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The Role of Public Finance in PPPs

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The exclusive use of private finance is not a defining characteristic of a PPP—governments can also partially finance PPP projects. Reducing the amount of capital investment needed from private entities reduces the extent of risk transfer—weakening private sector incentives to create value for money, and making it easier for private entities to abandon the project if things go wrong. Nonetheless, there are several reasons why governments may choose to provide finance for PPP projects. These include:

- **Avoiding excessive risk premiums**—the government may consider the risk premium charged by the private sector for the project to be excessive in relation to the actual project risks. This can be a difficult call to make, since financial markets are usually better at assessing risk than governments, but can apply particularly for new projects or markets, or during financial market disruptions.
- **Mitigating government risk**—where project revenues depend on regular payments from government, the risk of default by the government will be assessed by the private party and will be reflected in the project cost. Where reliability of government payments may be in doubt, providing subsidies or payments upfront in the form of loan or grant finance, rather than on-going payments, could improve the bankability and lower the cost of the project.
- **Improving availability or reducing cost of finance**—particularly when capital markets are under-developed, or disrupted, the availability of long-term finance may be limited. Governments may choose to provide finance at terms that would otherwise be unavailable. Some governments have access to finance on concessional terms, which they may pass on to lower the cost of infrastructure projects. This may also be part of a broader policy of involving state financing institutions to provide long-term lending for developmental purposes.

There are different ways in which governments can contribute to the financing structure of a PPP. Governments may provide loan or grant finance directly to the project company, or provide a government guarantee on a commercial loan. The APMG PPP Certification Guide discusses de-risking approaches and credit enhancement instruments (APMG 2016, Chapter 1, Section 7.4.2) Government-owned development banks or other finance institutions can also be involved—either providing finance to PPPs as part of a broader portfolio, or being established specifically to support the PPP program. Finally, governments may simply not transfer the financing function to the PPP project to the private sector, instead retaining on-going responsibility for capital expenditures. These options are described in more detail further in this section.

The rationale for government financial support to PPPs may be strengthened during periods of capital market disruption, and many governments introduce specific forms of financial support in response.

Loan or grant finance directly from government to project company

Governments may provide finance directly to a PPP in the form of loans or upfront grant subsidies. These can be critical for project viability, where revenue projections show that the project is not likely to be financially viable without government funding. Capital contributions can also reduce the project's costs to the government by making finance available at better terms than would otherwise be possible. For example:

- In the **United States**, the Transportation Infrastructure Finance and Innovation Act (TIFIA) established a flexible mechanism for the United States Department of Transport to provide loans (as well as loan guarantees) directly to private and state project shareholders for eligible projects. The credit assistance is offered on flexible terms, and typically takes a subordinated position, which in turn makes it easier

to attract more private debt (US 2010, Chapter 4).
- India's Viability Gap Fund uses funds appropriated from the national budget to provide upfront capital subsidies for PPP projects, as described in The Viability Gap Fund Program in India. The **Indian government's guidelines on financial support for PPP in infrastructure** (IN 2013a) provide more details on this initiative.

The APMG PPP Certification Guide discusses credit enhancement instruments. (APMG 2016, Chapter 1, Section 7.4.2).

The willingness of the public sector to provide funds can also act as a signal to help build confidence of private investors. For example, after the 2008 financial crisis, the United Kingdom's Treasury recognized several infrastructure projects could have difficulty raising debt and were in danger of being scrapped. The Treasury created the Treasury Infrastructure Finance Unit (TIFU) to lend at commercial rates to PPP projects that were unable to raise enough commercial bank finance. The unit funded one major project in April 2009: The Greater Manchester Water project. According to a **United Kingdom National Audit Office report** (NAO 2011, 8), the Treasury's willingness to lend improved market confidence, and as of July 2010, 35 further projects had been agreed without public lending.

Government provision of SPV equity

Under the **British Government's revised PPP policy introduced in 2012**—termed *Private Finance 2*, or *PF2*—the Treasury may provide a minority share of the equity in PF2 projects (UK 2012a). The rationale was to give government better access to project information, including in relation to the financial performance of the project company; allow government to be more involved in strategic decision making; and improve value for money by sharing in the ongoing investment returns. A similar structure has been used by a few other governments, such as the Regional Government of Flanders in Belgium.

However, public equity in a PPP can also generate conflicts of interests within the public sector, and may enhance the perception of risk for private investors. In particular, government ownership can trigger conflict of interests with its regulatory function; and the private investors may be concerned that the government might be tempted to interfere in the management of the PPP contract within the SPV, if some decisions need to be taken to maximize shareholders value but are not necessarily in the public sector's best interest. Under the **United Kingdom's PF2 policy** (UK 2012a), this potential conflict of interest is mitigated by separating the ownership function from the contract management function. Hence, equity shareholdings are managed by a unit located in the Treasury separate from the procuring authority. France follows the same approach.

Government guarantee of commercial loan to project

Rather than providing lending directly, governments may instead guarantee repayment of debt provided by commercial sources, in case of default by the private party. **Farquharson et al** (Farquharson et al. 2011, 63) notes that guaranteeing project debt undermines the risk transfer to the private sector. For this reason, governments often provide only partial credit guarantees—that is, a guarantee on repayment of only a part of the total debt.

Partial credit guarantees have been used by both developed and developing country governments to help support their PPP programs. For example:

- **Korea's** Infrastructure Credit Guarantee Fund guarantees project debt through a counter-guarantee structure. That is, the Fund guarantees an on-demand term loan provided by a financial institution that can be called by the project company to meet its senior debt service payments (Fitch 2006a, 6–7).
- **Kazakhstan** has provided guarantees on infrastructure bonds issued for its transport PPPs. The guarantees on the bonds by the government gave security for the pension funds to invest in the projects (USAID 2008).
- **Indonesia** has established IIGF, as described in Budgeting for Government Commitments to PPPs.

The use of guarantees should be carefully considered, and cover the risks which the government is best placed to manage. Inappropriate use of guarantees can increase government's fiscal exposure, and reduce value for money as the transfer of risk to the private sector is mitigated. A more detailed discussion on this topic can be found in Considerations for Government which focuses on the dangers of over-leverage, and in Insufficient Funds which discuses the risks associated with the lack of fiscal clarity from PPPs. For more information on government guarantees and public financial management for PPPs, see Public Financial Management Frameworks for PPPs.

Forfaiting structures

A finance structure sometimes used to reduce the cost of finance for PPPs is the forfaiting model, which can be used for government-pays PPP projects. Under this model, once construction is completed satisfactorily, the government issues an irrevocable commitment to pay the project company a portion of the contract costs—typically sufficient to cover debt service. This can lower the project's financing costs.

However, it means the government retains more risk under the PPPs. The lender has less interest in ensuring project performance since government payments are no longer conditional on the private operator meeting performance objectives. Since there is certainty in government payments, this is effectively a government debt obligation—and government should account for this liability accordingly. Besides, the fact that payment is not conditional reduces revenue risk. It should therefore be reflected in the pricing of SPV debt. The forfaiting model has been widely used in Germany for small projects—typically municipal projects—where over half of the PPPs implemented between 2002 and 2006 used this structure. For more detail on the forfaiting model, see **Daube's article** (Daube et al. 2008) comparing project finance to the forfaiting model.

A variant of the forfaiting model is the ***cession de créance*** (assignment of receivables) used in France. In this case, upon verification of availability, the project company assigns its receivables payable by the government to the commercial bank financing the project. Therefore, once the infrastructure is built and operational the government payments are unconditional and can be used to cover some or all of the debt service of the PPP project company.

The government of Peru has also introduced a financing structure for PPPs that is a variant on the forfaiting model. In the Peruvian model, irrevocable payment commitments are issued *during* construction on completion of defined milestones. The CRPAO structure is described in CRPAOs in Peru. These forfaiting-type models allow for the private partner to gradually finance its investment by securitizing the guaranteed future flow of payments related to each phase of construction. However, it also means the government is committed to paying a proportion of the contracted amount irrespective of whether the asset is completed. The relevance of this approach may depend on the nature of the asset—in particular, whether it is readily divisible.

CRPAOs in Peru

In Peru, an innovative financing structure has been developed to finance construction of its road concessions. The government of Peru issues PAOs (Pago Annual de Obras or *annual payments for work*) to the private contractor for completing construction milestones. PAOs are obligation of the government of Peru to make dollar-denominated payments on an annual basis (similar to bonds). After they are issued, the payments are not linked to the performance or operation of the roads and are irrevocable and unconditional. Debt for the project is raised through bonds that are backed by the securitization of the PAOs, known as CRPAOs (Certificado de Reconocimiento de Pago Annual de Obras).

Peru first used this financing structure in 2006 to finance the first 960km piece of the IIRSA Interoceania Sur. The project raised $226 million in debt for the project with a $60 million partial credit

guarantee from the Inter-American Development Bank. Two subsequent pieces of the Interoceania Sur have also used the CRPAO financing structure.

Sources: (Fitch 2006b); (USAID 2009)

Development bank or other state finance institution involvement in PPPs

Many governments have established publicly-owned development banks or other finance institutions, which may provide a range of financial products to PPP projects. These financial institutions may be capitalized by the government, and can often also access concessional financing. Where these entities operate as commercial finance institutions, they may be better placed to assess the viability of a proposed PPP project than the government itself—although they are sometimes also exposed to political pressure that may undermine the quality of due diligence or project structuring.

In some cases, established development banks may expand their activities into the PPP sector. For example, the **Banco Nacional de Desenvolvimento Econômico e Social** (BNDES, Annual Report) has been a major lender to private infrastructure projects in Brazil—appraising risk and providing finance.

Alternatively, governments may establish finance institutions specifically to serve PPPs, and sometimes other infrastructure investments. For example, the India Infrastructure Finance Company Limited (IIFCL) was established in 2006 to provide long-term debt to viable infrastructure projects undertaken by public or private companies. The Indonesia Infrastructure Guarantee Fund (IIGF) was established in 2009 as a state-owned company to provide guarantees for infrastructure projects under PPP schemes. However, as described by **Klingebiel and Ruster in their paper on infrastructure facilities** (Klingebiel and Ruster 1999), unless policy and institutional frameworks are developed to provide a pipeline of bankable projects, government-backed financing facilities are unlikely to provide the desired results.

Government-owned finance institutions can also be used to provide PPP policy coordination and enforcement, by establishing clear rules and requirements for when financing will be available. This can particularly apply when a financial institution is set up specifically to serve the needs of a PPP program. For example, in Mexico most PPPs have been implemented with the support of FONADIN, an infrastructure investment fund under the national development bank BANOBRAS. The operating rules for FONADIN *de facto* established the rules and procedures by which PPP projects will be implemented, as described in Mexico's FONADIN.

Mexico's FONADIN

Prior to 2012, Mexico had no PPP Law. However, most government agencies that implement projects through PPP schemes did so with the support of the *Fondo Nacional de Infraestructura* (FONADIN). Exceptions are typically projects that are self-financing—that is, projects that generate revenues that are sufficient to cover the costs; the two government entities that generally follow this path are CFE (the national electric company) and PEMEX (the national oil company).

In addition to providing subsidized lending and, in some cases grants, FONADIN can help agencies in providing grants for the preliminary studies for the project, preparing the project documentation and implementing the tender process. In practice, this has meant that the **Presidential Decree that established FONADIN** in 2008 has effectively governed most PPP projects. Under that decree, the **Rules of Operation of FONADIN** set out the scope, and the processes and procedures to identify, assess, and approve PPP projects.

Source: (FONADIN 2011)

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