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New needs for technical assistance

Responding to the effects of the financial crisis on private participation in infrastructure

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In developing countries the global financial crisis is leading to serious difficulties for infrastructure projects with private participation. In some cases governments are responding by simplifying their project approval processes or by substituting public for private financing. Even if markets recover quickly, these responses could pose significant risks. Containing those risks and dealing with the effects of the financial crisis calls for specialized technical assistance—in assessing contingent liabilities, maintaining existing assets, assisting projects in distress, and maintaining a project pipeline.

The global financial crisis is likely to have severe adverse effects on private participation in infrastructure (PPI) in developing countries. Although events are still unfolding, available evidence suggests that liquidity for private infrastructure investment is drying up. In mid-2009 a few PPI projects are still reaching financial closure, though with higher spreads, and a few in countries with deep local financial markets are turning to domestic debt. But most PPI projects in emerging economies are facing serious difficulties as a result of the crisis. These difficulties highlight the need for specialized technical assistance.

Three kinds of problems

Although the global financial crisis is having different overall effects in different regions and countries, it is affecting PPI projects in at least three related ways.

Financial impacts

Financing for infrastructure has fallen sharply, a trend already apparent by the end of 2008. The upward trends in costs, delays, and cancellations

are expected to continue through 2009. International project finance is now much more expensive and difficult to arrange because lenders (those still willing and able to offer project finance) have less money and are more risk averse in selecting projects and markets. In most emerging economies PPI projects that reached financial closure in the first four months of 2009 were either well along in development or relied heavily on a mix of local public banks, export credit agencies, and bilateral and multilateral agencies for finance. But these financing institutions are unlikely to be able to fully close the gap left by departing private international lenders (Izaguirre 2009).

Economic impacts

A second set of impacts is expected to stem from the ongoing global economic contraction. In addition to the impact on debt flows, private capital flows of all kinds are expected to decline by half in 2009, to about 20 percent of the peak level of 2007 (IIF 2009). Foreign direct investment and portfolio investment are sharply down in most developing countries. African stock markets have fallen by an average of about 40 percent. Stock markets in Asia and Latin America are also down. Remittances, so important to many developing economies, are falling because of the downturn in remittance-sending countries. Economies that depend heavily on exports, such as those in East Asia as well as oil producers in various regions, are seeing far lower revenues. The sharp drop in the prices of commodities will have dramatic effects in many areas where much of the population depends in some way on commodity exports.

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Governments and their partners are responding to the crisis in several ways

The slowdown in economic growth that will result from these and other factors means a reduction in the ability and willingness to pay for retail infrastructure services and thus in the revenue streams needed for debt service. The economic slowdown will also reduce the ability of government agencies and utilities to pay for the off-take of bulk services.

Policy impacts

The crisis may also take on a policy dimension as government budgets come under growing stress. Empirical evidence from past crises suggests that policy makers are often tempted to turn away from constructing, rehabilitating, or even maintaining infrastructure assets to deal with other, more immediate priorities. This was true in Latin America in the 1990s, when half the fiscal adjustment came through cuts in public infrastructure spending. In Asia many countries severely cut infrastructure investment in the wake of the 1997 financial crisis, then suffered years of sharply lower GDP growth.

This “turning away” from infrastructure is unfortunate for several reasons. Neglecting operations and maintenance (O&M) expenditures increases the economic costs of a recession through lost capacity and lower employment. In the long run the cost of replacing an asset is higher than the cost of continuing to maintain it. Allowing project pipelines to become depleted also compounds the cost of a downturn: since infrastructure projects have long preparation lags, they often take much longer to recover after an economic crisis than the economy itself. The Asian crisis led to the postponement of long-gestating infrastructure projects, contributing to what is sometimes referred to as the “lost decade” of infrastructure investment for many Asian countries.

Responses to the crisis

Governments and their development partners are responding to the crisis in several ways. One way is to recognize that infrastructure investment is an important tool for dealing with the economic downturn. Many countries are considering—or have already put into place—some form of stimulus package in response to the financial crisis, often highlighting infrastructure. Well-planned infrastructure investments not only provide countercyclical economic stimulus; they also help lay the foundations for economic growth in the long term. A judicious mix of O&M and investment

expenditures is critical. O&M expenditures can be scaled up quickly and countercyclically. Larger investment projects may take some time and require sound project identification and prioritization.

A second response to the crisis is to act aggressively to maintain a role for the private sector in managing and financing infrastructure projects. Here, governments are doing at least two related things. First, they are altering their approval processes for PPI projects to reduce or delay the effects of debt pricing on these decisions. Governments typically try to review and give preliminary approval to PPI projects as early as possible in the project development process so as to avoid wasting money developing projects that would be unaffordable or would not offer value for money.¹ But project finance debt has become too expensive for many projects to be judged affordable. And where debt may be affordable, the use of loan agreement clauses like “market flex,” which have the effect of delaying final lender pricing, means that tests of affordability and value for money cannot be done with any certainty until projects reach financial closure—and sometimes not even then.

Some governments, particularly in developed countries, are responding to this uncertainty by simply delaying as long as possible the requirement for firm financial commitments that must be met for government approval of a project. The French government is exploring ways of developing and approving PPI projects—even accepting final offers from bidders—without such commitments. The Polish government has awarded a 35-year toll road project to a firm that will start on design and construction, though financial closure has been postponed for a year. During that time an assessment will be made of the project’s capital investment needs and market pricing options. Some banks and financial advisers in Western Europe are promoting the use of “mini perm” financing for PPI projects. The term, borrowed from real estate development, refers to loans meant to cover a project’s construction period, after which the debt must be refinanced.

Second, governments are providing some or all of the financing for PPI projects, through loans, equity, grants, or guarantees. Again, developed countries, such as Australia and the United Kingdom, have taken the lead. The U.K. government is attempting to salvage its Private Finance Initiative with a proposed investment fund that would provide up to 100 percent of the financing needed

for projects to proceed. The financing is intended to be as short term as possible, with the loans refinanced from commercial sources as soon as markets recover.

In developing countries such as Brazil, India, Mexico, and South Africa government-owned development finance institutions are providing funding or guarantees to kick-start PPI projects. In countries without such resources, donors and multilateral development banks are preparing to help fill the gap. The International Finance Corporation is creating a global fund that will substitute donor funding for commercial finance to start new PPI projects and keep existing ones alive. In other developing countries donor or multilateral development funding may allow infrastructure projects to begin using conventional public sector procurement and implementation, with the aim being to bring in private participation when it becomes feasible.

The role of technical assistance

Even if markets recover quickly, the risks associated with some of these emergency measures are substantial.² By downplaying debt pricing as a way to evaluate PPI projects, governments may increase the risk of being stuck with contingent liabilities on projects that are unaffordable or even nonviable. The same concerns hold for government or donor funding support—and are even greater for projects with simplified approval processes followed by large public investment. Rigorous appraisal, selection, development, structuring, and implementation of projects will be essential for many of these emergency measures to work. In emerging economies, that suggests a need for specialized capacity building and technical assistance. Several priority types of such assistance appear to be emerging.

Assessing contingent liabilities

Many governments, especially those with significant PPI project portfolios, will need rapid-response assessments of the contingent liabilities they face with existing projects. Which projects are likely to come under stress because of the crisis? How have project risks been allocated, how much have these risks changed, and what has been done to mitigate risk? How do the contracts and agreements with lenders handle the catastrophic lack of global market liquidity? In particular, what liabilities do governments face if projects are terminated early under such conditions?

On the basis of this kind of liability assessment, governments can prepare frameworks for responding to overtures by project companies on project restructuring and can act preemptively to avoid problems on some projects. Over the longer term governments may be willing to work out risk management frameworks that integrate contingent liabilities on PPI projects into their budgeting processes. Finally, understanding contingent liabilities on existing projects is a prerequisite to prioritizing new projects, some of which may need to move forward in a timely way while others may need to be delayed until markets more fully recover.

Maintaining existing assets

This is a good time for governments and their development partners to consider the value of PPI arrangements that focus primarily on O&M rather than investment. A greater focus on O&M projects at this point makes sense both economically and practically because they are relatively easy to structure at a time of constrained liquidity. Because of their smaller size, O&M contracts often involve the domestic private sector, including small and micro enterprises. In addition, some O&M contracts can be designed to shift to longer-term, capital-intensive PPI projects after markets begin to recover.

Assisting projects in distress

Some governments will need technical assistance to help with projects already in distress or to put into place measures for dealing with contractual issues that may arise. Governments will have to make decisions on whether to slow or stop investments, how to respond to the potential entry of new investors into distressed projects, and whether to contribute their own debt or equity to projects, allow asset sales, permit extraordinary tariff increases, or negotiate mothballing of projects or termination of contracts. And in some cases they will need to consider social programs to protect the most vulnerable groups in society. Governments in these situations will need legal, technical, economic, and financial advice to help compare options and conduct negotiations with project companies and lenders.

Maintaining a pipeline of projects

Finally, many governments will need help in maintaining their PPI project development pipelines in the face of changing market realities. Once these pipelines shut down, fully restarting them typically takes years. To keep the momentum going, governments will need to evaluate innovative approaches

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to structuring PPI projects. These could include using public sector debt and equity to replace commercial finance; designing public projects so that they can be transformed into PPI projects when the markets begin to recover; using subsidies to lessen the impact of necessarily high tariffs, especially for poor customers; and adjusting legal and regulatory frameworks to facilitate the development of PPI projects under the changing conditions.

Conclusion

Some changes in the global project finance market are likely to be long term. Whether this will lead to another “lost decade” for infrastructure investment in emerging economies is still open to question. But it is already clear that the technical assistance needs and challenges stemming from today’s financial crisis are markedly different from those of the Asian crisis that began in 1997. Today far fewer governments in emerging economies are criticizing the basic PPI model than in the late 1990s, when many did not fully understand how PPI contracts were supposed to work.

In the early 1990s many governments had come to use these mechanisms out of a belief that they could turn over all responsibility for infrastructure provision to private partners, who would cover all costs and accept all related business risks. When projects became distressed during the Asian crisis and private partners did not do this, they were accused of renegeing on promises and the PPI model came under attack. Governments often ignored or

misunderstood the contingent liabilities associated with these contracts, and under the intense pressure of the Asian crisis, many simply repudiated these obligations.

Today the situation is different. Many governments in developing countries are taking a more pragmatic approach toward PPI-related issues. Not all of them fully understand their contingent liabilities on PPI projects, but many now recognize that such liabilities exist and are asking for help in understanding them. While many PPI projects are likely to experience problems, the PPI model does not appear to be under threat. That should help ease efforts in emerging economies to find innovative PPI approaches for dealing with the long-term market changes.

Notes

1. Probably the best-known vetting techniques are those associated with the U.K. Private Finance Initiative, though variations of these are widely used in many developed and some developing countries.
2. A companion note (Leigland and Russell 2009) discusses in greater detail the possibility that some market changes may be long term.

References

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