

# General drive

---

01/10/2004

The concept of the General Contractor was first established in Italy by a parliamentary act - the so called 'Legge Obiettivo' - in 2001. This concept represents a novelty in the Italian public works sector. Indeed, the whole framework of the Legge Obiettivo is innovative, creating a fast track to promote, support and accelerate the growth of Italy's infrastructure sector (transportation, mass transit systems, water, health, etc.) particularly with regard to the country's strategic projects, i.e. the largest and more socially motivated.

The underlying idea of the Legge Obiettivo is twofold. First, it is to simplify and speed up the central and local public administration procedures for granting whatever permits, licences, concessions or authorizations are normally needed to upgrade existing or complete new infrastructure. Second, it identifies a figure from the private sector (the General Contractor) as the focal point of accountability for the implementation and completion of the each individual project.

The General Contractor is one of the principal instruments for the successful construction and completion of primary infrastructure projects in Italy. It is therefore expected to play a fundamental role over the coming months and years to overcome some past inefficiency in developing a high quality of infrastructure throughout the Country.

The Legge Obiettivo and its ancillary legislation define the role of the General Contractor by a number of elements that differentiate it from the traditional roles of contractor or concessionaire used to date to carry out public works. The activity of the General Contractor includes:

- \* definitive and executive designs;
- \* construction and related supervision (excluding operation and management of the project following its completion); and
- \* financing of the construction.

The General Contractor is responsible for the completion of the works on behalf of the awarding public authority, which undertakes to pay the General Contractor at partial or full completion of the works. The General Contractor is also responsible for a number of other activities, such as the acquisition of land, which under the normal procurement route is the responsibility of the awarding public authority. Therefore, its main characteristic is related to the risk profile (and assumption of risk), which is similar to a turnkey contract, undertaking the construction and pre-funding risk for the works.

## Developing General Contractor financings

From a banking and financial perspective, the General Contractor's main characteristics are notably:

- \* the fact that it is required partially or fully to pre-fund the project; and
- \* its responsibility within the risk allocation grid with regard to a wide range of obligations.

These aspects, combined with the large financing needs of the Legge Obiettivo's initiatives, articulate the risk profile of

the financing needs and of the relating mitigations essential to make it bankable. This requires innovative debt structures and also entails a 'sustainable' creditworthiness of the General Contractor itself.

In order to assess efficiently all the risks and to define an appropriate ring fence, structured finance techniques, such as those that can be associated with a Special Purpose Vehicle (SPV), are suitable. The Legge Obiettivo actually allows the establishment of an SPV among the sponsors of the project, which can step into the relationship with the awarding public authority without the existing contract being terminated.

Although most of the specific initiatives of the Legge Obiettivo are still going through the bidding process or even the preparation of the bid itself, some important projects have recently been awarded through the General Contractor route. These projects confirm the willingness of sponsors and financiers to use structured financings with limited recourse to the sponsors of standalone SPVs.

### **Limited recourse route popular**

The general trend over the last few months, during which there has been an acceleration in the development of some projects falling within the Legge Obiettivo's framework, has shown that financiers and sponsors tend to prefer limited recourse financings based on a multi-tranche arrangement, similar to the simplified following structure:

- \* the main tranche is allocated to pre-fund the construction works and it usually amounts to 30-40% of the total value of the project, the remainder being funded by the ongoing payments from the awarding authority during the construction;
- \* further tranches, normally in the form of working capital and stand by revolving, cover the fact that the General Contractor is expected to be responsible not only for the pre-funding but also for providing the ordinary financing needs of the works such as, for example, those relating to the achievement of specific construction milestones and to the delay of the payments from the awarding authority. This means that, because individual milestones are pre-funded, this tranche provides a bridging payment pending receipt of payment from the authority for the particular milestone.

In relation to the security package, the structure of the financing is based primarily on the assignment to the banks of the payment receivables due to the General Contractor. These payments are generally made within approximately 90 days of achievement of certain construction milestones, with the remaining portion being paid at completion of the works.

### **Certainty of payment**

The element that makes the structuring of a General Contractor financing more complex than traditional financings relates to the certainty of payment by the awarding authority of the pre-funded debt.

In the worse case scenario, there could be the risk that the awarding authority does not agree to pay part (or even the whole, although the latter is very unlikely to occur) of the works at completion, thus determining for the financiers the need to assess during due diligence the potential implications of such a risk and set up the appropriate measures to manage and mitigate it.

This non-payment by the awarding authority could arise from possible claims raised by the authority itself in the commissioning phase or at the provisional acceptance milestone due, for example, to a performance by the General Contractor not totally in line with the contractual specifications. In this case, it would be possible for the authority to offset the credit deriving from the claim against the value of the work still to be paid. If this were to occur, the pre-funded portion of the financing could be assimilated to a 'performance bond'.

This issue however does not concern risks normally associated with performance guarantees, which are actually already part of the security package requested by the authority. In fact, the completion of the works is guaranteed by appropriate bank or insurance guarantees, up to a maximum of 10% of the value of the project (and in future such guarantees will be substituted, by law, by the Global Completion Guarantee which is currently under discussion at the Italian Ministry of Infrastructure).

In reality, the uncertainties regarding the payment (or not) of the pre-funded debt arise from the fact that the details of

the Legge Obiettivo framework are to be defined by specific ancillary legislation currently been devised in the Italian Parliament. In the meantime, existing laws referring to public works awarded through the traditional procurement arrangements fill the gaps.

The simple extension of such laws to the General Contractor route creates doubts in the interpretation of certain aspects of the Legge Obiettivo, such as those connected with the financing and guarantees. A clarification is urgently needed on the likelihood of payment of such credits, which would greatly simplify the structuring of financings without recourse, thus resulting in a risk matrix with fewer grey areas and therefore encouraging a steadier and more secure flow of funds to engineering and construction companies.

### **Creating more legal clarity**

These ancillary laws will add consistency to the awarding system of public works and will refine the role of the General Contractor through the introduction, inter alia, of a qualification system and of the Global Completion Guarantee.

The laws are expected to be approved shortly, after almost two years of negotiation between the Italian Minister of Infrastructure and the associations of Italian bankers and constructors. But due to this negotiation, these further laws will almost certainly include the necessary measures to help construction and engineering companies to have access to a wider range of more efficient types of funding other than traditional full recourse corporate loans.

These additional ancillary laws will also facilitate the role of the financiers, who will be in a position to structure the financing facilities making reference to an improved and better defined allocation of risks amongst the parties, as well as tackling appropriately the key questions of bankability of a transaction (these questions include: What risks exactly are the Public Administration's responsibilities? Where do the General Contractor's obligations begin and end? What residual risk remains with the financiers? How much say can third party companies have if left out, for example, from the winning bid?).

These further laws will also allow financiers to avoid being forced to make debt underwriting commitments without having full due diligence in place, as was foreseen in the early drafts of the ancillary laws relating to the General Contractor qualification system.

The final drafts of these laws are also expected to reduce significantly the risk of differential treatment between the financiers themselves and the insurance companies with regard to the proposed Global Completion Guarantee. In the initial drafts, insurance companies were actually the only entities to be granted step-in rights, with serious limiting effects on the financiers' security. The latest white paper puts the subject into a more sensible and balanced perspective, with financiers also sharing step-in rights.

### **Tangible progress**

The legislative process of effectively and efficiently closing the gaps within the Legge Obiettivo's framework is still in progress. However, in BNL we believe that finally, perhaps for the first time in years, we are now witnessing a real and material progress, both at the legislative level and at the individual project negotiating level, towards what, as financiers, we most like to see: receiving mandates and closing deals.

We have been following the evolution of the Italian infrastructure sector for some time and have deepened our interest in it since the Legge Obiettivo was first being devised. For this purpose, BNL's Wholesale & International Banking Division has established a specific first class team of professionals within its Investment Banking area, dedicated to understanding the trends characterising the relevant legislation and to assisting not only private sector contractors and sponsors, but also central and local Public Administration, to appreciate and exploit the business opportunities arising from these developments.

BNL is currently assisting large contractors in the analysis and structuring of 'General Contractor' financings. We believe that we have devised for our clients financial structures appropriate to the Legge Obiettivo's General Contractor scheme that balance the need for bankability with the sponsors' objective of completing the project, whilst allocating risks to

those parties best able to manage them.

*Thank you for printing this article from IJGlobal.*

*As the leading online publication serving the infrastructure investment market, IJGlobal is read daily by decision-makers within investment banks, international law firms, advisory firms, institutional investors and governments.*

*If you have been given this article by a subscriber, you can contact us through [www.ijglobal.com/sign-in](http://www.ijglobal.com/sign-in), or call our London office on +44 (0)20 7779 8870 to discuss our subscription options.*