

CMFB Consultation

Role of ISPA in the financing of TAV

Background document

Description of the operation

Institutional issues

Infrastrutture S.p.A. (ISPA) is a joint-stock company whose main activity is to provide financial consulting and financial resources directly to private and public enterprises engaged in large public works and/or infrastructures, normally jointly with other financial institutions (co-financing).

ISPA acts in a complementary role to banks and other financial intermediaries in providing financial support to constructing and operating companies, with a view to facilitating and encouraging the realisation of Public-Private partnerships projects.

ISPA is 100% owned by the Cassa Depositi e Prestiti, (CDP), a financial corporation whose equity capital is owned 70% by the Italian Treasury and 30% by non-government shareholders (Bank Foundations¹, which are classified in S.124 and can be defined as having a mixed private-public nature). For the purpose of this consultation it is enough to say that the government is at least indirectly able to control ISPA.

ISPA is registered, like other financial corporations, in a special register held by the Bank of Italy (as created by article 107, section 1, of the Legislative Decree 385/1993), under specific supervision by the same Bank, and its financial activity is subjected to specific risk limitations.

ISPA operates in the market for the financing of large public works and infrastructures. Given the fact that it started its activity only in 2003, ISPA has only developed a relatively small number of projects so far. By far the most important project is a high speed railway project ("High velocity / High capacity") of the national railway operator, RFI-TAV. Starting in 2004, ISPA has been engaged in the structural planning of a number of new projects, although only one of such projects, apart from the RFI-TAV one, has at present already started. For many of these projects ISPA provides financial consulting and co-financing activities in co-operation with other important financial intermediaries operating on the international financial market. However, the main part of the activity carried out so far concerns the funding of the high speed railway project.

ISPA was originally classified by ISTAT, the national statistical institute, in sector S.123, as in principle its main task is to provide financial intermediation and / or auxiliary financial activity. Since in fact ISPA is not at present assuming risk by its own account in the operations in which it participates, and following specific objections by Eurostat in this

¹ The bank foundations have the task of promoting savings activities by acting in their capacity of shareholder of a bank and to make the credit market effectively competitive. Besides the goal of promoting savings activities and ease the competitive process in the credit market, the foundations may also promote research, education, sports or culture.

respect, it has now been reclassified by ISTAT in the sector of financial auxiliaries (S.124). The classification of ISPA might be the subject of further debate in the future (as it appears to have a segregated patrimony and carries no risk in the operation it participates). For the purpose of the RFI-TAV operation however, there is full agreement by ISTAT, Eurostat and the participants in the task-force that ISPA is acting on behalf of another unit (either the government or the railway company).

ISPA has a very limited number of staff, and its costs are extremely small (a few million € per year). The capital of ISPA is 10 mio €

The High Velocity/High Capacity railway project

ISPA is at present taking care of the entire financing of the construction of a high-speed railway link between Turin, Milan, Rome and Naples (the “High-Velocity/ High-Capacity“, hereafter HV/HC, project). For this purpose, ISPA raises money on the market by issuing notes and loans. The proceeds are then provided to RFI and TAV in order to finance the construction of the high-speed railway link.

RFI (“Rete Ferroviaria Italiana S.p.A.”) is the company that owns most of the Italian railway network. It is classified outside general government though it is fully owned by government through its parent company, Ferrovie dello Stato SpA (“FS”). TAV (“Treno Alta Velocità S.p.A.”) is 100% controlled by RFI. For simplicity and for the purpose of this consultation, RFI-TAV can be considered as a single institutional unit. The two companies are part of the railway group FS and are classified, according to ESA95, as market units, i.e., outside the general government sector, since their revenues seem to cover more than 50% of costs. (*Note: in the course of this consultation, questions have been raised on the structure of costs and revenues of RFI-TAV, on whether some of its revenues might be classified as sales or not, and on the fact that RFI-TAV does not seem to undertake entrepreneurial risks, hence putting in doubt its classification as a market entity. As these issues were not properly discussed in the task-force, and as some information is still missing, this will not be the object of this consultation. However, Eurostat will be consulting with ISTAT very soon on this issue*). Although it makes losses, the railway group FS is a market unit, as in recent years its revenues have covered around 70% of costs.

According to Law, ISPA will provide to RFI-TAV a maximum of 25 bn € through its “High speed railway funding programme”, with a final maturity set at 31 July 2060. To this effect, in 2004 ISPA made an inaugural 6 bn € issue, with a credit rating equal to that of the Republic of Italy. This credit rating was assigned due to the willingness of the State to support the transaction.

ISPA has a segregated balance sheet for this operation (for the benefit of the relevant creditors), which contains the liabilities incurred by ISPA to finance specific investments and the corresponding assets. ISPA note holders will be reimbursed through a combination of the cash flows to be generated by the operation of the high-speed network and State transfers to RFI-TAV.

More specifically, the State is obliged by Law to assure the economic and financial stability of ISPA. For this purpose the State will provide to RFI and TAV the amount necessary to cover the difference between the debt service owed to ISPA and the revenues arising from the

new railway services. As a result, during the construction period (which will run at least until 2009), the State will be fully responsible for servicing the debt of RFI-TAV towards ISPA.

At present almost all the cash raised by ISPA on the market is invested in the RFI-TAV project, where ISPA does not bear any risk. According to documents and business plans provided by ISPA, it is certain that the operation related to the railway projects will represent a very large majority of the ISPA activities for a considerable number of years. Even if all projects being planned at present materialise in the future, this project with RFI-TAV will still account for far more than 50% of the whole debt raised by ISPA for the foreseeable future.

In 2004 ISPA issued four *tranches* of bonds for a total amount of • 6,5 bn and has been granted a 20-year funding loan of • 1 bn by the European Investment Bank. In turn, it has granted a loan in five *tranches* (Project Loan Tranches – PLT), corresponding exactly to the amount of the bond tranches issued, to the HV/HC public companies carrying out the investment project.

The high-speed railroad project is atypical because of its size, the time needed for building the infrastructure and the fact that a single company is in charge for the realisation of the project. The efficient execution of the project could not be attained without guaranteeing:

- wide access to the capital market, in order to obtain enough resources for the project;
- a financing with long term maturity bonds to obtain a more balanced financial profile.

In order to meet these objectives, it was deemed opportune that RFI should access the market through an intermediary with the specific vocation of long-term financing for complex infrastructural works. To this end, ISPA acted as a broker to ease financial market access to RFI, a market unit. The debts issued by ISPA and the loans granted to RFI, together with other financial obligations arising from this financing activity, are not shown in the balance sheet of ISPA, but in a separate annex. In fact they represent, as allowed by law, a *segregated patrimony*².

Moreover, ISPA earns no interest margin in relation to the HV/HC project. ISPA will only earn a commission fee on this project, as interest paid to bondholders will equal interest received on the loan made to the HV/HC companies. Only assets in the segregated patrimony can be used to pay liabilities; bondholders will not be able to set claims on ISPA assets that are not “segregated”.

The loan contracted by RFI/TAV must be repaid with the revenues deriving from the management of the railway infrastructure (track access charges received from the transport companies). It benefits from a State guarantee, i.e., for this loan a State contribution is foreseen in case the revenues of RFI/TAV are insufficient to repay the debt. Consequently, the government will continue to service the debt (which includes at present only the payment of interest and is recorded as a transfer in national accounts) until the end of the construction period. It is foreseen at present that the commercial opening of the Turin-Milan-Naples high-speed railway link will take place in 2009. Currently the service of the debt only includes interest, as principal will start to be repaid in 2014.

²The law foresees that assets and liabilities, together with the cash flows related to a certain activity can be separated from the principal and shown in a dedicated statement (Law Decree 63/2002).

According to RFI-TAV, it had been estimated (in 2003, although meanwhile the future costs related to the construction of the high-speed railway link seem to have increased compared to the original assumption of 2003, and therefore the original assumptions about the part of the debt which RFI-TAV will be able to repay itself might have been too optimistic) that the State will have in the end to cover 50% of the debt service. (*“Lo Stato si farà, inoltre, carico di integrare quella parte del servizio del debito che i proventi non riusciranno a coprire (stimato nell’ordine del 50%)”*).

It is also stated by RFI-TAV that new high-speed railway links (Milan-Verona and Verona-Padua) will in the future also be financed by ISPA, using the same mechanism and financing arrangements.

The issue

It was agreed by all participants in the task-force that the debt issued by ISPA, in the context of the financing of the high-speed railway operation, is not to be recorded as debt of ISPA (ISPA is clearly acting on behalf of another unit, without putting itself at risk, and the debt for financing the project does not appear in its balance sheet). Consequently, the main issue relates to the fact whether it should be recorded as debt of the railway company or as debt of government.

Option 1 – The debt of ISPA must be reclassified as government debt

ISPA has issued bonds with the specific purpose to finance the building of high-speed railway tracks. During the whole construction phase the interest on the debt is paid directly by government. No repayments of the principal are scheduled for this period.

Subsequently, when the HV/HC project will start generating revenues, part of the debt service will be paid by RFI-TAV and part by government. In fact, the government is contractually obliged to ensure the repayment of the bonds at maturity, until all principal and interest of the bonds will be repaid to investors, if the high speed railway link does not generate sufficient revenues to reimburse ISPA in full. This contractual feature allowed the bonds to receive a very high rating, thus ensuring a lower cost of funding of the project.

In general terms a guarantee given by government would not be a sufficient criterion for classifying non government liabilities as government debt. However, this issuance took place in the very specific context of a long-term project where it is certain that the operator will not be in a position to repay its debt for a long time. In addition, the projected profitability of the HV/HC project is based on assumptions of costs and traffic that may not be confirmed. This is why funding generally needs a specific mechanism for reducing investors’ risks. According to a business plan provided by the Italian statistical authorities in 2003, government payments to reimburse ISPA’s bondholders will continue until 2042 (the whole debt is allegedly going to be completely repaid by 2050) and will be higher than commercial revenues obtained through track access charges resulting from the new railway services until 2027. Until that time, government will in practice be responsible for the reimbursement of the biggest part of the debt. Moreover, according to estimations undertaken in 2003 and reported in the website of RFI-TAV itself, it was estimated that government will be finally responsible for repayment of 50% of the total debt of the operation.

Government is at present the only unit repaying the interest, and this will be the case for a number of years. Moreover, it is certain that when part of the principal will have to be reimbursed in 2014, government will have to reimburse most of it. The chapter on public enterprise debt guaranteed by government states that when a guarantee is called this is to be recorded as a transfer of the liability to the government. This is also the case when the guarantee is not called, but everyone knows with certainty that at the issuing of the liability by the enterprise the government is committed to actually paying the debt – interest and principal – instead of the enterprise.

The features of this operation could be assimilated to a call of a guarantee. What is certain is that at present TAV does not have the money to reimburse interest of the debt and therefore it is the government that is doing so, and will continue to do so for a considerable number of years.

On the basis of the HV/HC business plan, it is evident that the government would have to ensure the repayment of the bonds issued by ISPA for a long time, independently of any unfavourable possible event (higher cost, delays in starting commercial operation, lower than expected traffic), which might increase the proportion of the debt to be repaid by government with respect to present assumptions. The contractual schedule of bond repayment does not match the expected operating balance of the manager of the tracks.

Therefore it is likely that the government is effectively committed to repay the major part of the current debt that has already been issued and will be issued for the project. Moreover, the rating agencies provided a high rating to the bonds issued by ISPA, as it was known from the outset that, whatever the circumstances, not only would the government guarantee its repayment, but it would do so in practice right from the start of the project. The investors are fully confident that they are acquiring claims on government in this respect.

Under these conditions, recording ISPA debt outside government debt would not give a fair picture of the financial situation of the government. Moreover, the repayment of the debt by the government is not only limited to a certain number of years (say, until TAV is fully operational), but it will run until the moment in which all bonds will be repaid.

Therefore the debt should be reclassified as government debt, as:

- At present the government is providing 100% of the debt service, and this will still be the case for a certain number of years (the first revenues from the high-speed railway link have been forecast not to come before 2009). The amounts paid by government are at present recorded in national accounts as government subsidies.
- Government will reimburse most of the debt for a many years.
- Government will be obliged to reimburse whatever part of the debt TAV will not be able to reimburse, until the whole debt is reimbursed.

This “guarantee” by the government is not to be considered as contingent and indirect. The government is in fact at present, as well as for a few more years, servicing the debt alone; it will continue to do so for an additional number of years, and it will presumably continue to reimburse a part of it for a long time, possibly until the whole debt will be reimbursed, should the assumptions of the business plan not prove correct. In these circumstances, it would be inappropriate to consider this as a liability of RFI-TAV.

In other words the government is de jure and de facto committed to reimburse a significant part of the debt of RFI-TAV. In this situation, the debt should be reclassified as government debt through re-routing. The actual payments by government would of course impact the government deficit as they are made.

Concerning the counterpart entry for the recording of the debt of ISPA as government debt, there are three options:

Option 1a

According to this option the debt of ISPA is to be recorded entirely as government debt and the counterpart entry is a financial transaction.

Cash is put at the disposal of RFI-TAV by the government, in the form of a loan, in order to build the high-speed railway link and pay for the construction. The government provides a loan to RFI-TAV in the expectation that RFI-TAV would not normally be able to reimburse all of it at the end of each issuing. For the next few years, it is likely that government will reimburse a sizeable proportion of the debt. The possibility for RFI-TAV to reimburse part of the debt is contingent and will depend on whether the high-speed railway link will generate revenues which could be used to reimburse part of the debt.

All the debt would be recorded as government debt at the beginning of the operation, with a financial counterpart transaction under the form of a loan to RFI-TAV.

This loan would be cancelled through a capital transfer to RFI-TAV at the time of the redemption of the debt, for each emission, except for the part that RFI-TAV would be in a position to take in charge at this time.

If at the moment in which the debt has to be reimbursed by RFI-TAV (that is, at the end of reimbursement of each tranche issued) this does not happen, the debt assumption by government must be imputed with a capital transfer from government to RFI-TAV as a counterpart. According to this option, of course, capital transfers will be imputed only in those years where a part of the principal of the debt will have to be reimbursed, and only for the part which RFI-TAV will not be able to reimburse.

Option 1b

According to this option the debt of ISPA is to be recorded as government debt and the counterpart entry is a capital transfer, when it is expected from the beginning that most of the debt servicing will be done by the government.

Based on the business plan at the time of issuance of the debt, it is very likely that government would be obliged to reimburse a significant share of the debt, for a specific emission.

All the debt is recorded as government debt with a non-financial counterpart transaction in the form of a capital transfer at time of issuance.

This treatment would be applied on the basis of currently available evidence. If at present it is clear that the majority of debt servicing for each emission, is to be done by government, then a capital transfer will be imputed from government to RFI-TAV equal to the full value of the

debt. In subsequent years, any repayments of principal or interest by RFI-TAV must be recorded as a capital transfer to Government at the time the repayments are made.

Option 1c

According to this option the debt of ISPA is to be recorded partially as government debt and the counterpart entry should be a capital transfer. The capital transfer part is the proportion of total debt to be reimbursed by government, estimated on the basis of the business plan.

Based on a business plan, there would be evidence that the redemption of the debt would be shared by government and RFI-TAV. If it is very likely that at least part of the debt will be reimbursed by government, this part of the debt (whatever its proportion) is recorded as government debt with a non-financial transaction in the form of a capital transfer to RFI-TAV at the time of issuance. The rest of the debt is recorded as debt of RFI-TAV. In case the government guarantee is called also for this part, the government eventually assumes the debt through a capital transfer.

According to this option, if there is evidence from a business plan that, for example, half of the debt in the context of an emission, will be repaid by RFI-TAV, then a capital transfer would have to be imputed at the moment of the emission from the government to RFI-TAV for an amount equal to one half of the issue. And if, when the debt is reimbursed, it turns out that such was not the case, then the recording should be readjusted through another capital transfer.

To resume, if the business plan shows that (say) half of the debt will not be reimbursed by RFI-TAV, in the context of a specific emission, the that part of the debt is recorded as government debt, and a capital transfer from government to RFI-TAV is also recorded. If at the end of the emission RFI-TAV reimburses a bigger or smaller amount than was originally foreseen by the business plan (say, 70% instead of 50%), then a capital transfer is imputed at the moment in which the debt is reimbursed.

Option 2 – the debt of ISPA must be reclassified as the debt of the railway company

Option 2(a)

Under this option, the government's guarantee for the debt of ISPA is considered a contingent liability and the full amount of debt is treated as RFI-TAV debt.

According to ESA95, ISPA has to be classified among financial corporations (S12), insofar it is engaged in financial transactions on the market and it carries out a market activity. Profit and loss accounts data in all years have in fact showed that revenues cover much more than 50% of costs. Provisional data for 2004 show a ratio operating revenues/operating costs equal to 110%. Revenues consist mainly of interest margins and advising fees.

With respect to the main transaction carried out by ISPA, i.e. the 2004 operation of financing HV/HC, the profit and loss account (recently published) does not show any interest margin and the balance sheet does not show the related assets and liabilities, which are instead shown in a segregated patrimony.

It is clear then that, as far as the transaction HV/HC is concerned, ISPA is acting on behalf of TAV/RFI, i.e. the corporation carrying out the project, to which it is providing funds. ISPA's role is to issue notes on the market and provide the funds to RFI/TAV, receiving fees as payment for the service provided. With respect to the HV/HC project, ISPA is not placing itself at risk by acquiring financial assets and by incurring liabilities on its own account (ESA95 2.33), but it is acting as a financial auxiliary (S124 in ESA95). In particular, according to ESA 95 §2.39, the bonds issued by ISPA are liabilities of its customer, RFI/TAV, the market corporations carrying out the project, to which it is providing funds and from which it receives consulting fees.

On the debt issued there exists an indirect, contingent guarantee by the State that should be treated according to the ESA95 Manual on deficit and debt, par. II.4.3.

In fact, there is almost certainty that the State will not repay the whole debt of ISPA, but that part of it will be reimbursed by commercial revenues of the project.

The national account treatment then would register the whole amount of the debt as RFI/TAV debt, because it is RFI/TAV that assumed the liability and received the funds (i.e., they are the real borrower from the market). The counterpart of this RFI/TAV liability is the financial assets (issued notes) purchased by the public on the market.

Whenever the principal and interests will be reimbursed (through ISPA) by RFI/TAV (out of their commercial revenues) national accounts will register a redemption of a liability and a payment of interest by a market unit. Whenever the State guarantee will be called and the government will provide the funds that RFI/TAV needs in order to repay the debt and the interests, a transfer for the total amount (principal and interest) will be recorded from the government to a market unit with direct impact on public deficit.

Accounting examples

Option 1a (financial transaction)

Based on the current business plan at time of issuance of the debt, it is likely that government would reimburse a significant share of the debt for a specific tranche of the debt

All the debt is recorded as government debt

(RFI-TAV repays no part of principal in the example)

ISSUANCE YEAR							
General government				RFI-TAV			
Financial account							
• A		• L		• A		• L	
F.4	+1000	F.3	+1000	F.2	+1000	F.4	+1000
		B.9	0			B.9	0
Closing balance sheet							
A		L		A		L	
AF.4	1000	AF.3	1000			AF.4	1000

REDEMPTION YEAR

General government

RFI-TAV

Opening balance sheet

A	L	A	L
AF.4	1000	AF.3	1000

Capital account

• A	• L	• A	• L
	D.9		D.9
	-1000		+1000
B.9	-1000	B.9	+1000

Financial account

• A	• L	• A	• L
AF.2	-1000	AF.3	-1000
AF.4	-1000	AF.4	-1000
		B9	+1000
		B9	-1000

Option 1b (initial capital transfer)

Based on the current business plan at time of issuance, government would reimburse a significant share of the debt for a specific tranche of debt

All the debt is recorded as government debt

ISSUANCE YEAR

General government

RFI-TAV

Capital account

• A		• L		• A		• L	
	D.9	-1000			D9	+1000	
B.9	-1000			B.9	+1000		

Financial account

• A		• L		• A		• L	
	F.3	+1000		F.2	+1000		
	B.9	-1000			B.9	+1000	

Closing balance sheet

A		L		A		L	
	AF.3	1000					

Option 1c (“mix”)

Based on the current business plan at time of issuance government is assumed to repay less than 50% of the debt (40% in the example, although the example could be used with every proportion)

ISSUANCE YEAR

General government

RFI-TAV

Capital account

• A		• L		• A		• L	
	D.9	-400			D9	+400	
B.9	-400			B.9	+400		

Financial account

• A		• L		• A		• L	
F2	+400-400=0			F.2	+1000		
	F.3	+400			F.3	+600	
	B.9	-400			B.9	+400	

Closing balance sheet

A		L		A		L	
	AF.3	400			AF.3	600	

Improvement of RFI-TAV

YEAR N					
General government			RFI-TAV		
Opening balance sheet					
A		L	A		L
	AF.3	400		AF.3	600
Capital account					
• A		• L	• A		• L
	D9	+100		D9	-100
B9	+100		B9	-100	
Financial account					
• A		• L	• A		• L
F.2	F.3	-100		F.3	+100
	B.9	+100		B.9	-100
Closing balance sheet					
A		L	A		L
	AF.3	300		AF.3	700

Note:

In case where an opposite trend would be observed before the final maturity of the debt and it would become clear that RFI-TAV would pay less than foreseen in the beginning, a debt assumption by government would be recorded, increasing the part of the debt allocated to government.

