Concession in the Lithuanian central heating market: mission impossible?

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Overview

- What is a concession?
- Lithuania’s experience of concessions in the district heating sector
- The UK perspective: prerequisites of an effective concession regime
- Conclusion

What is a concession? (1)

- A concession can be defined as:
  - The grant of exclusive privileges (such as to be the only supplier of a service) for a fixed term
  - By a government authority
  - To a private sector operator known as a granteee (or a “concessionaire”)
  - In return for the privilege, the concessionaire pays the government authority a certain percentage of the earnings

What is a concession? (2)

- In the EU, concessions are subject to the public procurement legal regime and are based on a negotiated contract
- The sectors where concessions are applied most commonly are public utilities (water, waste, heating) as well as public services (hospitals, schools, prisons)
- A typical term of a concession ranges between 10 and 25 years (longer terms more likely)
- There is a direct relationship between the concessionaire and the customer
- Asset ownership remains with the authority and reverts to it at the end of the term
- Fees received by the authority are typically ringfenced for future investments into the assets

Lithuania’s experience of concessions in the district heating sector (1)

- A number of Lithuanian city municipalities entered into concession agreements with private operators around 2000-2002
- While in Vilnius the agreement was with the French operator Dalkia (now Veolia), the practical operation of the assets was passed on to UAB Vilniaus energija, part of the Icor group
- In other cities, the agreement was signed with Litesko – also part of the Icor group

Lithuania’s experience of concessions in the district heating sector (2)

- **Expectations**:
  - Competitive tenders to ensure best value for money for the consumer
  - Investment: large scale investment needed, both to pay off the municipal district heating companies’ debts, and renew the district heating infrastructure
  - District heating prices expected to drop due to increased efficiencies
  - Smooth transition back into municipal ownership at the end of the term

Lithuania’s experience of concessions in the district heating sector (3)

- **Reality:**
  - Tenders were not run transparently; current operators’ own procurement activity comes under regular investigation by the public procurement authorities
  - Scale and profile of investment have significantly disappointed; overwhelming majority of investments have been financed through the consumer – but the upside has not been shared
  - Heating prices have been considerably higher than in municipalities where the assets were not leased out
  - Transition back into municipal ownership is likely to be very challenging: weak municipal companies, issues of asset valuation, issues of ownership of IT / CRM systems, big customer debts etc

Lithuanian experience of concessions in the district heating sector (3)

- In conclusion, the Lithuanian experience has been **overwhelmingly negative**
- Future scenarios being considered by the municipalities do not rule out concessions, but favour assets being retained by the municipal companies
- So is there a future for concessions in the Lithuanian district heating market? Or is it a mission impossible?

UK perspective: prerequisites of an effective concession regime (1)

- The UK is not a leader in district heating: only 2% (200,000 households) of UK homes are centrally connected
- DECC would like to see that proportion rise to 40% by 2050 and is allocating financing for feasibility studies
- Where the UK does have long-term experience and expertise, is in delivering improvements and efficiencies to **concession agreements**

UK perspective: prerequisites of an effective concession regime (2)

- In 2003, the UK National Audit Office found that over 70% of concessions (PPP or PFI projects) were delivered late, and over 75% of them exceeded agreed budgets
- Since then, a **significant review of the concession regime** has taken place in the UK
- Over the past 12 years, in excess of 600 projects/operations have been implemented under the UK concession regime, with the capital value of over £60 billion

UK perspective: prerequisites of an effective concession regime (3)

- If done properly, there are key advantages to running a concession:
  - Risk is diversified, with some of the key risks being transferred to the private sector
  - Private sector expertise in project/operation delivery tends to be superior to the public sector's
  - Public capital gets freed up for other purposes
  - In the context of municipal indebtedness in Lithuania, private sector borrowing costs can be more favourable than those of the public sector
- The key challenge is to ensure the **right balance of rights and responsibilities** between the public entity on the one hand, and the private operator on the other

UK perspective: prerequisites of an effective concession regime (4)

- **5 prerequisites can be identified** as a means of protecting public interest and ensuring an effective concession agreement:
  - **(1) An effective public procurement regime.** The initial tender must be run **transparently and competitively**. To ensure the identity of the operator does not change further down the line, **change of control restrictions** must be imposed from the outset. The winning private sector operator’s own procurement activity must be closely supervised

UK perspective: prerequisites of an effective concession regime (5)

- **(2) Fair and balanced revenue stream arrangements:**
  - The private operator’s ability to increase charges ought to be tightly controlled. For this, a **stringent obligation to provide information** must be imposed, and the **national energy regulator** must have considerable powers in price controls
  - In addition, consider a **profit sharing arrangement** (profit beyond a certain fixed level gets shared between parties)
  - The public entity ought to have a right to get a **share of refinancing windfalls**

UK perspective: prerequisites for an effective concession regime (6)

- **(3) Investment scale, sources, timing and profile must be clearly specified:**
  - Investment must be financed at least partly via the operator's own/borrowed capital and recovered through efficiencies (and not just consumer payments)
  - Investment must have an smooth profile, and not be lumped at the beginning of the concession
  - Invested assets must include those that are not attractive to the operator, but essential for the smooth running of the operations (e.g. transmission assets)

UK perspective: prerequisites for an effective concession regime (7)

- **(4) Obligation to mitigate** must be clearly imposed on the private operator, including debt recovery, redeployment of unnecessary assets etc.
- **(5) End of life arrangements** must be clearly stipulated. This includes:
  - clarity on the value and contents of assets that will revert back to the owner
  - clarity on the process via which assets will revert back, including timings, entities involved, an effective dispute resolution method etc.

Conclusion

- Lithuania's experience of running concessions in the district heating sector has been bitterly disappointing
- However, the long-term experience of running concession agreements in the UK suggests it is possible to protect the public interest while maximising the benefits of private investment
- For that to be achieved, mutual trust, an effective public procurement regime, a strong energy regulator, and extremely tightly drafted concession contracts will be necessary