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EIC
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EIC Position Paper

on

„Facilitated“ PPPs in Developing Economies

Political Background

European International Contractors (EIC) has as its members construction industry trade associations from fifteen European countries and represents the interests of the European construction industry in all questions related to international construction activities. In 2008, European contractors were active in all world regions and generated an international turnover of more than 70 billion € *outside* of Europe, of which some 38 billion € originated from construction contracts executed in non-OECD economies. In the classification of major private developers engaged in the construction of transport infrastructure EIC member companies hold almost a total of 20 first positions.

EIC would like to recall the importance that Public-Private Partnerships have assumed in the last decade as a complement to public investment in developed countries. However, this powerful financial instrument hasn't managed to turn into a substantial element of development assistance – in spite of the interest that multilateral financial institutions have expressed in its promotion so as to increase the volume of infrastructure investment, investment which is indispensable for achieving the minimum levels of human development and productive capacity.

Talking about the future, with the horizon clouded with the current world financial crisis, the application of the above mentioned instrument is experiencing difficulty – precisely at a time when it is even more necessary to increase its use. All over the world economic growth is slowing down, or even going into reverse. Capacity for investment, both public and private, is decreasing and developed countries are likely to intensify their action and channel their resources towards their own economies, to the detriment of the development effort needed at world level. The multilateral bodies aimed at boosting development, are beginning to play an even more important role and it is necessary to review the existing instruments in their arsenal so as to not only maximise their efficacy, but also facilitate their implementation in the complicated context of recent global changes.

EIC has been a firm defender of Public-Private Partnership (PPP) systems and their application in developing countries. The *EIC White Book on BOT/PPP* published in 2003 contains a set of basic guidelines required to achieve success with these systems. What follows are current experiences, the possibilities to improve performance in the context of the present crisis and the proposals to start (together with multilateral institutions) work on the development of what we have called a "facilitated" framework allowing for a quantum leap forward in development through Public-Private Partnerships in the near future.

Effect of the global financial crisis on development and infrastructure needs in emerging economies

There is no need to dwell in detail on the importance of infrastructure in the social and economic development of a country. It is clear that without improvements in its infrastructure, a developing country will remain underdeveloped, whilst the cost of achieving such improvements represents one of the largest items of budgetary expenditure. Furthermore, investments in infrastructure are closely related to the functioning of ancillary public services so actions have to be co-ordinated if these are to lead to meaningful improvements. Thus investment in a new network of schools to which the pupils and teachers have no easy access because of transport infrastructure problems or which do not have electricity or drinking water supply systems is not going to achieve a meaningful improvement in the country's educational system. Neither will a new health care system in a country with an unreliable drinking water supply have the anticipated impact in the reduction of infant mortality rates.

But infrastructures are expensive and, as a result, the governments of developing countries face a delicate dilemma: to allocate a high percentage of their scarce budgetary resources to that end, hoping that in the more or less distant future this will help improve the provision of services to their citizens, or to give priority to other indispensible costs whose non-payment may provoke short-term social problems, such as civil servant salaries, unemployment benefits and the servicing of foreign or domestic debts.

To sum it up: the poorest countries need investment support the most to lift themselves out of poverty. These countries however, have the least capacity to implement this investment. It's true that return on investment at low and medium levels of development is very high, but it takes these countries decades to prepare the ground for even the most basic of infrastructure projects. Multilateral institutions, recognising that boosting investment is an indispensible condition of successful development, have traditionally played an important role in assisting these countries via funding and know-how support programs.

In the late 20th century, the proliferation of project financing methods applied to infrastructure projects through the use of private financial resources was hailed as a promising complement to existing means development fundraising and implementation. Some recent successful examples, such as that of Chile, show how the transport system of a country can radically improve in quality for the benefit of the whole economy through the rigorous application of an ordered system of public contracting based on the award of Public-Private Partnership contracts. The combination of infrastructure investments with upgraded service provision has led to a growing tendency to use PPP. According to the World Bank's database, commitments to invest in transport infrastructure projects with private capital participation in developing countries equalled $144,000m during the decade1996 - 2006, of which $21,700m corresponded to 2005 and $29,700m to 2006.

However, it is noteworthy to recognise that the level of application of private infrastructure financing in developed countries is a lot higher than in developing countries. The application of these methods in the transport and services industries has reached noticeable levels, especially in Europe. This indicates that PPP is a Value-for-Money solution even when public funds are available for direct state procurement investments.

On the other hand, the financial crisis has called into question the continuity of investment in new infrastructure projects in developing countries. According to the World Bank's report published in December 2008, [*"Although it's too soon to evaluate the total impact on new public private investment (PPI) projects*], *there's mounting evidence of a fall in the percentage of projects completed by the end of the year and of projects cancelled or postponed"*. According to the said report, between August and November of 2008 about $90,000m out of a total of $120,000m in investment in 173 infrastructure projects included in the Bank's database was cancelled or postponed.

The need for concerted action to encourage capital flows to developing countries

If even before the crisis it was necessary to make an effort to avoid PPP application being limited to developed countries at the expense of developing ones, evidence of the difficulties of its application in the context of the financial crisis requires an analysis of ways to make this system attractive under the present challenging circumstances in a sustainable manner going forward. Possibly one of the ways to deal with this problem given the uncertainty of world growth is precisely to ensure the allocation of resources to such investment projects which, regardless of their location in the world, offer high value-for-money.

The benefit of Public-Private Partnerships is that they represent a special tool for development, not only because they can raise private capital for planned investments, but also due to their capacity to ensure technology transfer and the adequate maintenance of completed facilities in the medium to long run. In fact, current experience shows that acquiring financing for the construction of a certain infrastructure is just the first step in guaranteeing its correct use and longevity. It is easy to come up with numerous examples of transport, energy generation, water treatment and other type of infrastructures which were financed and built but a few years later turned out to be unusable or hardly usable due to low quality maintenance, lack of spare parts or even because the initial concept had not taken into account a project's life cycle in a given physical and economic setting. This deficit finds a clear solution in long-term Public-Private Partnership projects. Developers and financiers are mainly interested in projects' adequate long-term operation, which is the only way to recoup the investments made. Thus it guarantees technology transfer and the creation of project managers and maintenance technicians, which benefits the country.

However, evidence suggests that it is necessary to redesign policies so as to intensify the application of this powerful tool for development. If the difficulties of its application were considerable even before the onset of financial crisis, now they are enormous. As it says in Chapter 5.3.1 of the EIC White Book, *"Private sector participation holds enormous potential for improving the efficacy of infrastructure services and alleviating the pressure on public budgets, which for a long time were the only source of infrastructure financing. Despite its great potential for developing countries, private sector participation in infrastructure projects is slowing down and activity focuses on relatively few countries. This is largely due to the weakness of domestic capital markets and lack of government creditworthiness. Besides, there're few financial instruments available in the market designed to participate in infrastructure projects in developing countries. That's why the intervention of multilateral entities is especially important…"*

And further below it is recommended: *"The availability of an adequate risk mitigation system is one of the key elements essential to the success of a project. Highly precise and specialised guarantee mechanisms would help create a climate of confidence and security for borrowers"*.

In the same Chapter 5.3.1 of the EIC White Book on BOT/PPP a number of Multilateral Lending Agencies (MLA) are mentioned. Each of them, within their specific field of expertise, has been set up with the mission of assisting developing countries in financing infrastructure projects.

As the hurdles to obtain a financing of a project, such as:

- poor policies and inadequate regulations in the country
- expensive financing terms
- weak domestic capital markets
- difficulty of sub-sovereign governments to guarantee foreign direct investment

are more present than ever after the financial crisis, the role of each of the MLA's to support successful Public Private Partnerships has become key and accessibility of the specific tools made available through those MLA's is even more critical.

Beyond this mission, active participation of the MLA in a particular project has some undeniable important spin-offs:

- since a MLA is a natural partner to the governments, they can be involved in a project at a very early stage and as such make available to that government their expertise, experience and notoriety. This will automatically lead to a project based on realistic expectations and an appropriate risk sharing between parties.
- The publicly known involvement and interest of an MLA in a particular project, will contribute to the appetite of private lenders to get involved as well. Recent experience around projects with EIB involvement has proven the important facilitator role they can fulfill in order to make a project bankable.

A New Vision: "Facilitated" Project Financing – A new risk mitigation system for infrastructure development

It should be noted here that long-term private investment in developing countries poses a series of additional risks to those encountered in the developed world that the global financial system was not prepared to accept even before the crisis, let alone now. What is regarded as "orthodox" project financing is only applicable to a group of middle-income or high-income developing countries. This is no reason to ignore the possibility of using this powerful instrument – what's necessary is to unite in a single package the possibilities of risk mitigation already offered on an individual basis by various MLA's. The creation of this single instrument should facilitate its systematic application across numerous projects and jurisdictions, supplemented with training initiatives at the national authority level, so that the conditions of each project and the conceptual framework of their implementation should fit into a scheme previously developed and supervised in a multilateral setting. This would facilitate the highly commendable pedagogical work currently carried out by multilateral financial institutions and UNECE.

The projects covered by this "facilitated" system of project financing would reflect the following essential distribution of risks.

Risks attributable to the developer:

- Construction risk (price and period)
- Operation and maintenance risk
- Demand (to an extent bankable and consistent with characteristics of the country and of the infrastructure) or availability risk

Contractual risks mitigated by the MLA:

- Political risk including breach of contract, confiscation, expropriation and nationalisation, currency convertibility and foreign currency availability
- War and civil disturbance, including terrorism
- Currency exchange risk in certain cases
- Risk arising from refinancing for periods longer than those offered by the local market, refinancing that would be insured by the appropriate multilateral entity

As a counterbalance to the risk coverage referred to above the country should agree to certain **standard general conditions of the Public-Private Partnership contract** which guarantee certain basic clauses concerning:

- Force majeure
- Facilitation of construction: Availability of land, pre-approved Permitting and licensing & facilitation of sourcing (i.e. import tax exemptions)
- Assurances relating to "competing facilities"
- Change in law provisions and International arbitration for dispute settlement

Acceptance by the country of the above-mentioned general conditions could also suggest a premium allowance derived from the agreement with the MLA.

The way in which the above described risk distribution and coverage framework can be implemented should be the object of discussions between the MLA's, the private sector and the relevant governments. We outline below, however, a number of more specific instruments that, based on our experience, could be part of such framework:

- Provision of clear guidelines for the legal framework of PPP's, in particular in countries with legal systems based on Civil Law rather than Common Law and professional and financial support to Governments in the preparation of such legal framework and the regulatory prerequisites for the implementation of PPP projects;
- Joint development by MLA's and Governments of standardised tender documents and contracts;
- Technical assistance and financial support to governments in the preparation of the tender process and documentation of large projects;
- Where the country risk is substantial or the financial markets may not be able to cope with it in amounts consistent with the volume of investment of the project, possibility that multilaterals could either provide the coverage directly or provide a counter-guarantee to a commitment by the Government;
- Provision by MLA's of financing denominated in local currency or of FX coverage;

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- In the current context of scarcity of financing for the private sector, provision of temporary financial guarantees by MLA's to facilitate the debt funding of PPP projects at a reasonable cost. Such guarantees should (i) be dimensioned in such a way to be consistent with investment grade ratings, (ii) carry a cost which would incentivise their unwinding once market circumstances are normalized, (iii) provide a symmetric risk / reward limitation to developers benefiting from them, and (iv) be attached to specific projects from the bidding process, thus maximising their efficiency through competition between different bidders and between different financial institutions.

EIC's offer for further co-operation

EIC hopes that the creation of a "single window" responsible for the mitigation of the financial system's most typical risks through multilateral institutions, combined with the establishment of certain basic contractual provisions reassuring private investors and financial backers about the long-term risks assumed, will greatly facilitate the development of infrastructure projects.

Consequently, EIC is ready to use its experience and work skills to participate in the development of the scheme referred to above. As outlined in its 2003 White Book: *"EIC regards the present White Book not as a completion of its tasks aimed at promoting the concept of Public-Private Partnerships, but as a starting point to make the points of view of both construction companies and concessionaires part of the political debate. We have great hopes of the response from the political and economic decision-makers in public institutions, including multilateral development banks and private businesses, and would like to explain our recommendations to them in greater detail. We believe that through the flexibility and cooperation of all participants, from both the private and public sectors, we could find the way ahead."*

The present situation confirms and reinforces the offer made earlier. The ongoing economic crisis should prompt the world's economic leaders to work together in order to make sure that the development of the poorest countries not only isn't hindered but picks up speed.

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