

Marketing Data Sheet

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Application: Concession Agreements

A **concession** in its most simple form is an agreement by one party to manage the assets of another for an extended period of time, perhaps as much as 50 years. Parties which grant concessions are often governmental but may be private non-government owned (NGO) companies as well. Parties that receive the concession agreement are referred to as the concessionaire.

Concession Agreements have been around for many years throughout the civilized world. Within the last 20 years the associated concepts of **privatization** and **public-private partnerships** (PPP) have emerged in the marketplace side by side with concession agreements. As a practical matter, the marketplace activities of each are similar regardless of the specific name applied. The common feature of all three is incentive on the part of the government is to use private sector finance in the procurement of new infrastructure thereby eliminating the need to divert tax revenue or to increase public debt. The saved public funds can then be used for other competing areas such as education, health, welfare, defense, and perhaps pensions as well. The incentive on the part of the concessionaire is a reasonable rate of return on its financial investment. The generic term **privatization** encompasses a broad range of private sector participation in public services. Public-Private Partnerships between the public and private sectors in the water and wastewater industry range from providing basic services and supplies to the design, construction, operation, and ownership of public utilities. The basic reasons that the public sector historically privatized services were to realize important cost savings, utilize expertise, achieve efficiencies and quality in construction and operation, access private capital, and improve the quality of water and wastewater services.

Marketplace activities that have been included in concession agreements include the utilities of potable water, sanitary wastewater, municipal solid wastes (MSW) collection, MSW landfill management, electricity, fuels, roads, mining, manufacturing, pharmaceuticals, timber, trading, technical services, land development, and even land conservation trusts.

During the life of the concession agreement, the concessionaire possesses a monopoly on the specific management task imposed by the concession agreement. The concession agreement sets for all of the known or anticipated requirements that directly or indirectly impact on its routine performance, including penalties, or possibly even cancellation due to insufficiency of agreed upon performance. After the completion of a concession agreement the total assets can be returned to the government or, in the alternative, the concession agreement may be renewed for another length of time at the discretion of the government.

In short, anything that is legal in a particular country may be successfully incorporated into a concession agreement.

Because concession contracts require long-term investment by the concessionaire, the associated regulations must be designed to ensure that:

- The concessionaire earns a reasonable rate of return on the investments it must make to meet service improvement targets.
- Incentives for efficiency are maintained throughout the long concession period.
- The concessionaire has incentives to make appropriate investments throughout the concession period.

The main advantage of a concession to the government is the passing of full responsibility for operations and investment to the private sector and so brings to bear incentives for efficiency in all the governmental utility's activities. The concession is therefore an attractive option where large investments are needed to expand the coverage or to improve the quality of services, or both. On the government's side, administering a concession is a complex business because it confers a long-term monopoly on the concessionaire. The quality of regulation is therefore important in determining the success of the concession, particularly the distribution of its benefits between the concessionaire (in profits) and consumers (in the form of lower prices and better services).

In concession agreements consideration may flow from the government to the concessionaire or from the concessionaire to the government. It all depends on the condition of the assets, the profitability of the existing service, the need for additional investment, and many other matters. In the case of technologies which are provided on a build-own-operate basis the need for consideration passing from one party to another completely disappears thus eliminating this potential barrier to a successful and speedy concession agreement.

Concession agreements may cover electricity generation, wastewater treatment, wastewater collection, solid waste treatment, solid waste collection, potable water treatment, potable water distribution, liquefied petroleum gas (LP Gas) production and distribution, compressed natural gas (CNG) production and distribution, liquefied natural gas (LNG) production and distribution, and any other existing or new assets so long as the intended marketplace activity fully complies with local and national governmental regulations and all associated permit requirements. In each and every instance it is entirely appropriate to provide a com-

plete copy of the concession agreement to local, state, and the national governments as well as to all local citizens to fully disclose how the agreement will be implemented and managed over the next many years in a completely open and transparent manner.

Where a potential project is located impacts on its ability to attract project financing:

- **Russia**, for example, in recent years has exhibited a much publicized pattern of taking over private businesses and interrupting the flow of natural gas to distant customers. According to the European Union (EU), Russia's conduct will have a long term adverse impact on its ability to attract foreign investment interest.
- After nearly a decade of stagnant economic activity and high inflation in **Mexico**, the Mexican government liberalized the trade sector in 1985, adopted an economic stabilization plan at the end of 1987, and gradually introduced market-oriented institutions. Those reforms led to the resumption of economic growth, which averaged 3.1 percent per year between 1989 and 1994. In 1993 inflation was brought down to single-digit levels for the first time in more than two decades. As its economic reforms advanced, Mexico began to attract more foreign investment, a development helped by the absence of major restrictions on capital inflows, especially in the context of low U.S. interest rates. Indeed, large capital inflows began in 1990, when a successful foreign-debt renegotiation was formalized. The devaluation of the peso in December 1994 put an abrupt end to these capital inflows and precipitated a financial crisis. The crisis lasted for several years but now appears to be mostly gone due, in large part, to its participation in the 1994 North American Free Trade Agreement. The willingness on the part of foreign investors to participate in Mexican projects will act as a marketplace barometer to its recovery. Project financing may otherwise have to come from within Mexico. Recently, foreign institutional investors, such as G.E. Capital, are currently providing convertible debt financing that include non-payment provisions which convert the debt to equity.
- Several past concession agreements in **Eastern Europe** have failed for a variety of reasons. These failed agreements will likely have a long term adverse impact on future Eastern Europe concession agreement developments.

Notwithstanding the above historical facts, concession agreements continue to gain in popularity throughout the world because of their quite favorable financial impact on continuing infrastructure development.

Concession agreements last many years. To anticipate the necessity for changes in tariffs or other associated charges and fees over the life of the agreement

is generally viewed as requiring a very complex and sophisticated agreement.

- In order to attract prospective concessionaires, the government must make the associated financial investment attractive to the concessionaire by tariff schedules.
- In order to attract prospective governments, the concessionaire must make the agreement attractive to the government in terms of services provided.
- In order to create concession agreement sustainability the concessionaire must be willing to provide its management services at quite favorable tariffs to the ultimate benefit of the citizens. **The citizens are to be viewed as silent but ever present third parties to every concession agreement.** Historically, such has not been the case in Latin America, particularly in South America. The recent political change in Bolivia has occurred as a direct result of failed concession agreements in that country. It is now quite clear that the voters weren't getting nearly enough value for their money.

So long as the citizens are provided with favorable economic benefits on a sustainable basis the supporting concession agreement need only contain provisions to consider the modification of tariffs in order to retain the continuing services of the concessionaire. It then becomes a matter of public debate on the issue

The concession agreement (sometimes referred to as the implementation or project agreement) is the primary contract between the government and the concession company and forms the contractual basis from which the other contracts are developed. It entitles the concession company to build, finance and operate the facility and imposes conditions as to design, construction, and operation of the project as well as its concession or operation period.

The equity investors' and lenders' security for their loans and investment is limited to the revenues to be received by the concession company. They will therefore have considerable interest in the revenue forecasts produced by the concession company. Likewise the two areas that place the concession company and equity investors and lenders at risk are the construction contract and the operating contract.

The parties would prefer a contractor to give a fixed price for completion of the **construction contract** by a fixed date without exclusions. This is rarely possible in projects of this nature. Finance providers are therefore only prepared to commit themselves to a fixed amount because if the project costs more their funds will be in jeopardy due to the interest burden. Lenders will not accept the risk of delay to completion, although they will normally provide a

standby facility to offer some protection against time-and-cost overruns.

The operating contract. The lenders have to be assured that an experienced operator will be available on completion of construction.

The offtake contract. This is one of the key contracts. As limited-resource projects are, by definition, funded on the security of the future cash flow, there has to be some form of buyer. Projects fall into two categories: those where the identity of the buyer is obvious, for example toll roads and some power stations and those where there is physical product which has to be sold, often on the world market. If the product to be sold is electricity, a power purchase agreement would be required to enable the financing entities to rely on that source of revenue to repay debt obligations. Where there is a product involved it is essential to identify the offtaker or buyer and to establish the basic terms. The financing of a concession agreement is no different than the financing of any income producing prop-

erty—similar to the construction of rental apartments. The builder must establish to the satisfaction of the lenders that the projected income from the property is sufficient to repay the building loan with some room to spare.

There are always four components to a concession agreement, namely the project designer, the project builder, the project operator, and the project financier. In concessions sponsored by **WaterSmart Environmental, Inc.**, the company will provide the **complete project design**, its **Bio-WastePower Constructors Division** will provide project construction services, and its **BioWastEnergy Division** will provide subsequent project operation. These companion capabilities within a single company are designed to enable project completion on time and within estimated budget.

The Engineers, Chemists, and Scientists at **WaterSmart Environmental, Inc.** welcome your inquiries with enthusiasm.

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