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# Italian PPPs

## The development of a funding unit

*Luigi de Pierris & Velia Leone*

Compared with the OECD average, the Italian economy has long faced a high level of public debt to Gross Domestic Product. The management of this deficit has been critical, in the context of Italy's requirements to adhere to the Maastricht macro-economic convergence criteria.

Today, the public sector in Italy still accounts for over 25 per cent of the economy. Over the past decade several landmark privatisations have begun the gradual shift in ownership towards greater private sector participation. Privatisations such as those of ENI (the oil and gas company that, until recently, was the largest quoted company on the Italian Stock Exchange) and the initial public offering of a minority stake by the Treasury in ENEL (the power company) marked important episodes in the shift in public policy.

Italy's level of public spending on infrastructure has lagged behind that of its European Union (EU) partners. Nevertheless, it is only recently that the political climate has changed sufficiently to embrace the concept of allowing greater levels of private participation in the ownership and management of historically public infrastructure. Indeed, the 2001-2004 Economic and Financial Planning Document, prepared by the Italian Government, estimated that the private sector would need to contribute 9 billion euros towards the financing of new infrastructures.

Recent studies of the state of infrastructure in the EU ranked Italy fourteenth - with a score of 54.1 per cent compared to 63.4 per cent by the UK and 100 per cent by Belgium.<sup>1</sup> In Italy, the infrastructure gap presents some stark contrasts: for example, in the water sector, the South lags 23 per cent behind the national average.

Consequently, the need to contain the public debt and to enhance the level of infrastructure left the Italian Government no option but to foster the participation of private investors in infrastructure projects.

The response by the Italian Government was threefold:

- The existing legislation enacting the EU Directives on public works was amended in 1994 to deal specifically with project finance
- Additional legislation enacted in 1999 identified three 'champion' projects (two motorways: the Pedemontana-Veneta and the Salerno-Reggio Calabria; and the link between continental Italy and Sicily)

- An 'ad hoc' team of professionals (the *Unità Tecnica Finanza di Progetto* or UFP) was created and entrusted with the mission of promoting project finance techniques in the infrastructure sector

### **The *Unità Tecnica Finanza di Progetto***

The UK Treasury's Private Finance Initiative Task Force, established in 1997, had a significant influence on the need to create a special unit within the Italian Administration. A group was established whose members were recruited through an international competition and were appointed by Decree in April 2000. The UFP was launched in July 2000. The creation

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of a specialised team of project finance professionals within the Italian Treasury and an inter-ministerial commission (CIPE: *Comitato Interministeriale per la Programmazione Economica*), brings with it certain key challenges in fulfilling its dual role of providing project finance expertise to the public sector and to assist them in identifying projects capable of attracting the private sector.

The UFP will also liaise with the CIPE on general policy issues concerning infrastructure investment, even when the provision of private capital and/or expertise is not required. A significant difference between the UK Treasury Taskforce, precursor of the current Partnerships UK and the Italian equivalent, is the consultative nature of the Italian model. The

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administrations have the option to consult this group, but are not necessarily required to do so. This reflects the relative autonomy that the Regions enjoy with regard to economic planning, but could provide a barrier to the smooth implementation of homogeneous models within specific sectors in Italy. In this context, the UFP is called to play an important role of conduit through which the private sector will channel its requirements and concerns, in order to create a level playing field. This is a critical factor for a fully developed project finance market to evolve in Italy.

The UFP will also need to concentrate on the policy-making aspects of adopting project finance, which will include:

- A project finance guide and an interactive internet site
- Training of the public administration
- Developing a methodology for comparing project finance to public finance and the implementation of best practices across projects
- Dissemination of information on the activities of the UFP
- Creation of a Public Private Partnerships (PPP) database

In order for PPPs to develop in Italy, the underlying contractual and financial models need to be further developed. PPPs rely on limited recourse project finance, a structure based upon the inherent economic merits of a particular project, rather than the sponsor's credit-worthiness. project finance has been used to a certain extent in Italy to date, with the financing of approximately a dozen private power sector projects over the past six years.

Project finance, in the context of PPPs, requires both the private and the public sectors to acknowledge the risks involved in a particular project and, on the basis of a flexible contractual structure, to divide these such that the private sector is being paid adequately for the risks that it has been asked to assume. Once the contractual structure is in place and the risks identified and allocated, the sponsors need to mitigate or assume those risks and then enter into discussions with lenders on a non-recourse basis in order to establish whether they are willing to lend to a project and on what terms. This will require a fundamental change not only in the way banks analyse and manage projects and but also in the levels of risks that private sector companies are required to assume to attract non-recourse finance.

Another significant change that the adoption of PPPs entails is greater accountability for the level and quality of service. Where a private sector operator assumes the role of managing, say, the non-health services of a hospital in a PPP transaction, the contract will stipulate the exact nature and level of service to be delivered over the life of the contract and the penalties involved if the prescribed standards are not attained. It is this penalty mechanism that introduces a financial discipline that was lacking with the public management of such services. In addition, within specific sectors these service contracts will enable benchmarking to take place.

An example of this is the privatisation by the UK Government of British Rail, by the creation of 25 concession companies and a network operator (Railtrack). All these companies must adhere to a set of quality standards in order to be awarded a licence that allows them to earn revenue from passengers (or the rail operators, in the case of Railtrack). The repercussion of not meeting quality standards is the imposition by Opra and/or the Rail Regulator of heavy fines. Such fines clearly erode the return on equity of these companies, which are therefore heavily incentivised to ensure that quality is maintained.

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The Italian Government is undertaking a deregulation process through 'competition by comparison' in order to achieve value for money and enhance the quality of services.

Historically, Italy has used a process of public tenders for public projects that have created significant bottlenecks. The private sector was limited to executing the construction contract and with no further contractual involvement in the management or ongoing investment commitments, this imbued some construction companies with a tendency to short-term philosophy.

New companies will need to be created in Italy that are either independent or are affiliated to the large construction companies, willing and able to provide services on a long-term contractual basis and also willing to invest equity in such projects, such as Laing Hyder and Carillion in the UK. Nevertheless, this trend has already begun, with companies such as Benetton investing in Autostrade SpA, the country's largest motorway operator. With regard to equity investments, large Italian construction companies have often needed to invest in projects as a condition of doing international deals, especially in the emerging markets. Thus there is no shortage of the necessary skills, just reticence to acknowledge that the domestic market has changed; no doubt this will change with greater competition.

In Italy today, excluding the power sector, there are several PPP projects:

- Police Training Academy, Bari - reached financial close
- Salerno - Reggio Calabria Motorway - advisers appointed
- Pedemontana Veneta Motorway - advisers appointed
- Link from Italy to Sicily (Stretto di Messina)

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The following sectors have been identified by the UFP as eligible for PPPs:

- Water (distribution, wastewater, integrated water utilities)
- Transportation (toll roads, mass transit systems, airports, ports, car parks)
- Environment (waste to energy)
- Defence (housing)
- Public Works (social housing, hospitals, prisons, government offices)
- Tourism (hotels, conference centres)
- National Heritage (restoration of historical monuments, museums and libraries)

### Legislative framework

In order to fully appreciate the magnitude of the legislative intervention the Italian Government has been called to enact, it is necessary to understand the role played by administrative law within the current Italian legal framework. This is a distinctive feature of the Italian legal system.

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In the UK, once a contract has been awarded - even through public competition - the public administration negotiates the contract with the private sector on an equal basis, with both parties enjoying equal rights and obligations. Conversely, in Italy, the pursuit of public interest allows the public administration, in certain instances, to protect its position by negotiating more favourable conditions or even modifying the contractual terms during its execution (*ius variandi*). Although this position is justified by the pursuit of public interest, it also creates two sets of problems:

- A widespread distrust of the public sector by the private sector, which does not feel comfortable in entering into a contract with a partner that has binding powers, capable at any time of modifying the terms of the contract
- A high level of litigation which, although not as expensive as in the UK or the US, is nevertheless capable of lasting more than a decade

The lack of a level playing field was clearly not conducive to the development of project finance within Italy. The key element needed to ensure success of project finance, in any country, is that the contractual terms are clear at the outset, so that the investors and bankers are comfortable to invest. This partly explains why the Italian Government was obliged to enact specific legislation for the project finance model to work in Italy.

### The Merloni-ter law

The Merloni-ter law, passed in 1998, represents the third amendment to the Italian legislation implementing the EU Directive on public works and introduced project finance in Italy. This choice reflects the fundamental approach by the Government to upgrade Italy's infrastructure.

Important features of the Merloni-ter law include:

- *Promoter*: the private sector is allowed to submit a proposal to the public administration for a specific infrastructure project, provided that the project in question has been included by the Administration in its three-year plan on infrastructure investment. The law is very prescriptive in terms of the type of information the promoter has to submit for the proposal to be received
- *Procedure*: a very prescriptive procedure is established for the proposal to be declared of 'public interest'. This procedural step is *conditio sine qua non* for the proposal to represent the benchmark for the competition to be launched and the contract to be awarded
- *Public tender*: the public authority has to launch a competition in order to award the contract. The law entitles both the promoter and any participating third party to recover part of the costs of participating in the competition in the event that the offers are rejected
- *SPV*: the successful tenderer has to set up a special purpose vehicle (SPV) once the contract has been awarded. The law allows the awarding authority to require a specific company structure and capitalisation. Furthermore, once set up, the SPV can issue bonds beyond the limits set by the Civil Code
- *Termination*: in case the awarded contract is terminated by the awarding authority, the concessionaire is entitled to be refunded the costs of the works already accomplished, penalties and other costs deriving from the termination, and compensation for works and/or services yet to be completed
- *Step-in rights*: financiers can implement changes in the structure of the SPV in order to prevent the awarding authority from terminating the contract. The law prescribes the conditions under which these rights can be exercised

- *Warranties*: the law prescribes that the lenders are given specific legal privileges over the works built by the concessionaire

In addition, the *Merloni-ter* allows the awarding authorities to initiate a competition, through a typical concession contract. Interestingly, when dealing with this type of contract, which is typical under the Italian law, the conditions under which the contractual terms can be revisited are set out explicitly. The law still allows the awarding authority to implement modifications or to enact new legislation to the same effect. However, should these variations have a bearing on the economic and financial equilibrium of the contract, then the parties are entitled to renegotiate the length of the concession, which is defined by statute as being not more than thirty years. The alternative remedy available to the concessionaire is to terminate the contract and be compensated according to the provisions described above.

The *Merloni-ter* has been complemented by additional, more prescriptive legislation that came into force on the 30th of June 2000. This means that it is only from this year that it is possible to verify in practical terms whether the legislative approach implemented by the Italian Government will be successful. However, comparisons can already be offered with other international experiences:

- When looking at the complex nature of a project finance contract, it is questionable whether stressing the 'works' side of the project has been a wise choice. This is clearly very different from the approach followed in the UK and other countries
- The law has a very prescriptive approach, in both the procedural and the compliance requirements placed upon the private sector. This will add costs and make it less attractive to the private sector altogether
- The playing field is still tipped in favour of the awarding authority because they are able to modify the 'concession' contract, even if some forms of compensation are envisaged in order to keep the private sector in the game
- The role played by the promoter may foreclose competition at the later stage of the procedure, i.e. when the competition is opened to third parties. This is particularly true if attention is paid to the submission of the offer, as this is a very time-consuming and expensive process for which the compensation envisaged by the law may be a little insufficient

Outside the specific issue addressed in the *Merloni-ter* law, there are other, fundamental difficulties in applying an Anglo-Saxon legal contract model to a different legal system. For example, the high propensity to litigation may jeopardise, or at least delay, the full implementation of project finance in Italy. In this context, the policy role of the UFP is of paramount importance. It would be unwise, perhaps, to try to implement new legislation before the current framework has been fully market-tested, but it is important to realise that the

UFP has the power to clarify some of the thorny issues identified above and provide the market with the necessary comfort. To this end, the UFP has already started a number of informal consultations with various representatives of the private and public sectors in order to identify the possible stumbling blocks and to provide guidance.

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In this complex context the private sector is called to play a new and challenging role, not just in terms of providing the necessary financing, but also - and perhaps more importantly - in providing those skills needed to bring Italian infrastructure in line with its international peers. The requirements for many sectors to liberalise (such as electricity and gas) is driven by EU Directives, and is an additional impulse to accelerate the process.

Given this situation, the UFP has a very significant role to play not only in assisting public authorities to push forward best project finance deals, but also in market-testing the private sector and identifying their critical needs so that a properly competitive PPP environment is encouraged. The UFP will operate through legislative and policy instruments, drawing from internationally acknowledged best practices and applying them to the Italian market. **ij**

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*1 Di Palma - Mazziotta (1998), World Bank (1994)*