- Public Private Partnership –

A dual approach:

Infrastructure model and / or operational model ?

Sydney, Australia – December 13th and 14th , 2004

PECC

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Foreword and table of content

- A worldwide economic, social, political challenge:
  - ➔ How to cope with a global public services infrastructures gap and efficiency improvement whilst being exposed to budgetary constraints and "affordability" limits ?
- If in the 1990s, there was an increasing faith in the private sector, the PPP concept remains an "umbrella notion" in constant evolution and covering a wide range of economic activities.
- Although being the upteenth conference on such a topic, the PECC, together with its sponsors, are still daring to revisit the notion and try to "look under the umbrella".
- Deriving its activity with and from PPPs for the past 100 years, revisiting the PPP concept is for Veolia Environnement always a topical issue and, in that instance, from Veolia Environnement's experience, a distinction could be made between the 2 main PPP objectives:

  ➔ Either to develop a public service "infrastructure model";

  ➔ Or to develop a public service "operational model".

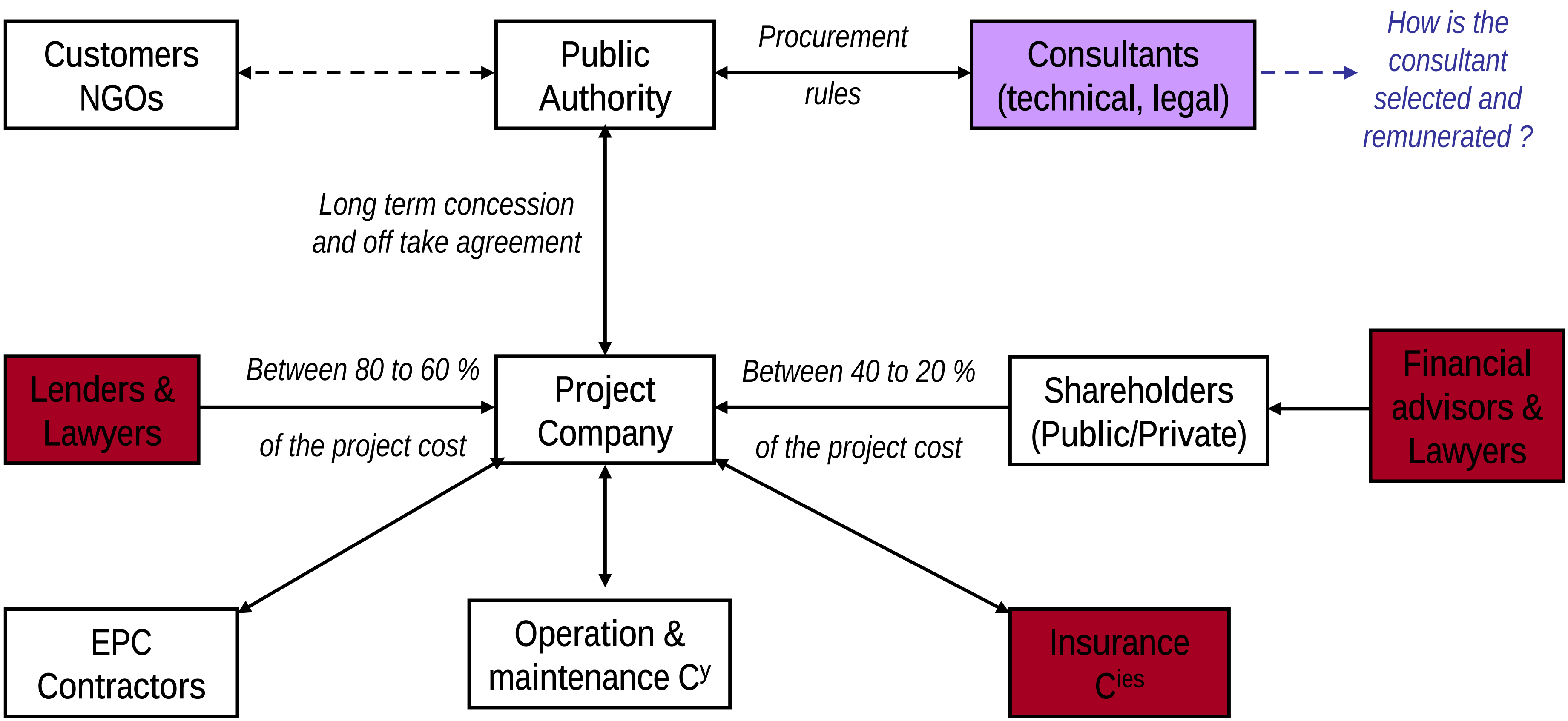
Part I

An infrastructure model

An infrastructure model

- A model based on a "project finance" approach with clear objectives and features:
  - ➔ **To develop** an "off budget" infrastructure financing
  - ➔ Supported by:
    - ★ A transparent and competitive procurement process
    - ★ A business plan with cashflow projections
    - ★ A recourse (sometimes limited) on the sponsor's balance sheet
  - ➔ **Enabling long term financing** (on commercial terms).
- Such a model implies a sophisticated implementation mainly driven by the financial parties.

A model mainly driven by financial parties



Comments: Lenders (and their lawyers) are the main drivers of the "project finance structure":

- ➔ Project company gearing (debt/equity)
- ➔ Risk sharing between the public and private parties
- ➔ EPC Contractors / procurement process
- ➔ Loans: terms and conditions (guarantees, levels of recourse)

The Public Finance Initiative

- Such sophistication has been successfully rationalised by the UK "Public Finance Initiative" introduced by HM Treasury in the mid 1990s.
- The standardisation of the project finance model has 3 objectives:
  - ➔ To promote a common understanding as the risks encountered to be shared between the public and private parties
  - ➔ To allow consistency of both approach and pricing across a range of similar projects
  - ➔ To reduce the time and costs of negotiations enabling all parties concerned to agree to a range of areas
- Which explains the constant widening of the PFI scope:
  - ➔ Sector scope: public transport, hospital, prison, social housing, landfills,…
  - ➔ Financing scope: from bank financing to project bonds
  - ➔ Refinement of the procurement process since mid 1990s, we are at Standard Form N° 3.

A model which is attracting the French public sector

- **A new legislation,** enacted in June 2004, authorizes public authorities to enter into agreements with private contractors covering matters such as building, operating, financing, maintaining public sector assets.

> The new PPP agreements are **neither a procurement agreement nor a delegation agreement.**

- If the main objectives are to seek after more efficiency in procuring technically sophisticated projects, **the other objective is to benefit from the "off budget" EU statistical Office (Eurostat) decision.**

  PPP financing can be treated as being "off budget" for the government **if 2 conditions are satisfied:**

  - ➔The private sectors bears the construction risk
  - ➔The private sector partner bears either the availability risk or the demand risk.

- **But Eurostat recognizes that the analysis of the risk allocation in PPP utilizing complex structures may not always be conclusive.**

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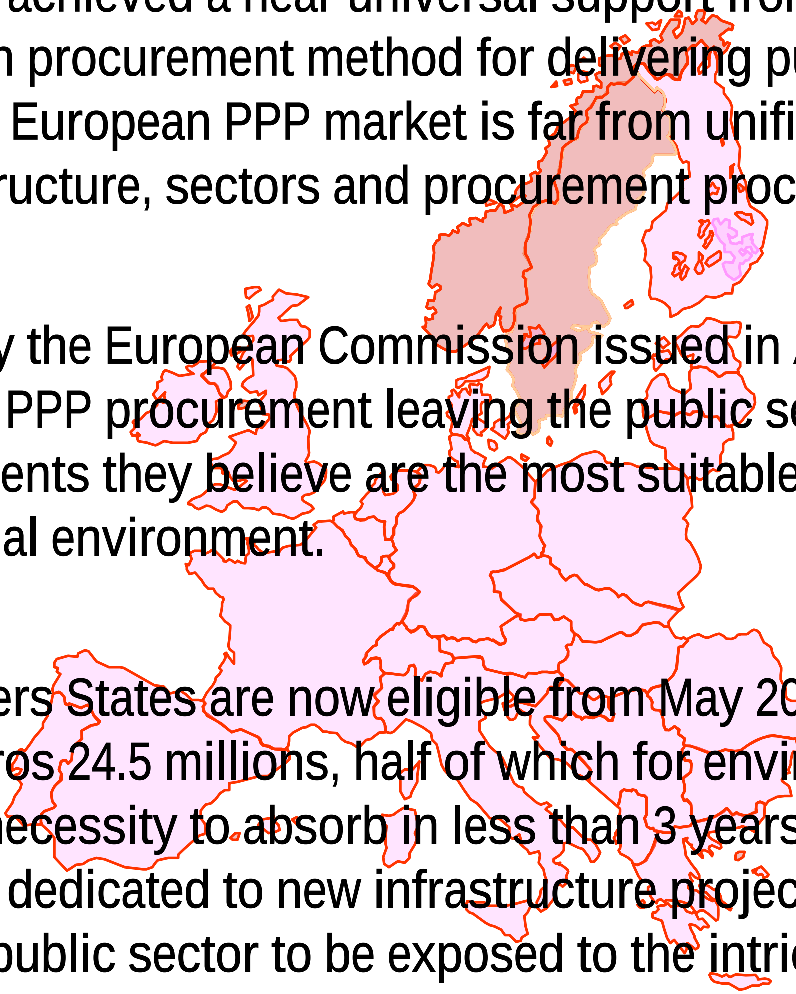
Outside the UK (and the PFI discipline), the Project Finance have experienced some specific hurdles

- **There need to be a more realistic risk sharing model** from one where governments try and shift the maximum amount of risk to the private sector, **and then** the investment banks seek **to shift that risk onto the construction contractor.**

“Risks should be managed by the party or parties best equipped to do so, rather than those least able to resist.”

- **Bank driven consortia can have negative implication** especially when the investor is not a **real long term equity player**
- **The bid cost issue (and legal fees)**
- **Last but not least: since Enron, the SPV’s debts are consolidated as a direct sponsor’s debt.**

The new situation created in the EU by the Cohesion ans Structural Fund for which the 10 New Members States are eligible



- If in 2004, PPP has achieved a near universal support from the governments of Europe as a proven procurement method for delivering public infrastructure and allied services, the European PPP market is far from unified, in terms of bidders, funders, project structure, sectors and procurement process.

- It is the reason why the European Commission issued in April a Green Paper mainly focused on PPP procurement leaving the public sector free to adopt which PPP agreements they believe are the most suitable for their own political, economic and social environment.

- The 10 New Members States are now eligible from May 2004 to May 2006 to a total amount of euros 24.5 millions, half of which for environment and transport investments. The necessity to absorb in less than 3 years this amount of free capital specifically dedicated to new infrastructure projects limits the political willingness of the public sector to be exposed to the intricacies of the PPP.

Conclusion Part I

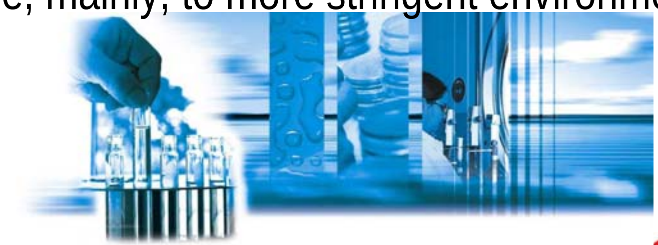
- **The success of the PFI infrastructure model relies on several pre conditions:**
  - ➔ **Clear contractual structures** of risk sharing
  - ➔ **Professional parties**: banks, lawyers, infrastructure investors, public sector, private contractor,
  - ➔ **A mature financial market** able to understand a project risk and therefore to provide long term financing
  - ➔ **A clear demonstration of the PFI approach:** "Value for money".
- **Such a sophistication is therefore not easily adaptable** in other countries which can not benefit from the same political, professional, financial environment. (It took 10 years for the UK to achieve this level of sophistication).
- **Moreover, such a model is addressing only one specific issue:** to finance and operate efficiently **off budget** a specific infrastructure. It does not address the more global objective which is to improve the public service by introducing the private sector's governance rules.
- It is the reason why another model, **"the operational model"**, copes with this issue while being also able to address the new infrastructures requirements.

Part II

The operational model

The approach (1)

- **Such a model is mainly related to “basic” municipal public services:** water, sanitation, urban public transport, district heating,
- Is characterized by:
  - ➔ **The end-consumers sensitivity to the tariff level (affordability).** In that respect, there is a fundamental difference between the “infrastructure model” and the “operational model”:
    - ★ *In the first one, the sensitivity of the end-users is impacted by the project finance efficiency through its taxation level*
    - ★ *In the second one, the end-user is* ***directly impacted by the tariff level.***
  - ➔ **The cost coverage is, in many cases, limited (at best) to the maintenance cost:** the new infrastructures are financed either through the budget (taxes instead of tariff) or through a direct loan to the municipality (anticipating new revenues) or not at all (which is often the case in developing countries).
  - ➔ <u>An increasing level of investment sophistication</u> due, mainly, to more stringent environmental regulations and rapid urbanisation.



The approach (2)

- In such an environment, the strict financial discipline of the “ project finance “ is not enough to cope with global managerial issues. It is the reason why 2 <u>main approaches have been developed</u> :

- <u>The full privatisation</u> which has not always been successful <u>regarding municipal public services</u>. It is the reason why there is now a clear difference being made between privatisation and Public Private Partnership (the history of the tram and train operating agreements signed between the State of Victoria and the 2 private companies Connex and Yarra illustrates such a difference).

- <u>The delegation of a public service, whereby</u> :
  - The public sector (the municipality) is responsible for the required service quality level and the affordable tariff;
  - The public sector (the municipality) delegates the global management (operation) to a third party (public or private) according to a “concession agreement”.

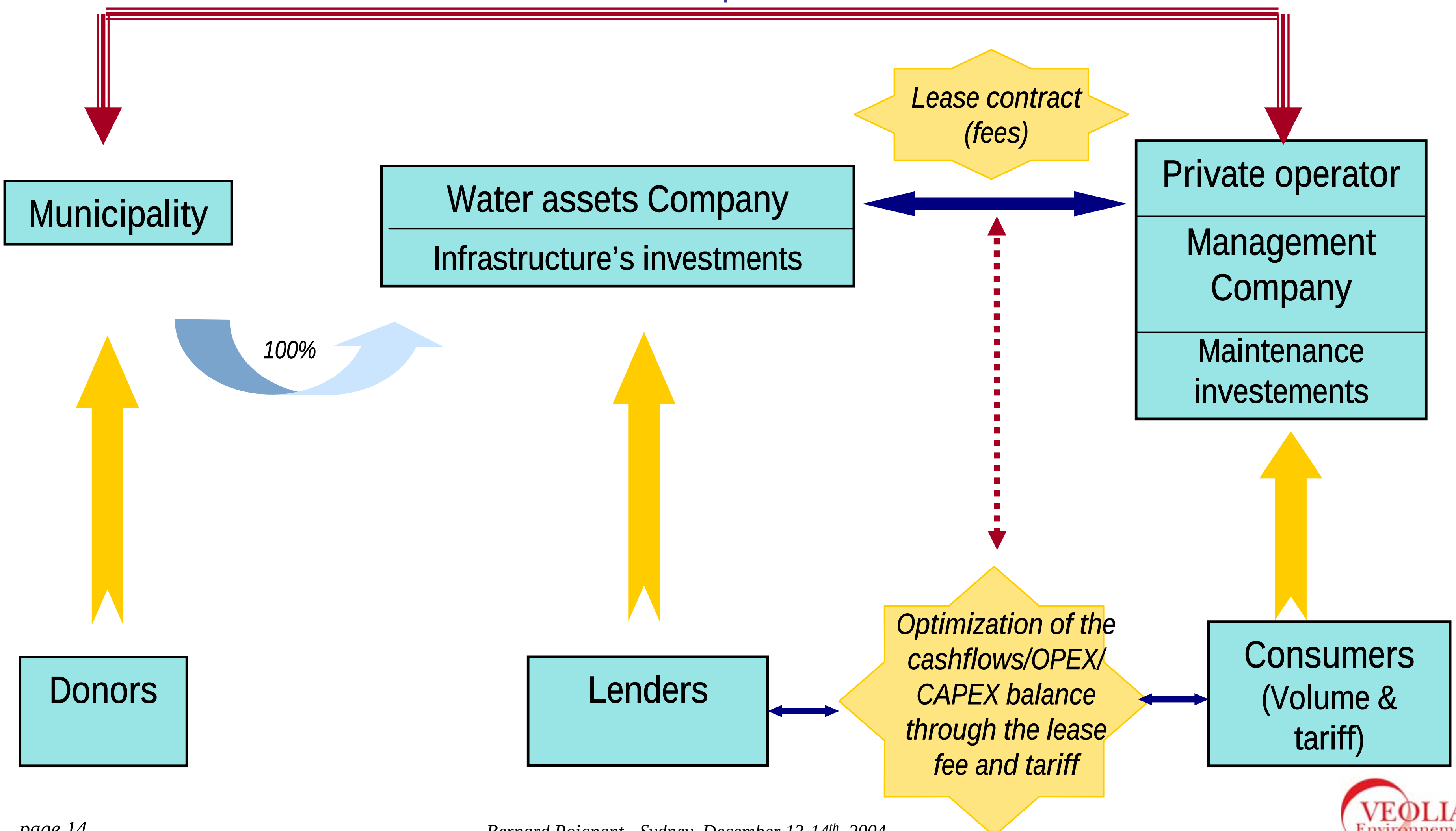
Such delegation can take 2 forms:

- The lease contract
- The “corporatisation” of the public service.

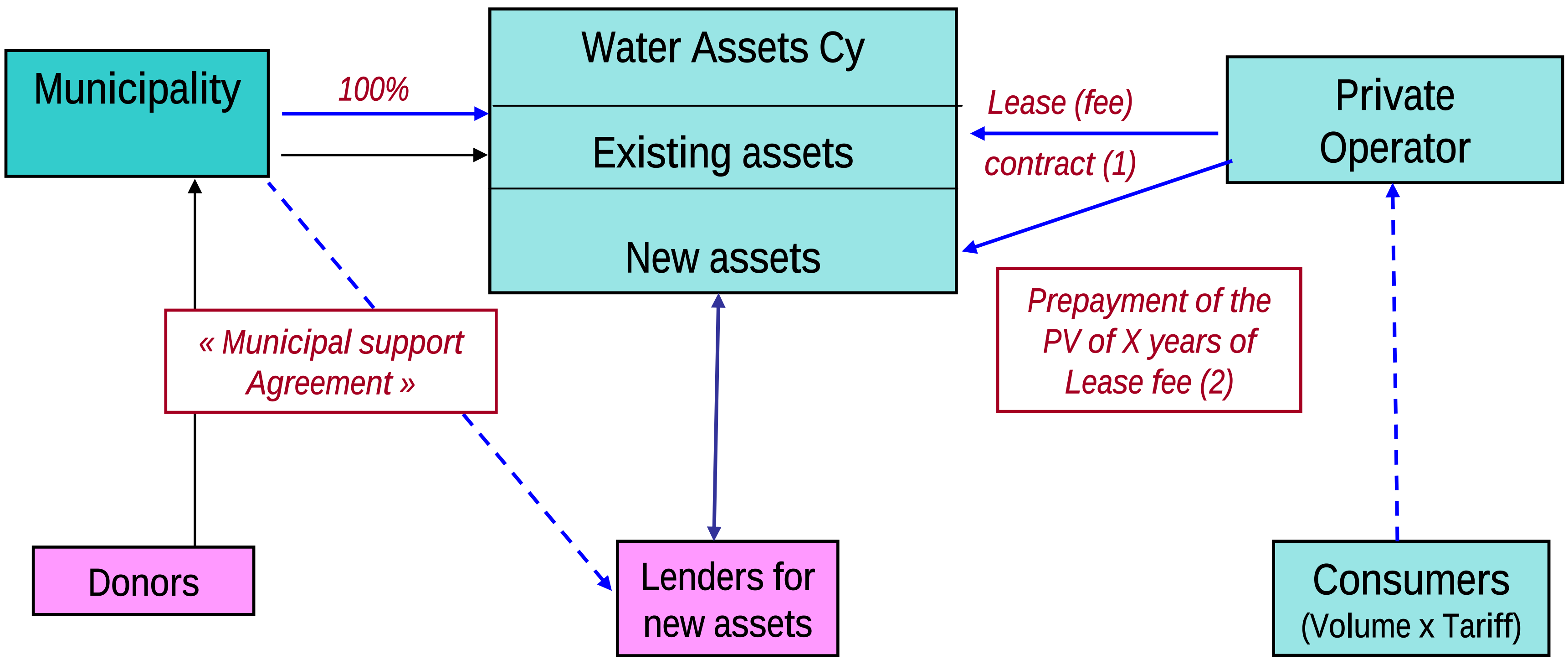
Lease contract

Mixing the « Municipal risk approach » with the
« Private operator technical and managerial capability »

Ex. Water Sector : Czech Republic 50 % and France 85 %



Combining lease contract and new assets financing



Three remarks:

- ★ *The private operator can participate to the financing of new assets which it will operate by paying in advance the present value of X years of an additional lease fee*
- ★ *Lenders may pledge Lease (1) and (2)*
- ★ *Lenders may benefit from a "Municipal Support Agreement"*

The "Corporate approach"

Public Service Company

concession agreement

Municipality

Financing needs

By

Funding sources

OPEX
- Operational expenses
- Maintenance

Capex:
- New assets

Financial costs:
- Debt service
- Equity remuneration

Optimization of
- **the equity / debt levels**
- **With the cashflows OPEX/CAPEX requirements**

Internal financial sources

- Cashflows:

Volume x tariff (affordability)

Consumers

External financial sources

- Equity:

- Private

- Public / Private

-Public

Shareholders agreement

Debt:
- Public – Private
- Foreign - Local

Lenders

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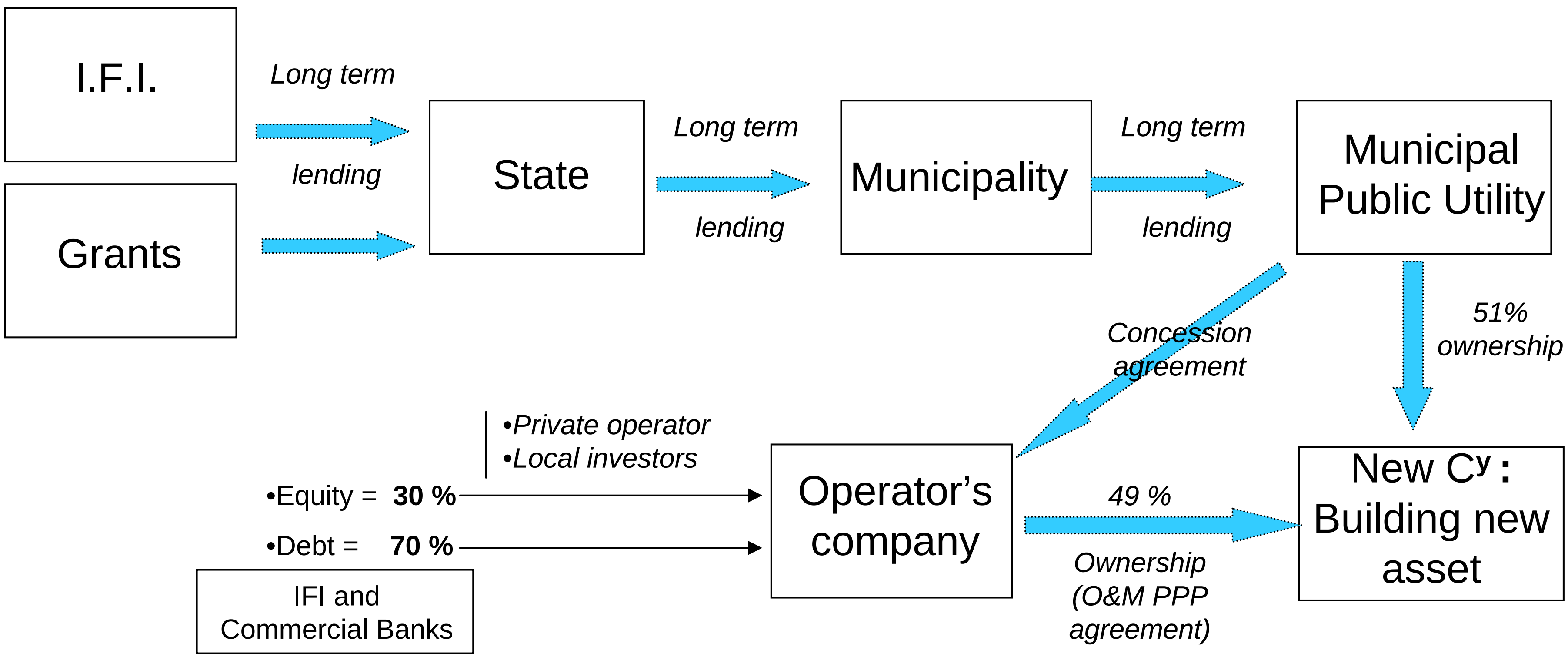
How to combine IFI financing – Commercial Banks financing and a PPP agreement ?



Such a model allows the Municipality to remain the owner of the new assets, to combine long term IFI sovereign lending with commercial lending, and to benefit from a private operator technical, managerial and financial expertise.

Chinese Veolia Water's PPP agreements: main features (1)

	Type of PSP		Water sector			Population served in drinking water (million)	New wastewater treatment capacity	Financing (Debt + Equity)
	Nature	Total	Drinking Water	Wastewater	Global operational responsabilitis			
Renovation of existing assets New assets	BOT Lease/BOT Concession Joint venture	1 1 7 1	1 1 2 1	0 0 5 0	0 0 0 0			• Equity (around) Cv = us$ 400 millions (local partners around us$ 200 millions) • Debt (around) Cv = us$ 600 millions : - us = us$ 100 millions - Rmb = cv us$ 500 millions
Sub-Total :		10	5	5	0	10.5	280,000 m³/day	
Water company global operational responsibility	Concession (joint owner ship with Municipalitis)	2			2 1= drinking water 1= drinking & waste water	4.1		
	TOTAL	12	5	5	2	14.6 million	280,000 m³/day	

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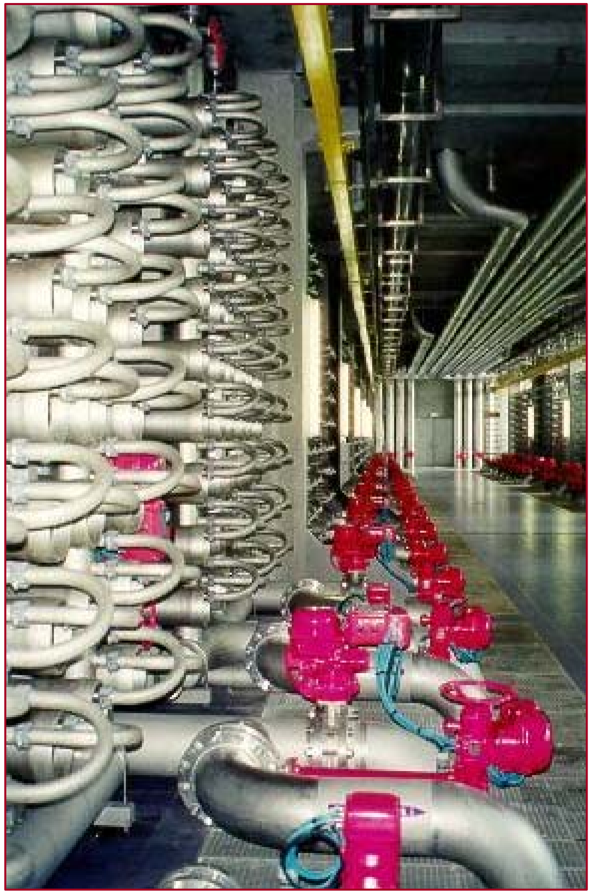
Conclusion Part II: the main PPP operational model objectives regarding customers

- Long term planning is the key issue to reduce the demand risk, considering several factors:
  - ➔ Population, industries, local habits,…
  - ➔ Wealth (GDP per capita)
  - ➔ Legal requirements
  - ➔ Expected local economic growth
- Future customers need is the key parameter for:
  - ➔ Planning CAPEX
  - ➔ Design future organisation for operations
  - ➔ Design and secure financing
- Long term planning allows long term financing.



Conclusion

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- The approach should differ according to each political and institutional framework.
- Even if the infrastructure model seemed to be well adapted to developed countries (eg the "PFI"), its sophistication and some of its drawbacks make it sometimes difficult to implement. (At least, it takes time to gather all the preconditions).
- Supported by its worldwide experiences, Veolia Environnement believes that there is a distinct advantage to develop a PPP "Operational model" when addressing basic municipal public services (in both developed and developing countries).
- In that respect, the China case shows that several approaches can be developed mixing infrastructures financing and operational objectives.
- Whatever the approach – infrastructure or operational model – **the robustness of the cashflow projections** are the best incentive to attract lenders, institutional investors, operators. It is also **for the end-users** the best guarantee **of their public service sustainability.**

Thank you for your attention