



WATER INFRASTRUCTURE IN SPAIN: HOW THE AGUAS DE SEVILLA INNOVATIVE SCHEME COULD OPEN THE TAP FOR NEW WAYS OF FINANCING A SECTOR THIRSTY FOR INVESTMENTS

Rene Kassis & Anne-Laure de la Roche, Dexia Credit Local, present a pathfinder Case Study for the Spanish water sector in which an innovative structure was successfully used to maximise the projects benefits.

Dexia and Ahorro Corporación Financiera have arranged a Eur 100 million groundbreaking structured financing for Aguas de Sevilla ("EMASESA", the municipal water company of metropolitan Seville) in relation with a water supply and treatment investment program to be implemented in the Sevilla area. The financing involved the two institutions, the European Investment Bank ("EIB") as well as the monoline insurer Financial Security Assurance ("FSA", a Dexia Company) acting as their guarantor. The main novelty of the transaction resides in the financing being structured as a purchase from EMASESA's rights to charge end-users with an "improvement fee ("Canon de Mejora") established under a Decree promulgated by the Regional Government of Andalucia for the specific purpose of financing the works program. The main merit of this scheme, from the municipal water company's perspective, lies in its nature as a sale of rights on a non-recourse basis, with therefore no impact on the level of indebtedness of the municipality. These are attractive features that other Spanish Regional Government and municipal companies would be tempted to use as a way to undertake significant infrastructure investments without affecting their increasingly scrutinised debt ratios.

THE INVESTMENT PROGRAMME TO BE CARRIED OUT BY EMASESA

At the outset of the transaction is the increasing demand for quality services related to water in the Sevilla area, putting a significant pressure on the existing network, and calling for a vast plan to improve the water supply and treatment infrastructures. Such tasks are under the responsibility of EMASESA, the municipal company wholly owned by Sevilla Town Hall which manages the water supply

and sewage services for the city of Seville (fourth largest city in Spain) and 13 municipalities in its metropolitan area. On the whole, the population served is more than one million inhabitants.

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The improvement works, that need to be carried out until 2004, focus on the upgrading of the existing grid, consisting of mains, pumping stations and treatment plants. They are designed to improve the quality of the water supply, allow for the reduction of water losses in the grid, the increase of water pressure, and provide for a better treatment of residues.

AN APPROPRIATELY DESIGNED LEGAL FRAMEWORK: THE CANON CONCEPT

The concept of passing through to the end-user the cost of public infrastructure investment is already well established in the Region of Andalucia. It was first introduced in 1994 by a Regional Decree, allowing to charge users with a specific fee ("Canon de Mejora") based on their water consumption, designed to finance a first investment program extending from 1994 to 1996. It has subsequently been adjusted and extended in 1998 for a second phase of works. The Canon has therefore been already charged to and paid by the users for almost a decade. This historical background was particularly key for the financial institutions in their assessment of the social and political acceptability of the Canon.

In order to finance the current investment programme, and at the request of EMASESA, Junta de Andalucía issued in July 2001 a Decree increasing of the fee in terms of eur /m³ and extending its applicability from 2006 to 2016. The approach taken has been to set the Canon at a level allowing the amortisation of the financings dedicated to the works programme, based on a forecast of the future



proceeds from the Canon until 2016. By legal nature, the Canon is exclusively dedicated to service the financial institutions funding the works programme, and adds up to the users' water bill. Another key feature of the Decree is a provision for revising the Canon should certain economic assumptions of the base case scenario considered in the Decree (e.g. water consumption, interest rates) vary in a way jeopardising the amortisation of the underlying financing.

AN ATTRACTIVE FINANCIAL SCHEME FOR THE CITIES

The financing structure designed to fund EMASESA's programme takes the form of assignment by EMASESA of its rights on future Canon proceeds, and presents the advantage of being structured as a non-recourse facility against EMASESA's balance sheet. In such a scheme the financial institutions have recourse only to the Canon proceeds collected by EMASESA. By purchasing the rights on such proceeds, the financial institutions will pay to EMASESA an amount equal to the net present value of the future proceeds expected from the Canon, using the base case economic assumptions of the Decree. The purchase amount will be paid by instalments between the closing date and the forecasted end of the investment period (July 2004), in order to match disbursements to be made by EMASESA under such programme. A loan collateralised by the future Canon proceeds has been avoided because it would have impacted EMASESA's balance sheet, and would have therefore affected the debt/current revenues ratio of the municipality of Seville and left much less room for other investments.

A BALANCED FINANCIAL STRUCTURE

Under the financial structure, any shortfall of the Canon proceeds due to deviations from the assumptions of the base case, results in an obligation for EMASESA to request from the Junta de Andalucía a Canon adjustment so as to compensate the lack of revenues. That leaves the financial institutions mainly exposed to legal and regulatory risks. However, a mitigation of these risks is achieved through contractual provisions allowing for the resale of the rights to EMASESA (and therefore a recouping of the purchase price) should there be material changes to the legal environment of the transaction threatening

the existence of the Canon, its scope, or its applicability. This also implies that the financiers would be taking certain credit risks on EMASESA itself, though these are considered acceptable given the legal status of the municipal company wholly owned by the Municipality of Seville and providing a basic public service.

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Another feature of the transaction is that a portion of the financing will be provided by the EIB, acting through and guaranteed by the monoline insurer Financial Security Assurance (FSA), which typically requires an investment grade rating on the tranche it is guaranteeing. For that specific purpose, the EIB tranche was granted a senior ranking in terms of rights to the Canon Proceeds. On the other hand, and in order to maintain an overall balanced

structure for both parties, the commercial banking tranche benefits from an earlier amortisation schedule, allowing full repayment before the EIB tranche starts to amortise. The resulting compromise is that under a "base case" scenario the commercial banks get fully repaid before 2012 and the EIB in 2016, while the EIB enjoys a senior access to the Canon proceeds in downside and default situations.

It goes without saying that the inter-creditor issues arising from a structure where parties enjoy different rankings in terms of access to rights, different repayment periods, therefore different risk profiles, are by definition challenging. One of the outstanding achievements of this transaction was to design balanced inter-creditor agreements among the commercial banks, the EIB and the mono-line insurer. The main guideline of these complex agreements was to maintain a strong community of interest among the parties in terms of decision making, while leaving each party with the ability to enforce its own rights in extreme situations.

A SUCCESSFUL CONCEPT THAT CAN BE REPLICATED

The EMASESA transaction is clearly the first example of using a purchase of rights on improvement fees to finance water infrastructure investments on a non-recourse basis. This unprecedented structure has implied a great amount of negotiations among the



parties and complex financial and legal structuring, but has resulted in a "pathfinder" solution meeting the objectives of each stake-holding party: the municipal water company enjoys a financing at attractive terms without affecting its balance-sheet, and the financiers take comfort from a secured and predictable stream of revenues combined with a protective legal framework.

Most importantly, the end-users will benefit from improved environmentally friendly water services. Given the substantial financing needs still required by the Spanish water sector, it is very likely that this model will be followed by numerous Regional Governments that are also interested in financial schemes achieving these objectives. No doubt that the active involvement of the EIB in this innovative securitisation concept will only raise the prospects of seeing it applied in other areas where public infrastructure needs upgrading.

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