

# Square peg round hole

**Italy's project finance rules have an awkward legal foundation. If investors and sponsors can gain the benefit of project bond technology, radical reforms are needed**

**T**he recent placement of project bonds to finance Belgium's A11 motorway made Italian lawyers wonder when it will be possible to structure a similar transaction under our national project bond laws. The asset class was introduced in Italy two years ago, with the aim of financing infrastructures and public interest services through bond markets rather relying solely on bank lending.

Italian project bonds feature a number of benefits for issuers and investors alike. First, they are applicable to a vast variety of infrastructure projects including motorways, electricity transportation, IT networks, gas storage and transportation. Second, project bonds issued before June 26 2015 are tax efficient, having the same tax treatment as Italian government bonds in respect of interest received by the bondholders. Third, bondholders have the benefit of special liens (*privilegio generale*, similar to a common law floating charge) over certain assets of the special purpose vehicle issuer. And fourth, Italian banks, financial companies and insurance companies are permitted to guarantee project bonds (albeit only during the construction phase).

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Nevertheless, Italian project bonds are yet to experience any real success.

This is not due to structural inefficiencies or flaws in the financing tool, but rather the difficulty in finding financeable projects. This is the result of project financing, and therefore project bond regulations, having been created under the Public Procurement Code (*Codice degli appalti pubblici*) which was recently renamed the Public Works, Supplies and Services Contracts Code (*Codice dei contratti pubblici relativi a lavori, servizi e forniture*). In

short, Italian lawmakers took the rules originally designed to govern the complex process necessary to select a supplier of works or services under a public procurement and tried to adapt them to public-private partnerships (PPPs) – including project financings.

This inevitably led to a lack of compatibility between the rigid and complicated public procurement framework and project finance schemes which, by their nature, need flexibility to achieve a financeable result. In addition, the timing of such financing procedures are often unpredictable and not constrained by law. Not only did this limit the number of projects launched under the framework, but most of those that did launch were unattractive for investors. To increase the number of market oriented transactions, the possibility for private parties to submit a PPP project to public entities for a potential tender was also introduced into the law. But due to these same difficulties regarding the rigid process, this had little success.

As a consequence, project finance tenders were and are mostly originated by public entities which often lack the commercial, financial and legal skills needed to see the project through. They also often look for private funding for those projects unable to generate enough revenue to attract private investments.

Not surprisingly, a large number of project financing tenders originated by public entities fail to be awarded. Data released by ANCE (the Italian National Builders' Association) shows that between January 2003 and October 2013, of the 5,029 project finance tenders launched, only 1,896 – or 38% – were awarded.

The Italian legislature has tried to correct these defects. In the last four years alone, 10 amendments have been made to the PPP regime (including in relation to project finance). All of them were heading in the right

direction, but existing rules still struggle to fit the market's expectations of a project finance scheme. In addition, frequently adjusting the legal framework has the downside of keeping away investors who typically value stability.

This may result in lost opportunities. By way of example, there is a lot of talk at the moment about Italy becoming a continental harbour for receiving shale gas supplies from the US. Unfortunately, the average timeframe for receiving authorisation for the construction of a gas storage plant means such a possibility could very easily vanish.

### What must change

The Italian government seems to be aware of the lack of proper rules for project financing and, more generally, PPPs. It recently announced its intention to carry out a full review starting this Autumn. A radical reform of today's legal framework is necessary, namely by creating a new PPP Code that regulates project financing and other PPP transactions. This would clearly separate the PPP regime from public procurements which would continue to be governed by the existing Public Works, Supplies and Services Contracts Code.

Such a PPP Code should provide for a transparent, accountable, non-discriminatory and adequately advertised process, focused on two principles.

First, it should introduce a negotiation process. Standardised and rigid procedures remove the project parties' ability to address and allocate construction, management and operational risks. To the contrary, a genuinely interactive and competitive tender process would activate a virtuous dialogue between procuring public entities and the bidders, aimed at shaping a financeable project. In addition, when off-balance sheet treatment is a driver for a procuring public entity, it should be mandatory to monitor project compliance with Eurostat models during the negotiation process.

Second, it should ensure a manageable timeline for the project. For any investor, timing is an essential element of pricing and so having few firm deadlines should assist the project's process. At the same time, the absence of a rigid procedure should avoid challenges created in name only, and allow for a focus on breaches of law that materially impact on public interest.

A PPP Code would be a tool for generating solid, financeable PPP projects both by procuring public entities and private investors. Only then, are we more likely to see Italian project bonds on the market.

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