in case of the adoption of availability payments systems
- enhance the role of CDP in supporting public government bodies for the design of investment projects and their economic and financial viability
- widen the range of infrastructural projects that are eligible for CDP guarantees
- rebalance the fiscal treatment of equity and debt (ACE)

In the medium-term:

- develop the LTI role of CDP and its activity in supporting the EU/EIB project bond mechanism
- set up Independent Authorities for transport, water and waste treatment, in order to enhance the certainty and stability of regulatory framework, implement a rigorous pricing methodology, support public grantors in designing tendering procedures