PECC Workshop on Public/Private Partnerships

P3 Trends in Asia

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Discussion Topics

- Trends
- A New Model for Infrastructure Development
- Case Studies

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Trends

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Trends that led to the Growth of P3

- **Debt Crises:** The end of sovereign commercial borrowing (1980s) and severely limited public works/capital budgets
- **Growth:** A combination of high population and economic growth in emerging markets (1980s/early-1990s)
- **Subsidies:** Growth in operating subsidies needed by inefficient public utilities
- **Competition:** The increasingly competitive international market for infrastructure construction and equipment supply
- **Technology:** Telecom and IT revolutions, computerized system management models (billing and collections), environmental and pollution control technologies, etc.
- **Visibility:** Successful PPP/BOT projects

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Perceived Obstacles: Project Finance

- Despite recent currency and accounting crises, long-term private sector interest in international project finance remains strong
- The biggest perceived obstacles to project finance by private investors and lenders are:
  1. Lack of good/strong candidate projects identified and studied
  2. Lack of clear and unambiguous legal, regulatory, and procurement frameworks for project finance
  3. Lack of capacity across government agencies to understand the full requirements of projects (project identification, risk allocation, credit enhancements, contracting, regulation, etc.)
- Governments and donors must first establish the enabling conditions and provide capacity building capabilities

Source: IP3 Poll

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Lack of P3 Candidates

- In the past, poor project performance is often a result of inadequate project feasibility studies that fail to properly analyze the risks
- Governments are unwilling to spend their own scarce funds to fully analyze and study the commercial and financial risks of public projects
- Most infrastructure feasibility studies are paid for by, and represent, bilateral trade development agencies or private developers and equipment suppliers - <u>not</u> governments

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Financing vs. Efficiency

- Governments have focused too much on the short-term goal of a new financing sources, rather than the long-term goals of improved efficiency, lower costs, and better quality services

- Difficulty in assessing if P3s really will result in "value for money" and provide services that are affordable

Inadequate Transaction Expertise with PPPs/Project Finance

- Tendering for, Procuring, and Negotiating long-term contracts for services are different than traditional government procurement for goods/materials

- Lowest price is not necessarily the best "value for money"

- Answer: Hire experienced independent advisors
  - Financial/Legal/Technical
  - Social/Environmental/Other

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Inadequate Credit Enhancements/Guarantees

- Most candidate P3 financings stop because they fail to satisfy private lenders that projects are truly “bankable”

- Developing economies with sub-investment grade credit ratings need to enhance the creditworthiness of candidate projects to attract international capital

- **Tool: Multilateral/Bilateral Guarantees**
  - Political Risk/Credit Guarantees from ADB/World Bank Group/EBRD/OPIC/NEXI, etc.
  - Need for National Government Counter-guarantees to MDBs
  - Private Sector Infrastructure Development Funds

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Increased Perceptions of Foreign Exchange Risks

- P3 projects borrow in hard currencies and collect revenues in local currency – currency mismatch
  - Asian Financial Crisis 1997-98
  - 1998 Financial Crises in Brazil & Russia
  - Argentina’s Financial Crisis 2002-03
- Unrealistic expectation that governments will bear foreign exchange
- **Tools**
  - Maximizing local currency financing
  - Inconvertibility/Non-Transfer insurance

Inadequate Regulation/ Dispute Resolution

- What to do when project conditions change?
  - New laws, inflation, etc.
  - Price/tariff adjustments
  - Contract renegotiation/refinancing
  - Contract cancellation/termination

- **Tools**
  - Strengthened regulatory frameworks and bodies
  - Alternative dispute resolution mechanisms
  - Better-structured contracts that foresee needs for renegotiation and dispute resolution for good projects
  - Insurance

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A New Model for Infrastructure Development

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The Need for a New Model for Infrastructure Development

During the decade leading up to the Asian financial crisis we saw rapid expansion of private sector

- Investment in, and
- Management of

public infrastructure, often through BOTs, BOOs and other P3

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The Need for a New Model for Infrastructure Development

With hindsight, we need to reconsider:

1. Comparative advantages of the
   - Public sector
   - Private sector
2. Critical role of regulation and governance
3. Tariff structures
   - That are viable and affordable for the entire project life

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The Need for a New Model for Infrastructure Development

- We need to develop better, more bankable versions of these models
- Backed by the fundamental willingness and ability of customers to pay
  - Rather than on government guarantees or payment assurances

In short, we need a new "best practice" P3 model for infrastructure development

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Issue 1: The Role of Government

Historically, infrastructure industries remained in the public sector because they have components that are natural monopolies:

- High capital costs
- Long lead times
- Need for universal access

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Issue 1: The Role of Government

Now, public ownership and management is neither:

- Necessary, nor
- The best way to ensure universal access

A key advantage of having the private sector provide public services, is that it allows government to concentrate on:

- Planning
- Policy
- Regulation

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Issue 1: The Role of Government

And, it allows the private sector to concentrate on doing what it does best:

- Invest capital
- Manage the business
- Improve efficiency and service quality
- Create incentives for management and staff
- Satisfy customers

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Issue 2: Strategic Planning

Acceptance of private sector investment in infrastructure was often due to governments' failure to:

- Anticipate future bottlenecks, and
- Make timely strategic investments to prevent shortages in capacity

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Issue 2: Strategic Planning

Now - even with increased private sector involvement in infrastructure - some governments:

- Neglect their responsibility for sectoral planning
- Offer public assets to the private sector in an ad hoc manner
- Fail to ensure that “up and down stream” investments are made

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Issue 2: Strategic Planning

The private sector has historically supported projects that offer the:

- Highest rate of return
- Lowest risk or
- Greatest short-term benefit

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Issue 2: Strategic Planning

Governments have failed to subject these proposals to rigorous financial analysis to determine their sustainability without major increases in:

- User charges, and/or
- Government guarantees

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Issue 2: Strategic Planning

The results have been unsolicited proposals that:

- Involved little commercial risk, thanks to
  - government guarantees
  - other assurances
- Were politically generated

Under the "New Model" …

Governments should:

- Maintain and strengthen their in strategic planning role
- Identify where private sector participation should occur
- Ensure that "up and down stream" investments are made

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Issue 3: Regulatory Framework

In some countries, the effectiveness of private sector participation has suffered from weak tariff regulation. In some cases,

- Regulation and administration are not separate
  - Creating conflicts of interest
- Governments have been slow to establish autonomous regulatory agencies

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Under the "New Model" …

Governments can un-bundle power or water supply networks into competitive components

- To reduce the need for regulation
- Competitive components can be transferred to the private sector
  - In a way that promotes competition and allows deregulation
- Monopolistic components can then be transferred
  - Once an effective regulatory framework has been established

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Under the "New Model" …

Tariff regulations should have:

- Autonomy
- Accountability
- Transparency
- Predictability

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Issue 4: Legal Framework

Perhaps most important is the lack of established legal procedures in many emerging markets that apply to contract law:

- Enforcement
- Dispute resolution

This is a key issue, especially when it comes to concession or off-take agreements

- Which could underpin the entire project viability

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Issue 4: Legal Framework

A well-developed legal framework lowers the:

- Level of risk to investors, and
- Cost of infrastructure projects
  - Ultimately paid for by consumers

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Issue 4: Legal Framework

The transfer of infrastructure services to the private sector should not lead to:

- Privileged deals, or
- Profits secured by government guarantees

It should result in regulated income streams that derive profits from:

- Increased efficiency, and
- Attraction of additional demand

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Issue 5: Currency Mismatch

During the Asian financial crisis, devaluation of local currencies bankrupted several infrastructure projects

- Which had un-hedged currency risks

Although some projects could pass through currency depreciation they still suffered

- As consumer affordability levels decreased

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Issue 5: Currency Mismatch

It is now well understood that high tariffs due to local currency devaluation is a major risk for 'user-pays' structures

But, the root problem that prevented mobilizing local currency debt needed to fund long-lived assets was the lack of:

- Depth in local capital markets, and
- Ability of local investors to analyse project finance risk

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Under the "New Model" …

ADB and other IFI's should help member countries:

- Develop and liberalize their capital markets
- Allow foreign banks and insurance companies to compete fairly in these markets

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Under the "New Model" …

Further, we should help project sponsors access cost-effective medium-to-long- term local currency financing via local currency:

- Direct loans
- Partial credit guarantees
- Currency swaps

And encourage ECAs and others to follow our lead

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Issue 6: Risk Allocation

To reach financial close, governments often accepted commercial risks that should have been left to the private sector, including:

- Foreign exchange risk, and
- Demand risk

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Issue 6: Risk Allocation

An obvious example has been take-or-pay provisions in power purchase agreements, which:

- Created contingent liabilities for governments,
- Isolated private sponsors from the market influences, and
- Encouraged price rigidity

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Under the "New Model" …

- Commercial risks would be assigned to the private sector

- While other risks should be assigned to the party best able to mitigate the risks

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ADB's Role

- Forming alliances: Corporations, governments, NGOs, foundations, educational institutions
- Focuses on comparative advantages
- Creates 'enabling environments'
  - Legal/regulatory frameworks
  - Good governance
  - Investor confidence

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Objective

- Tackle broad spectrum issues
- Achieve accountability by all parties
- Help to dilute ‘unholy alliances’
- Encourage broadly-based participation in economies

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P3 Support

ADB can support P3s with:

- Equity investments
- Direct loans
- Credit guarantees
- Political risk guarantees
- Other innovative products (currency swaps, bond issuances, local currency financing)

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Case Studies

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Philippine Power Sector Development Program

- In discussion stage with the GOP
- Objective: promote power sector restructuring by encouraging privatization of gencos, transcos, and the flow of FDI into new power assets and reduce electricity costs
- Three forms of assistance:
  - *PCG for debt restructuring* – up to $500m to enhance new PSALM bond issues

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Philippine Power Sector Development Program

- *PRG to promote FDI* – would cover both existing assets, and new forms of investment
- *PCG for electricity market trading* – would be extended to institutions that extend credit for financing power purchases to a variety of buyers

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Benefits to PSALM

- Achieved investment-grade rating (from BB+ to BBB)
- Allowed for a longer maturity and significant cost savings (2% p.a.), which were passed on to consumers
- Fixed-rate long-term coupon benefited the issuer more than a floating rate syndicated loan
- A broader investment base was tapped (including insurance companies and asset management firms)

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Market Reaction

- Commercial banks/project sponsors like the idea
- Provides the comfort they seek
- Are awaiting additional details from ADB following completion of negotiations with the GOP

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Afghanistan Investment Guarantee Facility (AIGF)

- Joint venture with MIGA
- Political Risk Guarantee (PRG) facility focused on promoting FDI into Afghanistan
- Administered by MIGA
- Open to public/private sector coinsurers

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AIGF

- Funded by $5 million each from IDA and ADB
- $10m in PRG coverage each from ADB and MIGA
- Can accommodate up to $60m in investments
  - Assuming $30m in coverage from coinsurers

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Pakistan Terrorism Facility

- Political Violence/Terrorism reinsurance facility
- For local and foreign investors/lenders
- Counter-guaranteed by the GOP
- Parallel reinsurance from the private sector
- ADB’s total is up to $175m / $20m per deal

Purpose of the Facility

- Support new or existing assets of national economic significance
- Support the direct underwriting and reinsurance markets in Pakistan
- Encourage participation of private PRI providers
- Promote development

Tenor and Risks Covered

- Risks Covered
  - Political Violence
  - Terrorism
  - Strikes, Riots, Civil Commotion

- Tenor
  - ADB: Up to 10 years
  - Private market interest is generally limited to 12 months
  - ADB could take the back-end risk to lengthen tenor

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Market Reaction

- The private PRI market has interest
  - Level of interest and rates range widely, depending on nature and location of risk
- Individual risk assessments from external sources may be required
- ADB participation is perceived as adding great value to the proposition

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Trade Finance Facilitation Program ***(TFFP)***

- Designed to 'level the playing field'
- A revolving PCG that guarantees payment if an issuing bank fails to pay an LC or other qualifying instrument
- A Risk Sharing Agreement with EBRD where our countries overlap
- A revolving credit facility providing short-term loans to issuing banks to help fund client working capital needs

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TFFP Basics

- Initially focused on Mekong and the Central Asian Republics
- Initial program life 5 years
- Will support L/Cs for 180-360 days
- All reputable confirming banks and top local issuing banks are eligible to participate

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Looking Ahead

- ✓ Recognize that there is a need to shift to new best practice models for infrastructure development
- ✓ Close cooperation and partnership between:
  - Host governments
  - Project sponsors
  - Financiers
- ✓ Willingness to tackle new important issues - such as sub-sovereign lending and local currency financing – in the future

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