# Spaghetti Junction

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Italy has a dire need for infrastructure investment. But it has always promised much and, other than the TAV high-speed rail bond programme started last year, delivered little.

For the first time there are tangible signs that this is about to change: the PPP sector has undergone radical legislative change over the past three years and bankers and lawyers are staffing up their Italian offices in preparation for an upturn in deal flow.

PPP procurement processes have been refined, with the existing Merloni (concessions) law amended, the inception of a law aimed at projects of strategic importance and a new procurement process based on EU public works legislation.

And the new systems are beginning to produce deals. The Messina Straits Bridge tender is finally underway, phases 1 and 2 of the Salerno-Reggio Calabria motorway are nearing financial close, and the Catania-Siracusa motorway is also rumoured to be nearing financial close. In the longer term, new metro lines are also planned in both Milan and Rome.

But there are still potential hurdles: the lack of public sector expertise; the weakness of Italian contractors' balance sheets; overlapping competencies at federal and regional government level; and in some cases the constitutional entrenchment of the regions and power of local electorates - all combine to make delays and lack of clarity a continuing, if diminishing, facet of the Italian PPP market.

**New regime - new interpretations**

Fuelling the Italian drive toward PPP is an irreconcilable public sector equation - the demand for infrastructure investment offset by the fiscal restraint required by the EU stability pact. Italy has yet to meet successive stability programme targets and the trend is up rather than down. The EU Commission forecasts a budget deficit of 3.2% of GDP for 2004 compared to a target of 2.2% of GDP in the 2003 update and of 0.6% of GDP in the 2002 update.

Successive Italian budgets have been based on overoptimistic growth assumptions, especially the medium-term growth outlook. The projected interruption of the reduction of debt, which at 106% of GDP is the highest in the euro area, is an added concern, and without major intervention the debt ratio would have barely decreased since 2001.

With Italy operating so close to the stability pact threshold, PPP has long been the most credible solution. But until now both domestic procurement legislation and interpretation of European legislation have been confused.

For example, there was an initial misconception that to comply with EU regulations for off-balance sheet treatment - a must given Italy's Stability pact problems - a concession agreement needed to transfer economic and financial risk by transferring revenue risk. This caused headaches given that many deals under development were availability and performance payment based.

The situation was clarified by the Eurostat guidance in February 2004, which stated that structures based on availability and performance can be categorised as off-balance sheet for public accounts purposes.

Domestically, the corpus of law governing concessions - the Merloni law - has undergone piecemeal revisions after ping-ponging between ministries and committees of overlapping competencies that actually made PPP projects more difficult to complete.

Merloni has now been amended to enable a concession period to extend beyond 30 years and allow the public sector to contribute more than the previous limit of 50% of project costs.

The Legge Obiettivo - introduced in 2001 - also allows the government to fast-track strategically important projects, a response to the numerous projects that were being stopped by regional governments caving into local electorate pressure.

The law sets down rules for key infrastructure projects and makes them subject to a single authorisation process. The Legge Obietivvo also listed priority projects (originally 280 and now over 300) in order of importance, with the top 30 projects categorised as high priority and first to go before the ministry of internal economics, Comitato Interministeriale per la Programmazione Economica (CIPE), for funding approval.

At least 40% of the financing of these major projects will be met from the private sector, with the rest coming from state and European grants, and possibly EIB loans. The projects can be procured under either the traditional Merloni concession model or through the newer General Contractor (GC) scheme.

**Are General Contractor schemes bankable?**

The biggest of the GC projects is the Eu5 billion Messina Straits bridge (part of Trans European Network (TENs) Corridor 8) linking Sicily with the mainland. Roadshowed recently by parastatal project development company Stretto di Messina - which is advised by MCC, RBS and Allen & Overy - five bidders formally registered their interest on 16 September: three prequalifiers (consortia led by Impregilo, Astaldi and Rialto respectively) and two unsolicited bids.

The GC procurement method, which became law through Decree No. 190 in August 2002, falls between a PPP concession and a public works contract and is similar to German style deals.

Unlike a concessionaire under the Merloni law, the GC does not operate or maintain the projects. But neither is a GC a straightforward public works contract. The contractor takes on more risk than a public works contract, in that the GC's obligations will normally include design, site acquisition, construction and financing.

GC is purely construction financing and restricted to 20% of total project costs.

At predetermined milestones the awarding authority pays for the value of the works minus a retainer (prefinancing) that is paid on successful completion. The prefinancing is usually 10-40% of the contract costs (in real terms up to Eu800 million on Messina), which the contractor raises either as on-balance sheet funding, or more likely, given the relatively small size of the Italian contractors, commercially-provided bridge financing.

Banks are sceptical as to how GC scheme financing will work in practice, and whether such projects will be bankable. There is still a grey area over the legal standing of the milestones, prefinancing credit and the punctuality of the payment. At present the awarding authority does not legally recognise the credit at each milestone, only when completion is reached. And there is some doubt that ANAS (the public body responsible for managing the roads that is certain to be the most extensive user of the GC scheme) will be a timely payer despite the fact it is sovereign rated.

The GC scheme is complicated further by global performance guarantees - a guarantee required of the contractor where a third party guarantees completion of the project. The draft regulations for global performance bonds detail two components: 1) a financial undertaking to cover 10% of the works at auction price, and 2) a step-in undertaking where, in default, the bondholder will procure completion of the project.

The GC legislation also includes quirks - notably that the awarding authority is obliged to guarantee bonds issued by the SPV, up to its obligations that diminish on each milestone payment to the SPV. Bondholders will therefore be privy to a sovereign or sub-sovereign guarantee that will honour the SPV's debt, which appears to contradict the general intention behind the legislation to pass this type of risk to the private sector.

Although not a GC deal, the first and closest example of this type of guaranteed bond was Infrastrutture SpA's (ISPA) the relatively new state-owned infrastructure financing agency issuance on behalf of the TAV high speed rail project (for more details search ISPA on www.projectfinancemagazine.com)

ISPA is now also considering issuing and on-lending to the Eu750 million Pasimenti di Mestre bypass project - probably the next major tender to come to market. And there have been rumours that DEPFA will be the bond buyer.

Despite the guarantee bond, it remains to be seen whether banks will take GC project risk given the concerns over legal standing of milestones and prompt payment from the SPV to the contractor. And issues such as whether monolines can provide the global performance guarantees, and the potential conflict in step-in rights between lending institutions and guarantors, need to be resolved if GC is to progress smoothly.

**The PPP skills gap**

Although GC clarity is still an issue, parts of several projects are already being worked up under the scheme. In addition to the Messina Straits Bridge, both the Salerno-Reggio Calabria (for more details see the map on p40) and Catania-Siracusa motorways are progressing under the scheme, as well as the majority of the remaining Legge Obeitivvo high importance projects. And although Merloni concessions are the most effective way of spreading capital cost - GC schemes require sizeable public capital expenditure over a relatively short period of time (the construction period) - the GC scheme is the preferred route at the moment despite misgivings over its bankability.

And not without reason: many bankers, analysts and lawyers cite the cultural and expertise differences between the public and private sectors as one of the most significant barriers to getting PPP projects off the ground.

That only a few promotore (public projects conceived by the private sector rather than the public under Article 39 of Merloni) have been worked through to completion, save for small car parking schemes, is probably in large part due to this cultural gap.

Delays to promotore projects have been suffered due to legal objections made by losing bidders because of the absence of a clear definition of public interest - the test that must be satisfied for the awarding authority to accept a promoter's scheme. Even where projects have progressed, they have been severely tested as a result of insufficient knowledge on the public side: the delayed Brebemi highway project (for more details see box opposite), where a promotore proposal passed the public interest test, despite using old maps, is just one example of public sector inexperience.

**Co-ordinating legislation and governments**

Despite the amendments to PPP specific legislation, there are still some contradictions to be worked through in Italian civil law

For example, there is uncertainty about how public transport legislation will interact with concession law and which would have supremacy - a problem affecting the Milan Metro Line 5 deal (for more details see box above). Under existing public transport legislation a tender for a new operator should be launched every nine years - Merloni concessions can go to 30 years plus.

And the situation is exacerbated by the shared competencies and conflicting aims of ministries and committees at federal level, and regional administrations.

Consequently, the entity responsible for providing a coordinated approach, the Unita Tecnica Finanza di Progetto (UFP), has a thankless task. The UFP is Italy's PPP taskforce, but acts only in a consultative capacity and will normally only consider a project if contacted by a party privy to it. The UFP is a division within the Treasury and has been caught between a struggle of power between the Ministry of Finance and the Ministry of Infrastructure.

Greater success has been had with PPP taskforces set up a regional level. The template for the public side and the most competent regional entity is Finlombardia. Most of the other northern regions are well advanced along similar lines to Lombardia, with the southern regions perhaps one or two years behind.

It is accepted, and must be accepted by those wishing to enter the Italian market, that the infrastructure market is segmented region by region, and sector by sector. At present a thorough legal due diligence is required on each infrastructure project, and a bespoke financial structure worked up from scratch. But a greater degree of homogeneity and workable templates should come after the first wave of projects.

Overall most bankers and lawyers are satisfied and optimistic about the evolution of public sector entities. At present it is too early in the Italian PPP market to say: 'this is the given gearing for this sector, this is the margin of lending'. Nevertheless, other sectors beyond transport are seeing deals close.

**Healthy healthcare**

In healthcare, Italy has a battling hospital deal pipeline, and the financing for the first UK-style PPP hospital, Mestre, is near close.

Mestre is a Eu230 million project that, given its precedence, will set an aggressive benchmark with gearing of 85:25. The project company is an SPV called Veneto Sanitaria, formed from the construction company Astaldi. ABN Amro, IntesaBCI and InterBanca are arranging. The deal benefits from an EIB refinancing tranche that will take out 50% of the bank debt on construction. The concession awarder, the Veneto regional health authority, is AA rated.

The concession length is 28.5 years and the operational tail beyond the tenor of the debt is thought to be about four years. The UK model is recognisable in the concession with similar risk transfer: hard and soft facilities management is taken by the private sector. The tariff differs, however, and there is not a unitary charge, rather multiple revenue streams from the regional health authority, municipality, and central government based on availability-type criteria.

The lead arrangers are currently tweaking the tranching and finalising documentation, with close slated for end of October/early November. A limited syndication is envisaged that will be more akin to a club deal than general syndication.

Other hospital projects are being worked along similar lines; the much larger Eu400 million, Brescia II will share a similar structure to Mestre.

There are now also hospital schemes being worked up through the little used Merloni law Article 19 provisions, whereby the public sector originates the plans and opens a tender for the concession to the private sector. The municipality of Milan has just received 10 bids for a hospital scheme under Article 19. This is an example of increased public sector expertise. Previously it was common for an Article 19 tender to receive no bids because the concession was not commercially bankable.

Some bankers have argued that the GC scheme may face similar problems to the failed Article 19 tenders, in that a large part of the specification is worked up on the public side. Unlike the Article 39 promotore provisions where the private sector conceives the project, those that are sceptical about the GC scheme suggest that the private sector is best positioned to decide what is bankable.

It is an issue that could stall the Italian PPP market, but it is also just as likely to be resolved quickly given the first GC schemes are among the most high profile Italian projects.

**New sectors and market trends**

Beyond transport and health, the waste to energy sector - which is regarded as within the infrastructure rather than power sector - is accelerating nicely. There are rumours that a multi-site Eu1.5 billion waste-to-energy project is expected in Sicily, with Unicredit, RBS, and BancaIntesa among the likely mandate winners.

Unfortunately the most high profile example, the Naples waste to energy project in the Campania region, sponsored by Impregilo (95%) and EBC (5%), with WestLB and BancaOPI pulling together the financing, has faced problems - though this should be viewed as an aberration rather than the start of a trend.

Despite obtaining the necessary permits the Naples waste-to-energy opposition, culminating in riots, has delayed construction. With chronic waste problems in the region, public opinion was stirred, less by the environmental impact of the plant, but more by the impact on local entrepreneurs who were profiting by transporting the waste to landfills.

In the longer term there is potential for Italy to become a PPP pioneer. Feasibility studies are currently ongoing at federal level about the widespread private provision of prisons and penitentiaries. Also, and perhaps more groundbreaking is the potential widespread use of PPP concessions in the tourism sector.

The UK has only just made its first tentative PPP foray into the tourism sector with a £25 million deal involving the Forestry Commission - there is a possibility that within two or three years Italy could blow right past this. Talks are at an advanced stage to develop a pedestrianised area through a PPP concession in Rome akin to Covent Garden in London.

With widespread investment in infrastructure and concurrent projects being worked through, the Italian PPP market is looking like the real thing. But delays - such as those witnessed in the Brebemi and Pedemontana Veneta highway projects - will continue to be a facet of the market. In the short term the closest deals to financial close in the transport sector are the first phases of the Salerno-Reggio Calabria motorway and the Eu300 million Florence light rail project, for which the main sponsor is French metro operator RATP supported by Banca Monte dei Paschi di Siena and Calyon. Both are predicted to close before year-end and should add to the growing list of Italian tenders.

**Italian Metro projects**

* The municipality of Rome first undertook a feasibility study four years ago to see whether project financing could be applied to a new metro line - Line C. After an amendment to the Merloni Law (L.166) that extended the maximum concession period beyond 30 years and allows a public contribution of more than 50% of the costs, KPMG undertook a further feasibility study. Four offers were received in December 2003 for a BOT 30-year concession with Eu2.9 billion total costs, a Eu2.1 billion public contribution and about a Eu900 million financing requirement. The public maintenance entity HATAC will operate the line.

Progress has stalled because the financing is not thought to be sufficient. The municipality is also wavering about using PPP and would rather go the traditional public procurement route. Add these issues with large technology, archaeological and geological risks and the project seems very distant.

The proposed line cuts through the centre of Rome north-south. Geological studies have shown that a tunnelling machine such as that used on the Chunnel, TBM, could create vibrations and vacuums that could lead to subsidence. It is surprising that a project requiring such a degree of expertise has not attracted more international contractors. The consortium, comprising Astaldi, Vianni Lavori, CCC, Ansaldo and Alstom, is advised by Unicredit.

* The Milan Metro Line 5 faces similar difficulties. At the beginning of 2002 an Alstom-led consortium presented proposals and another Astaldi-led consortium presented a competing bid. The municipality could not decide which to appoint so did not appoint any and decided to use a traditional public works contract. At the end of June 2003, the two consortia merged and presented a new proposal for a 30-year concession, which Mediobanca and WestLB advised.

In January 2004 the municipality appointed the consortium as preferred bidder. No news has been heard since about when the second phase public tender stage will begin, but it is believed the project has stalled over the unavailability of public funds - it is thought that at least 30% of the cost will need to be met by the public sector to make the remainder commercially bankable.

**Italian road projects**

* The Salerno-Reggio Calabria motorway project is divided into five parts, with each part awarded in a separate tender. The first two sections have been awarded to CMC: the first, 30km long and worth Eu512 million, and the second, 30km and worth Eu887 million. Financial close for both is expected before year-end. The private component for part one, arranged by BancaOPI and Dexia, is expected at about Eu200 million, and part two, arranged by Depfa, is expected to be Eu500 million. CIPE is investing Eu700 million across the entire project and Infrastrutture SpA (ISPA) is also considering lending commercial rates.

* The Eu800 million Brebemi, Brescia-Bergamo-Milano highway, project was worked up under the promotore provisions. After considering a scheme from the promoter Brebemi, (a consortium comprising BancaIntesa, Camera di Commercio of Milan, Brescia and Bergamo and a number of highway companies including Milano-Serravalle, Centropadane, Brescia-Padova and Autostrade) the CIPE approved the project. As it had passed the public interest test the plans were put out to tender, only then when the bidders looked at the plans was it realised that the promoter had used old maps, so it was almost impossible for rival bidders to provide accurate costings.

Despite the predictable misgivings, Brebemi was awarded the contract, only for a change in administration in the Province of Milan and another infrastructure project to delay proceedings. The new administration rejected an anticipated PPP ring road of Milan, to which the highway was to be connected, also CIPE wished to coordinate the footprints of the high speed rail link which will run parallel to the proposed highway. The consortium therefore has applied again to the CIPE to receive the requisite public interest authorisation for an extended highway, which they expect to receive spring/summer 2005. IntesaBCI is the financial adviser, advised by Norton Rose, and Brebemi is advised by Allen & Overy.

* The Pedemontana Veneta highway project has faced similar alterations to Brebemi. The Pedemontana Veneta toll highway has been worked up under the promotore provisions. Initially, the Eu1.2 billion project was progressed to entail a 65km motorway connecting the A31 near Vicenza to the A27 motorway between Treviso and Spesiano. The scheme featured a 10-year concession period and received the public interest approval from the Veneto region. However, an extension proposal was made by the promotore, a consortium called Societa' Pedemontana Veneta, to extend the motorway to 95km and connect with the Milan-Venice motorway. The project costs increase to Eu2 billion and a 40-year concession is proposed - a statement by the region as to the extended project's public interest is expected mid-October.

The consortium is led by Autostrade per l'Italia, and includes Autovie Venete and Autostrade Bs-Pd. BancaOPI, Banca Anotonveneta and Unicredit advise the company.

Private financing is likely to comprise about Eu970 million. The concession follows a typical real toll structure. Vehicles will be electronically tolled, and local inhabitants will have onboard units that will allow them to travel within a 15km stretch along the highway free of charge.

**Power, pricing and permissions**

**Italian national power reform is having the desired effect - new generation. And the renewables market is picking up despite uncertainty over the future of the green certificates regime. But at regional government level there is still resistance to greenfield development. By Paul Smith.**

Despite reform the Italian power sector is as needy of investment as the infrastructure market. The price of Italian electricity is amongst the highest in Europe, and the spark spread the widest.

But the power sector has moved on from the subsidised tariff CIP6 regime towards liberalisation with a streamlined permitting process. And the majority of bankers accept that, in the short term, power, rather than PPP, will be the most fluid and profitable project market.

Power provides healthier margins (the pricing war for upcoming PPP market share is already underway) and avoids the level of interface with the public sector that PPP demands.

However, the power market faces some of the same challenges as PPP: gaining permits and overcoming local opposition. Although Italy badly needs more generation capacity, it is not a vote winner for regional governments. And in Italy a grand toure (judicial review) can be raised against such projects in the constitutional courts with relative ease.

The problems potential LNG terminals have had in the south of the country are illustrative. Despite receiving all of the required permits and authorisations, the coming on line of the Brindisi LNG terminal has been delayed in the face of local opposition. The regional authority protested after it became apparent that half the population of a local town would have to be evacuated to test the terminal.

Regional problems stem from the fact that under constitutional law both the government and the regions preside over energy, and this causes an inherent strain in the system. Some sponsors and bankers are proposing a compromise - a regime of incentives resulting in lower power prices for those local authorities that accept power plants in their region.

**Shaping the new market**

At national level the Italian government has made several steps to facilitate investment since the break-up of ENEL into three gencos. What has emerged is a three tiered project market with bankability of deals - merchant, tolling or corporate-based - dependent on the credit strength of the project company, and genco deals getting to market quicker through a streamlined permitting process.

The first project to be issued a permit by the Ministry of Production Activities under the simplified permitting procedure introduced by decree 7/2002 (the sblocca centrale, or power plant unblocking decree) was the Energia-backed 800MW Termoli plant.

Termoli was also notable for being the first standalone plant to be financed using a merchant credit. Of the Eu400 million total project costs, Eu260 million was bank debt. The credit division of Banca Monte dei Paschi di Siena took the lead on the financing.

A more recent sblocca centrale decree has since been passed. And a draft law for the reorganisation of the energy market has been approved which allows business users to choose their electricity supplier from 1 July 2004, and domestic users from 1 July 2007.

The draft law also simplifies the authorisation procedure and provides incentives for the building of new pipelines and LNG terminals, and introduces the green certificate regime to the generation of electricity from hydrogen.

Energia, is now looking to finance a further two 800MW plants on a merchant basis, Modena and Aprila. WestLB is close to finalising the structure for Modena, a greenfield plant. The deal works like a medium-term bridge loan, with the refinancing risk mitigated with a final balloon after five or six years. Either the loan will be refinanced or, if Energia has sufficient funds, the loan will be paid. Aprila is currently in the permitting stage.

Energia's strategy is short term, whereby it looks to get these three power plants built so it is of sufficient size to IPO in four to six years' time. Energia is financing on a merchant basis because it lacks the balance sheet for a corporate deal, or non-recourse tolling strategy. Although this appears high risk, there should be sufficient upside in the electricity price and high enough margins in the short term.

Larger corporates, such as Tractebel and Mirant Italia, are looking at tolling agreements because bank appetite for merchant deals is limited and the debt comes at a premium. And corporates with the healthiest balance sheets with spare permitted capacity will develop on balance sheet. Edison and EdF are likely to pursue this strategy.

There are a number of financings approaching the market. EGL's Calidia and Edipower's refinancing should close before year-end. And the award of the mandate for the CCGT Voghera plant sponsored by ASM-Voghera, domestic utility Acea and Electrabel, is eagerly anticipated.

Financing for the Tractebel-Voghera Brindisi LNG terminal should also reach the market before year-end. And a UK private equity firm is believed to be acquiring Electra assets from steel firm Lukini and RWE. The three plants are supported by the subsidised tariff regime CIP6 - the last of which should expire in five to six years.

**Renewables**

Of the renewables deals due to finance, IVPC Verde is probably head of the pack. The renewables market has already produced some of Italy's first merchant deals under the new regime and provides a natural hedge against dependency on power fuels - useful given the delays on the LNG terminal projects.

The windiest part of Italy is the south, which fortunately for developers and financiers allows investors to tap the region's 488 development grants. These grants are currently running out, but it is expected that the commitment will be renewed.

Notwithstanding the grants, renewables are relatively easy to bank. Renewables benefit from priority despatch into the grid and from premium tariffs. (see www.projectfinancemagazine.com for analyses of the first two green certificates deals: IVPC 2000 and Andretta-Bisaccia).

There is some uncertainty about how the green certificate regime will work over the longer term. Under the scheme, renewable generators receive the pool price for their power and a premium by selling certificates matching that amount of power to utilities that do not have the requisite renewable capacity as set down by the government. The target is currently set at 2% of output, and will rise to 12% over time.

At present the Italian grid operator GRTN is effectively the price arbiter, issuing certificates against CIP6 renewable contracts transferred to it as an off-taker from ENEL. This is because there is not enough renewable capacity to meet the 2% requirement. To date GRTN has issued small amounts to purposely track the price of green certificates against the subsidised tariff of the CIP6 regime.

It is anticipated that in four to six year's time the price of green certificates will be driven purely by demand and supply. Prices are expected to fall, but not dramatically. Other predictions are that by 2005 there will be enough renewable capacity to match the 2% requirement, but it is expected the government will up the requirement in advance of certificate oversupply until it reaches the 12% mark.