

STATE OF THE ART



JOHN TELFER'S EXPERIENCE IN LOCAL AUTHORITY AND PROJECT FINANCE IS HELPING SCOTTISH WATER TO REACH ITS PFI GOALS – WHICH IN THE END MEANS THE PEOPLE OF SCOTLAND BENEFIT.

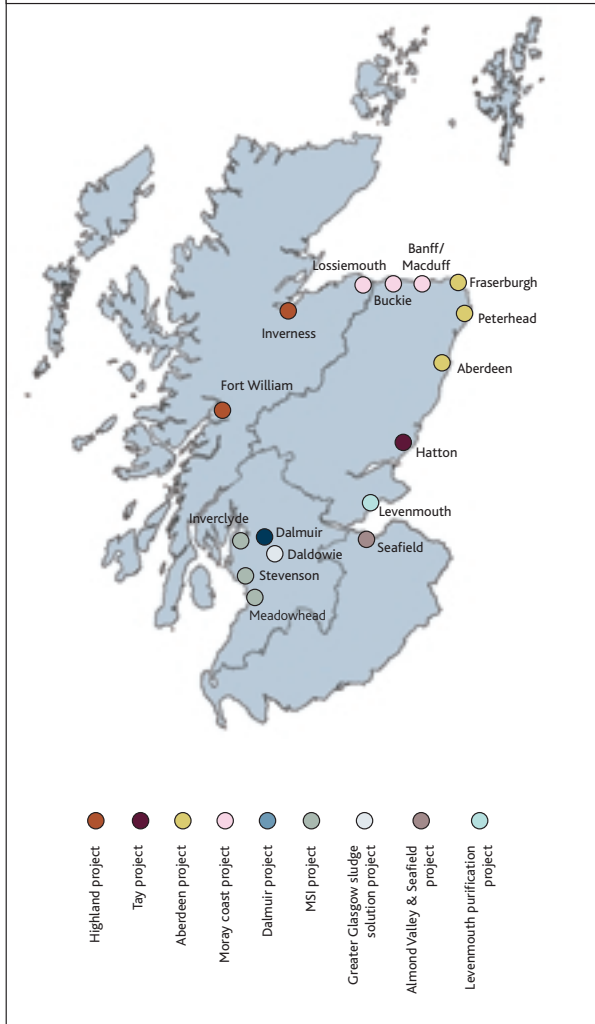
Before taking up the newly created position as Head of PFI at Scottish Water in August 2002, I had spent the previous 13 years at Deutsche Bank in Edinburgh involved in local authority and project finance. For the past seven of these years I acted as financial adviser to the North of Scotland Water Authority on the procurement of four large-scale wastewater projects under its PFI programme.

During this period I also acted in a similar capacity for a number of private sector consortia which tendered for the wastewater treatment concessions let by the water authorities in the East and West of Scotland. Following the enactment of the Water Industry (Scotland) Act 2002, these three regional authorities were replaced by a single company, Scottish Water, in April 2002, which assumed responsibility for the nine PFI projects entered into by the predecessor authorities.

PLAYING A KEY ROLE. The key aims and objectives of the financial adviser were to obtain the most financially beneficial deal for your client, be they private or public sector, in a manner which reflected the optimum split of risk between the parties. In doing so, these activities were very much geared up to achieving contractual and financial close as quickly as possible. From the adviser's perspective at that stage the construction companies moved in and the adviser moved on to its next deal. However, upon assuming this new role within Scottish Water, I have re-acquainted myself with the concession contracts underpinning these projects. In particular, I have sought to assess, admittedly with the benefit of hindsight, how effective these contracts have been in dealing with issues and circumstances that have arisen under the contracts during both their development and their limited operational phases to date. The outcome has been both revealing and thought-provoking, but above all demonstrates the requirement for both the public and private sector partners to work actively together in a pragmatic fashion to ensure best value is derived from these contracts.

In order to meet the requirements of new legislation, principally driven by the EC Urban Waste Water Treatment Regulations and the Bathing Water Directive, the predecessor water authorities embarked upon a large-scale PFI programme. Between 1995 and 2001 nine contracts were signed with six different consortia which have provided 21 new or substantially refurbished

FIGURE 1
LOCATION OF MAJOR PFI WORKS.



wastewater and sludge treatment works throughout Scotland (see Figure 1).

These works are responsible for treating and disposing of wastewater covering about 65% of the domestic population and a significant number of industrial dischargers in the Edinburgh, Glasgow, Aberdeen, Dundee and Inverness conurbations, as well as more dispersed catchments, with capital expenditure totalling about £550m.

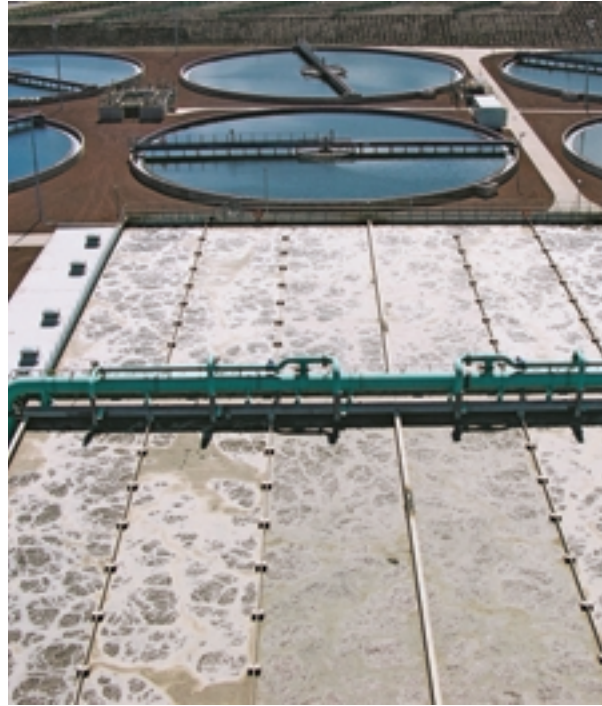
The procurement of these projects followed the templates of their day in terms of pre-qualification, tendering, best and final offers and final preferred bidder negotiations. Given the nature of the assets being procured and the environmental issues surrounding the disposal of the waste product issues, such as obtaining detailed planning permission and other regulatory consents, meant that negotiation periods usually extended beyond the originally set target dates. The existence of variable payment mechanisms required extensive funder (both bank and monoline insured bonds) due diligence. To combat potential programme delays extensive use was made of pre-contract development agreements, whereby the concession companies committed expenditure to design and preparatory construction work in advance of financial close. Part of this work was undertaken 'at risk', while an element was also underwritten by the relevant water authority.

In the negotiation of these deals some commonality in terms emerged commensurate with existing Treasury guidelines. However, each project displayed its own unique set of technical characteristics which required all parties to develop new or substantially amend existing contractual mechanisms to address these circumstances. Such issues related to the number of works contained within a project, the lack of reliable flow data and the composition of the industrial dischargers within a project catchment whose effluent, both in terms of volume and strength, could have a significant effect upon the ability of a works to perform.

All of these and many other points required detailed risk evaluation and negotiation between all parties, including sub-contractors, before funders would sign off on the due diligence process. In addition, as the PFI programme progressed over time, both public and private sectors gained greater insight into areas of risk and this was reflected in their subsequent analysis and negotiations. I believe it to be no coincidence that the first wastewater PFI project signed, the Highland Sewerage Scheme in December 1996, had the shortest tendering and negotiation period to financial close, as well as the shortest concession contract. Does that mean that, as a contract, it will operate better than the other eight? Not necessarily, but it will probably only be in about 25 years time that a balanced and considered answer can be provided to this question.

THE SPIRIT OF PARTNERSHIP. Returning to the present day, my core responsibility is the management of these nine concession contracts, whose tenures range from between 25 and 40 years, in such a manner whereby the contractual rights of Scottish Water are protected and its obligations properly discharged. As outlined in further detail below, this will require both parties to the contract to act in a manner which emphasises the spirit of partnership, involving the pro-active management of the concessions from a technical, commercial and financial perspective.

The objectives in managing these projects, now that they have



SCOTTISH WATER IS COMMITTED TO SPENDING SOME £2BN ON NEW AND REPLACEMENT ASSETS OVER THE NEXT FIVE YEARS

moved from their development and commissioning phases into the core operating period, can broadly be split into two categories.

The first is concerned with the day-to-day administration of the contracts, primarily to ensure that the required performance levels, in terms of quality of treatment and effluent discharge, are satisfied. Failure to do so not only results in financial penalties under the contract but may also lead to prosecution by the Scottish Environment Protection Agency, which acts as the environmental regulator within Scotland. Reflecting the sensitive nature of the operations being undertaken adherence to such conditions as odour limits are also of critical importance, given the proximity of some plants to residential areas.

While the private sector assumes operational risk, Scottish Water must also ensure that it fulfils its obligations by ensuring that its sewerage networks through which the flows pass to the PFI works are well-maintained and that industrial dischargers are 'policed' sufficiently to guard against the transmission of influent beyond the agreed quality parameters. Failure to do so could, at an extreme, lead to the biological processes within the treatment works being disabled and the service levels not being met. Where this has been proven to be as the result of a pollution incident then the private sector is held blameless and, while such occurrences cannot be guaranteed never to happen, they should be avoidable in a majority of circumstances.

Throughout the contract period there will be situations, either driven by new legislation or other actions, or inactions, of either party which may lead one partner to invoke the change (variation) mechanism against one another. Whilst all these contracts are prescriptive, sometimes it could be argued overly so, as to the process to be followed in such circumstances, the interpretation and discussions between the parties are seldom black and white. The aim should be for both parties to adopt a pragmatic approach to their resolution, while ensuring retention of their core positions regarding risk and returns.

In terms of longer-term ambitions – that is, beyond the next two to three years – the aim is to generate savings, from both a financial and operational perspective, so that both parties to the contract benefit. Examples include the refinancing of the projects on more beneficial terms, both in terms of costs and covenants, whereby a very visible part of these savings is passed back to the public sector. Readers will be familiar with the debate on this subject, and the government's desire to ensure that the public sector gets its share of the cake in these circumstances.

Other aspects whereby proactive management can bring about 'win-win' situations will involve undertaking root-and-branch reviews of the contracts to ascertain what scope exists to amend terms where experience does not necessarily reflect the expectation at the time the contracts were being negotiated. Such an approach may serve to highlight where risks were transferred for the sake of it that, in the light of actual experience, have not served either side particularly well.

In undertaking exercises of this nature one will always need to

ensure that any re-setting of risk parameters does not threaten the off-balance sheet nature of these transactions.

FUTURE OBJECTIVES. Scottish Water currently has an extensive capital programme and is committed to spending some £2bn upon new and replacement assets in both the clean and waste water sectors over the next five years. This figure is made up of a large number of small projects, which even under a 'bundling' approach do not lend themselves to the use of the PFI. Scottish Water is currently engaged in the tendering process that will lead to it entering into a partnering structure with the private sector to deliver this capital programme.

In so doing, the agreement entered into between the parties will seek to adopt certain principles and mechanisms which had their origins within PFI. In this manner, the skills built up within the organisation can be transferred to meeting its wider future corporate objectives.

The Scottish water industry has undergone and continues to undergo significant change. The PFI activities are and will continue to form an important part of its core service delivery to the inhabitants of Scotland. Its success in delivering state of the art works adopting highly innovative solutions delivering significant cost savings is already proven, a situation which it is hoped will also prevail throughout the operating life of these contracts.

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