FINANCING FOR INFRASTRUCTURE PROJECTS

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1. Rationale:

In context of a developing country like Pakistan, the rationale of encouraging Infrastructure Project Financing is to bridge the investment gap in infrastructure sector by inviting private investment for commercially viable projects. It is estimated that the annual requirements for capital investment in this sector would be about $2.5 – 3.0 billion. The GoP is not in a position to provide such large amount. At best it can afford to spend about $1.5 billion keeping the fiscal targets intact. Thus private sector will have to come up with an equal amount every year. In this connection, the respective roles of private sector business concerns (both domestic as well as international), the banking system and capital markets have to be carefully delineated. Such an arrangement would not only help in kick-starting economic activities in the country but would also provide the fiscal-space to the Government for diverting scarce public funds to other pressing demands such as for social sector services. Therefore, financing of infrastructure projects in the private sector would have dual impact on poverty alleviation i.e. (a) additional investment would lead to more job creation and higher economic growth by relieving congestions and shortages and facilitating quicker movement of goods and services. (b) Freeing up of fiscal resources from assuming full financing responsibilities of infrastructure would enable the government to undertake direct measures to address the needs of poverty stricken regions and population of the country in a more meaningful way.

As the rising population and rising incomes in Pakistan result in higher demand for infrastructure facilities the lumpy nature and up-front large investment requirements have created a chronic imbalance between the demand and supply. The supply of infrastructure services has lagged behind the burgeoning demand creating rationing, inefficiency and higher costs for the businesses. As the fiscal deficit has to be contained, the past track record of public sector institutions in providing these services efficiently and in cost effective ways has been woefully inadequate, the financial sector has ample liquidity and the learning experience of Pakistan in private

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sector involvement in these projects has been quite illuminating it is essential to rethink the new contours of financing for infrastructure projects. Sustainable provision of infrastructure facilities has to be commercially oriented, an approach that can lead not only to the strengthening of operations, and improvements in efficiency, but also opens up access to private finance. Private funding with no recourse to the "sovereign" introduces important market discipline, controlling costs, providing revenues and allocating risks. At the same time, private involvement calls for a strong and reliable regulatory framework, which remains a key challenge in many developing countries. While the potential for private involvement varies across sectors (being greater for example in telecommunications and power than in roads), there is significant scope for expansion in all sectors.

2. Commercializing Infrastructure Projects:

There are three levels at which infrastructure can become commercially oriented viz.:

i. At the very basic level, authorities can begin to operate the public sector in a manner, which reflects more closely the ways the private sector operates. This means paying close attention to revenues, costs and market demands. It also involves creating a governance structure, which provides clear goals, makes management responsible for performance and allows them independence to carry out their tasks. This may also involve bringing in a private sector partner on an advisory basis. District governments and Union councils are best suited to carry out such projects.

ii. At second level governments can seek the limited entry of new private providers through various forms of public/private partnerships, which refers to co-operation between public and private sector interests in completion of a project. This approach involves more active private sector participation, usually as an operator. Potential areas include power transmission company, backbone company for telecommunications, water supply and sanitation, toll roads, municipal services, ports and airports. The basis for this involvement is usually some type of "concession".

iii. Finally governments can opt for full privatization of some public services such as telecommunications, gas and oil pipelines, container terminals, port cargo handling, airport commercial services, thermal power generation and distribution companies etc.

3. Infrastructure Project Financing by Private Sector in Pakistan:

So far Pakistan has had only a limited success in attracting private investment in the infrastructure projects, which has remained limited to only highly marketable commercial undertakings such as Power Generation, Oil pipelines, LPG extraction and marketing, cellular telephone networks, and Container Terminals at Ports. In this connection, it is important to note that unlike many other developing countries of Latin America and Far East Asia, Pakistan had not been able to reap benefits from the first wave of private sector participation in infrastructure projects. The major inhibiting factors has been clear division of responsibilities between policy and ownership by the government tilting the balance in favour of govt. owned enterprises, lack of adequate regulatory framework, weak capacity and coordination among the government agencies, poorly structured concession and contractual arrangements, macroeconomic uncertainty, heightened political risk, poor governance and high transaction costs.

What is being done to relax these constraints in Pakistan?

- Macroeconomic uncertainty has been minimized to a large extent as there is a perceptible continuity of policies, consistency and predictability in the decision making process. Privatization of state owned utilities would further remove a major source of uncertainty faced by potential competitors.
- Governance has improved during the last four years and a level playing field is afforded to all potential and existing investors. Transparency in award of contracts and privatization transactions have become the

hallmark in recent years. Policy-making and operations have been separated in case of oil and gas and power sectors.

- Independent quasi – judicial regulatory agencies such as NEPRA, PTA, OGRA, SECP have been established to provide the supporting regulatory framework and lay down a well defined procedure for price determination and price changes.
- Financial sector and capital market reforms have been successfully carried out resulting in lowering of interest rates structure, tightening of spreads and availability of financing for long term.
- Experience from the Private Sector Energy Development Fund - has provided insights as to how avoid mistakes in structuring finances for infrastructure.
- A yield curve and benchmark for 15 – 20 years financing have been developed by introducing PIBs of the same tenor. Contractual savings in form of Provident Fund, Pension funds are available in large amounts for investment in long-term instruments. Foreign exchange availability is no longer a major stumbling block in converting rupee financing for acquisition of imported machinery and equipment.
- Political and geopolitical risks do still prevail but the overall country risk has been lowered as evident from the recent successful strategic re-entry of Pakistan in international financial markets.

Therefore, in accelerating transition from pure public to risk sharing between public and private sectors innovative and diverse financing techniques, have to be developed.

a. In order to facilitate private sector sponsorship of infrastructure projects, SBP has already allowed Banks/DFIs to accept "Concession

Agreement/License/Right of Way" issued by Government to consider as a collateral for infrastructure project financing, in the overall collateral arrangements worked out with the creditors.

b. As Pakistan's "Sovereign rating" has improved in recent years joint venture Infrastructure Funds between international private fund managers and Pakistani financial institutions can be set up under the present regulatory framework.

c. A majority of Pakistani bankers are still occupied with antiquated ways of doing business i.e. for them the Prime Security of a Project is 'marketability of collateral in case of default', besides 'reputation of sponsors'. This is a consequence of financial underdevelopment and lack of competition due to following the policies of 'financial repression' in the past. Financial Sector Reforms instituted in recent years have been able to assert the importance of evaluating 'intrinsic cash flow generating ability of the project' in undertaking project lending. However, development of expertise in Project Evaluation can only be realized overtime in medium to long run. In order to undertake cash flow based lending, commercial banks/DFIs are being encouraged by SBP to make their lending judgments on the basis of sectoral and sub-sectoral studies and other data regarding volume of expected use and future cash projections of infrastructure projects.

d. Information Sharing: The private sector can be facilitated by providing data on demand and information related to various potential infrastructure projects so that private investors, businesses, bankers and capital markets can plan their future investment decisions in accordance with the Cost and Benefits Analysis (CBA) of these infrastructure projects.

e. Pursuing a "Selective Approach": As regards envisaging market based financing system for various revenue generating Infrastructure Projects relating to Transport, Water, Sanitation and Sewerage, etc. it is important to follow a "selective approach". For example, initially, following

Infrastructure Projects related to Transport Sector may be selected for private participation as these projects have solid project economics:

- Roads with high traffic level of 15,000 vehicles per day.
- Road transport services in big cities.
- Bridges and bypasses around big cities.

In this connection, the Federal, Provincial, City/District Governments need to conduct a 'demand survey' with respect to the following key areas:

- to identify the nature and magnitude of the financing gap;
- the appropriateness of the fund as an instrument to support private investment and the timing of the fund;
- the design of instruments;
- the Infrastructure Financing Facilities (IFFs) funding requirements; and
- the staffing levels and skill mix needed to manage those instruments.

f. **Infrastructure Financing Facilities (IFFs):** Governments can encourage private sector investors to undertake funding of infrastructure projects by establishing *transitional* institutional arrangements i.e. Infrastructure Financing Facilities (IFFs), in the form of grants, soft loans, guarantees or partial guarantees. In Pakistan this has been a controversial issue because of the experience with the Independent Power Projects (IPPs) financed under the World Bank assisted Private Sector Energy Fund. It is therefore imperative that we learn the right lessons from this experience otherwise this can lead us to inaction or avoidance of private sector involvement for wrong reasons.

<u>Experience with Private Sector Energy Fund.</u>

The experience of Private Sector Energy Development Fund in Pakistan suggests that the IFFs should not transfer commercial risk to the government as the latter do not have any control over the management of that risk. Similarly, while the

government shared in the downside risks of a project, it was unable to take advantage of an upside potential. Moreover, direct funding instruments may be successful in attracting equity investment but they may reduce project sponsors' incentives to manage risk adequately particularly if it is provided on an unconditional basis. The mixture of direct funding, subsidies, tax exemptions and guaranteed pricing may even tempt project sponsors to be less prudent, take excessive risks while capturing upside and leave the downside to the government. The burden sharing was therefore too skewed in favour of the project sponsors.

There are still unresolved issues in the structuring of financing under the circumstances where there is a single supplier of inputs and a single buyer of output. The bargaining powers of the two parties are uneven and a private sponsor may not take the plunge in an aura of uncertainty about the future cash flows and profitability. Event risk under such a situation is highly pronounced and there is no satisfactory way either to price this risk or to hedge against this risk. A proper pricing leads to unaffordable tariffs thus reducing the attractiveness of the project itself. A sub-optimal pricing exposes the private sponsors to unacceptable risk. Event risk took place in case of Pakistan when Benazir government that had concluded the agreements with the IPPs was replaced by Nawaz Sharif Government in 1997 and the entire process came to a virtual halt. Reputation risk of both Pakistan as a sovereign and those of the private sponsors suffered immensely. The consequences of this loss of reputation for both the parties were quite difficult to manage. The lesson to be drawn is that government legal guarantees counter guaranteed by the IFIs do not always provide comfort or satisfactory mitigation against event risk and reputational loss. Thus a more fair and even handed agreement with equal burden sharing between the sovereign and private sponsors has much better chance of success than perceptively loaded agreements in favour of one or the other parties.

3. Role of International Financial Institutions (IFIs):

IFIs collaboration with the private sector can take a wide variety of forms. There is no obvious limitation on the financial structure of interventions, which can range from straight equity to quasi-equity instruments and debt, underwriting and guarantees. Intervention can also take the form of introducing financial instruments to

capital markets, for instance through IFIs treasury departments. Nevertheless, it is important and useful to consider particular sectoral challenges. An active presence and support of IFIs can help financing of infrastructure projects in the followings ways:

(i) **Development of Financial Markets:** It is immaterial whether the vehicle for IFIs impact is a candy factory or the national power grid, as experience has shown that cooperation of IFIs with foreign and local investors in the general industrial and services sectors can have far-reaching benefits in terms of the functioning of *markets, market-oriented behaviors and institutions*. To 'multinational financial institutions' cooperation of IFIs would provide an umbrella of political comfort derived from their long-term relationships with governments and their preferred creditor status. To local banks the cooperation of IFIs would provide much needed medium-term capital, besides helping in institutional development.

(ii) **Institution Building:** As regards provision of sustainable long-term funds, Pakistan is planning to reform social security systems, and in particular involving the private sector in providing income security to old age. Pension reforms will introduce privately managed individual retirement accounts. Successful reform depends on the existence of a solid private pension fund management sector on capital markets that fulfill some basic conditions (regarding liquidity, depth, and diversity of instruments), and on reliable regulation. In working with the private sector (in addition to providing advice at the policy level) IFIs can support such reforms by strengthening the institutional basis for their implementation and thus increasing public confidence in them.

(iii) **Promoting Entrepreneurship:** A further area where IFIs can play an important role is in promoting the availability of equity. Equity is widely sought after in developing economies for large capital intensive infrastructure projects. IFIs are well placed to participate in funds and help attract institutional investors, such as international pension funds and mutual funds, into these countries. In this way they can also help to

strengthen nascent capital markets. By being early in the game and showing good management and professionalism, they can provide a strong demonstration effect.

(iv) **Developing Financing Structures:** IFIs can also help develop financing structures that are simple, cost-efficient and can be easily replicated so as to encourage private sector, besides envisaging a system for risk allocation and mitigation. IFIs may not only share the general project risk with private partners (through equity or non-recourse debt), but may also assume those risks that they are well placed to mitigate. These tend to include general economic and political risks and risks arising from shifts in regulatory regimes.

4. Concluding Remarks:

Difficulties involved in structuring and implementing infrastructure projects must not be underestimated. Such a dispensation not only requires strong political backing, but also demands enactment of specific legislation or the introduction of the necessary regulatory environment. Moreover, most of the infrastructure projects have a complex project design, wherein certain costs tend to be *front-loaded*. Therefore, presence of multitude of political, regulatory and commercial elements make infrastructure project financing a complex process for the private sector, thereby creating scope for valuable contributions by the IFIs for facilitating/streamlining the aforementioned process.