



Mobilising Cost-efficient Capital for Water Projects: Options and Case Studies



T Craig Bennett

Deputy Head, Structured Finance, Société Générale

Before looking at new financing options for water projects, it is important to recognise and understand the stage we have reached, in terms of the private sector water market, and likely future developments. In short, 'the pace is quickening!'

A good indication of this development is the intense level of mergers and acquisitions activity on the part of water developers during the last 12 months. These acquisitions have been, as one might expect, cross border deals, of which the vast majority with a value in excess of US\$13 billion have been in the form of transatlantic traffic, thereby reflecting the dominance of French, British and American operators in this field. The major players are taking the opportunity to gear up, in every sense, their respective positions in the unfolding global market.

These large-value strategic investments have been driven by a number of considerations, including:

- the financial need to develop non-regulated earnings;
- the need to acquire the relevant technical expertise; and/or
- positioning for future public/private partnership (PPP) market growth, the prime example here being the US\$40-billion-per-year-plus North American water sector.

Such activities should continue to place pressures on other international water developers to maintain their competitive positions. Combined with deregulation in developed countries, it is believed that further corporate acquisition activity in the water sector will continue apace.

The other interesting development that is taking place is the privatisation of total utilities for municipalities – for instance, combining electricity and water in one concession. This is already happening in markets as

diverse as Morocco and Australia. It raises interesting financing questions, including investment questions.

Matching this demand side growth is the proliferation of PPP activity – whether concessions or build-operate-transfer projects (BOTs), or whatever form it may take – being transacted across developing and developed countries alike. The reality of involving private sector commercial, technical and financial skills to deliver tangible improvements to water networks is now with us on a global basis, the reason being that it is the only effective way to obtain a true allocation of risk to those parties best able to control exposure to the relevant risk.

Through experience and education, the virtues of employing private sector skills are becoming recognised. For example, in the US, the National Association of Water Companies recently commissioned an independent study which confirmed that PPPs between American municipalities and private water utilities are overwhelmingly successful in addressing the financial and environmental challenges most commonly faced by municipalities.

By contrast, the city authorities of emerging Central European countries, with the guidance and assistance of multilateral agencies, are actively pursuing water concession projects – in many cases the first PPP deals to be tendered in their respective regions.

Looking forward, we remain confident that regions such as South America, the Mediterranean rim, Central Europe and, on a more limited basis, Asia will continue to provide the business volumes that are driving this market.

Finance Issues

From a financier's perspective, water PPP projects, unlike, for example, their counterparts in transportation, cover the full range of private sector interventions; that is to say, anything from

T Craig Bennett is Deputy Head of Structural Finance for Société Générale. Previously, he was Global Head of Project Finance and has been with Société Générale since 1983. He has spent more than 20 years in the fields of capital markets and project finance. He has qualifications in law and finance.

operation and maintenance contracting through BOTs and concessions to full-blown privatisations. In turn, the associated financing needs of developers will be equally diverse and will require a funding package tailored to the evolution of the business, as much as the project.

BOTs and Capital Markets

Based on this, and taking into account both competition and the large size of transactions requiring finance, there is increasing pressure on bidders to identify and mobilise efficient sources of debt and equity capital, essentially over the long term. In developing markets, this inevitably requires the involvement of multilateral institutions, except in very special cases where the local capital markets are mature enough to provide elements of the funding.

On BOT projects it will, more likely, be the construction price, as opposed to the cost of

Finance Initiative projects. Société Générale was delighted to act as both financial adviser to the consortium and co-manager to the bond issue, which represented the majority of the project funding.

The £80 million bond issue was credit-enhanced by a monoline insurer and had a 27-and-a-half-year tenor based on a 30-year contract tendered by a quasi-governmental body, the East of Scotland Water Authority. The project comprises the installation and provision of integrated wastewater treatment services for the City of Edinburgh. The benefits of the long-term nature of capital markets could therefore be realised against the long concession period. Additionally, the all-in interest costs continued to be more competitive than the traditional bank debt alternative.

Looking at the transaction from an innovation perspective, the project profile had several key features:

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finance, that will produce a winning – i.e. lowest Net Present Value – tariff or toll stream. The value of debt finance is more associated with the maturity and profile of debt repayments relative to the life of the concession and this explains partly the attraction of the capital markets.

That stated, commercial banks are not necessarily giving up the fight! In the UK, for example, certain lending institutions are now actively competing against capital markets – anything up to 27 years on 30-year contracts. British PPP contracts have become standardised – if somewhat late, in our view – but this is still a major milestone in the commoditisation of raising competitive finance on future deals.

Stirling Water Case Study

I would now like briefly to run through a case study, namely the first PPP water bond, which was issued in the UK by Stirling Water in early 1999.

Stirling Water was a consortium put together by Thames Water in the UK to bid for Scottish Private

- Volume – payments to the project company are made on the basis of volumes of wastewater received and treated. The monoline rating agencies and investors needed to be satisfied with the base case as there is no fixed or availability payment structure.
- Flexibility – the structure of the project determined a requirement for two tranches of project bonds. The first covered the majority of the financing requirement for the scheme but the public sector widened the scope and, for regulatory reasons, could not time the second scheme (Esk Valley) with the first (Almond Valley Seafield). The second Sterling bond issue will be fully fungible with the first and will form a single series of bonds. This demonstrates that the capital markets can provide flexibility.
- Financial and contractual structure – Société Générale structured the deal to be extremely robust for both shareholders and bond investors to withstand fluctuations in volumes over the life of the concession. This was achieved by banding the



volume-linked tariffs and weighting the tariffs between bands according to the financial and operating costs of the project company. The bands themselves were determined following detailed statistical flow analysis. Additionally, it is possible to sever a part of the project that is underperforming and still keep the project whole without the risk of termination.

The key lessons learned from the process were based on the ability to tailor the capital markets structure around the needs of the project. Flexibility has been mentioned and this was an absolutely key requirement for the project and is a criticism often levelled at capital market based funding structures.

The single risk that proved most challenging was, of course, the volume risk. This was tackled by extensive due diligence by the sponsors, led by Thames Water – a company that is naturally better placed to understand this risk than any party. After all, it does run London's water system! The acceptance of this risk by the monoline insurer underlined the quality of Thames Water as a sponsor and the high level of interaction between the sponsors, the monoline, the rating agencies and the investors.

This case study demonstrates that the capital markets can be used as an efficient, cost-effective funding source for water projects in developed economies.

Accordingly, we believe that such project bonds, whether issued by way of public or private placement, will remain confined to developed countries for the near future.

As has been made painfully obvious to investors, albeit in other industrial sectors, cross border project bonds and political/regulatory uncertainty, together with currency devaluation risk, do not easily mix. The challenge for water sponsors in developing countries is therefore to identify and educate local investors with whom project paper may be placed.

Concessions

Turning back to the more favoured approach to PPP water projects, a few thoughts on concessions are offered, including the corporatisation/privatisation models. This is an extremely topical issue and the experiences of recent bids in Latin America have been quite inspirational, I suspect, for participants and observers alike.



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Restistered Office:

5th Floor Kailash, 26 Kasturba Gandhi Marg, New Delhi - 110001 Tel.- +91 11 3313131(1-3), Fax --+91 11 3313134

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With the much larger value concession/ privatisation schemes, a real price needs to be committed and funded up front. This requires a much more rapid and flexible financing package, the cost and terms of which will be far more influential on the success or otherwise of the bid. A combination of acquisition accounting and valuation methods, together with project finance style analysis, is required.

Where the optimum financing structure is not determinable at the outset, a two-stage financing approach may be required that combines corporate or bridge-style funding with a longer-term non-recourse financing takeout. In other cases, a structured finance package is established at the outset, with the expectation that, as future (say five-yearly) investment periods and tariff increases are determined, the financing package will be grown within a set of predetermined parameters. Such an approach clearly requires large amounts of effort and information at the outset.

The level of observed data and quality information that is made available to concession bidders is therefore a key factor in determining the value of the business to be acquired or operated. In theory, there should be linkage between the quality of bid data provided and the volatility or range of prices offered. The ability to assess the technical and other risks on a localised basis is critical to the process. Other key factors include public sector transparency, the local political and regulatory regime, performance standards, scope for changes and tariff adjustments and termination rights.

The need for acceptable political risk cover in emerging economies is a major factor in raising finance for concessions, given their susceptibility to local politics and socio-political factors. Local funding can play a key role in some markets, mitigating, to some extent, the exposure to currency fluctuations and the extended political risk.

Water privatisations such as those currently being pursued in Latin America (Chile, Bolivia and Panama, etc.) will normally be specific to a region or municipality and tendered by way of trade sales. Undoubtedly, competitive tenders are an important element in reducing socio-political factors and ensuring that there is an adequate availability of historic information to support an informed bid.

Key investment decisions, both to equity and debt providers, will include the percentage of voting shares on offer if it is a purchase of an ongoing entity, whether on a staged or immediate basis. Minority interests of foreign investors will lead to fears of significant political and regulatory risks arising for the investment and the loans.

In many countries, the continued involvement and support of the multilateral and supranational agencies and similar organisations will be essential in ensuring that the risk package, or the political context in which they are managed, is acceptable.

I predict that we will see more use of bridging finance on water concessions, as well as a greater proportion of local financing and the use of infrastructure debt and equity funds.

In terms of local financing, and based on Société Générale's own experiences, there is enormous value to be gained in identifying and securing local finance and/or investors, in particular in corporatised concessions. As with the PPP process itself, this often requires a degree of education and understanding on all sides.

There are already a number of established third-party infrastructure debt funds, most of which cover the water sector. In the last three years, however, we have also seen the creation of half a dozen dedicated water equity funds, with a combined capacity in excess of US\$750 million. Apart from being another source of equity finance and risk sharing, such funds provide bidders with the continued ability to secure larger value assets, especially in regions where lower debt gearing ratios are in force following recent debt crises.

Another option open to those successful water developers looking ahead will involve the packaging and refinancing of water asset portfolios. Such securitisation may be on a regional or wider geographical basis. We have already seen the packaging of several power projects in developing countries into one umbrella financing, with cross-defaults and cross-support elements. This has one big advantage for lenders in that it enables them to consider the portfolio effect of country risk and hence reduce the internal weighting of this risk. This leads to a better loan pricing for the investments. The justification for this approach is that the facility is structured to ensure that if one or two countries do have problems leading to loss of revenues for projects in those countries, the remaining projects in other countries can support the financing cost and reimbursement of the total facility. It is not hard to imagine that this will be extendable to the water sector.

The water sector is not an easy sector to finance, but the last few years have shown that the funds are available for those projects with viable investment plans and a good allocation of risks against the background of an established and open regulatory environment. ■