Government Support in Financing PPPs

Full Description

Funded products

The government may decide to provide direct support for the project for example through subsidies/grants, equity investment and/or debt. These mechanisms are particularly useful where the project does not in its own merit achieve bankability, financial viability or is otherwise subject to specific risks that the private investors or lenders are not well placed to manage. In developing countries where private finance is most needed, these constraints may necessitate more government support than would be required in more developed countries. Funded support involves the government committing financial support to a project, such as:

- direct support – in cash or in-kind (e.g. to defray construction costs, to procure land, to provide assets, to compensate for bid costs or to support major maintenance);
- waiving fees, costs and other payments which would otherwise have to be paid by the project company to a public sector entity (e.g. authorising tax holidays or a waiver of tax liability);
- providing financing for the project in the form of loans (including mezzanine debt) or equity investment (or in the form of viability gap funding); and
- funding shadow tariffs for roads and topping up tariffs to be paid by some or all consumers (in particular, those least able to pay) say in water and electricity projects to reduce the demand risk borne by the project company[1].

Few PPP projects are viable without some form of government technical or financial support. Efficient financing of PPP projects can involve the use of government support, to ensure that the government bears risks which it can manage better than private investors and to supplement projects which are economically but not financially viable.

Contingent Products

The government may choose to provide contingent mechanisms, i.e. where the government is not providing funding, but is instead taking on certain contingent liabilities, for example providing:

- guarantees, including guarantees of debt, exchange rates, convertibility of local currency, offtake purchaser obligations, tariff collection, the level of tariffs permitted, the level of demand for services, termination compensation, etc.;
- indemnities, e.g. against non-payment by state entities, for revenue shortfall, or cost overruns;
- insurance;

- hedging of project risk, e.g. adverse weather, currency exchange rates, interest rates or commodity pricing; or

- contingent debt, such as take-out financing (where the project can only obtain short tenor debt, the government promises to make debt available at a given interest rate at a certain date in the future) or revenue support (where the government promises to lend money to the project company to make up for revenue short-falls, enough to satisfy debt-service obligations).

For example, on the Zagreb-Macelj toll road, the government provided in-kind support in the form of land and contingent debt drawn down whenever revenues were insufficient to cover debt service. Thus, lenders were protected, but the risk remained with the equity holders.

The government will want to manage the provision of government support, and in particular any contingent liabilities created through such support mechanisms. Governments seek a balance between supporting private infrastructure investment and fiscal prudence.[2] Striking this balance right will help the government make careful decisions about when to provide public-money support and manage the government liabilities that arise from such public-money support, while still being aggressive in encouraging infrastructure investment. Government assessment of projects receiving such support is doubly important given the tendency of lenders to e less vigilant in their due diligence when government support is available, since this reduces lender risk and exposure.

Governments actively managing fiscal risk exposure face challenges associated with gathering information, creating opportunities for dialogue, analyzing the available information, setting government policy and creating and enforcing appropriate incentives for those involved. Given the complexity of these tasks, it is becoming more popular for governments, and in particular ministries of finance, to create specialist teams to manage fiscal risk arising from contingent liabilities, in particular those associated with PPP. This is often achieved through debt management departments, which are already responsible for risk analysis and management. The government may also consider creating a separate fund to provide guarantees, allowing the government to regulate better this function and ring fence the associated government liabilities. For more, see Management of Government Risk.

Financial Intermediaries

The government may wish to use its support to mobilize private financing (in particular from local financial markets), where that financing would not otherwise be available for infrastructure projects. The government may want to mobilize local financial capacity for infrastructure investment, to mitigate foreign exchange risk (where debt is denominated in a currency different than revenues), to replace retreating or expensive foreign investment (for example, in the event of a financial crisis) and/or to provide new opportunities in local financial markets. But local financial markets may not have the experience, or risk management functions, needed to lend to some sub-sovereign entities or to private companies on a limited recourse basis.

To overcome these constraints, the government may want to consider the intermediation of debt from commercial financial markets, creating an intermediary sufficiently skilled and resourced to mitigate the risks that the financial markets associate with lending to infrastructure projects. To achieve this, the government may want to use a separate mechanism (the “intermediary”) to support such activities without creating undue risk for the local financial market, for example, by:

- using the intermediary’s good credit rating to borrow from the private debt market (e.g. providing a vehicle for institutional investors who could not invest directly in projects) then lend these funds to individual entities or projects as local currency private financing of the right tenor, terms and price for the development of creditworthy, strategic infrastructure projects;

- providing financial products and services to enhance the credit of the project and thereby mobilize additional private financing, for example by providing the riskiest tranche of debt, providing specialist expertise needed to act as lead financier on complex or structured lending, syndication, credit enhancement, and specialist advisory functions; and/or

- providing support to finance or reduce the cost or improve the terms of private finance for key utilities. These entities may need first to learn gradually the ways of the private financial markets, and the financial markets may need to get comfortable with lending to infrastructure operators. This mechanism can help slowly graduate such sub-national entities or state owned enterprises from reliance on public finance to interaction with the private financial markets.

Current best practice indicates that such intermediaries should be private financial institutions with commercially oriented private sector governance. Intermediaries meant to create space in an existing financial market must have commercial incentives aligned to this goal, with appropriately skilled and experienced staff, and a credit position sufficiently strong to mobilize financing from the market. Existing private financial institutions with appropriate skills and capacity can help to perform this function. However, private entities often suffer from conflicts of interest (e.g. holding positions in the market such that their interests are not aligned with the role of intermediary) or would be constrained from taking positions in the market due to its role as intermediary (crowding out vital market capacity). The government may therefore want to create a new private entity to play this role.

Examples of financial intermediaries developed by Governments are:

India:

India's Infrastructure Development Finance Company (IDFC)

IDFC was set up in 1997 by the Government of India along with various Indian banks and financial institutions and IFIs. IDFC's task was to connect projects and financial institutions to financial markets and by so doing develop and nurture the creation of a long-term debt market. It offered loans, equity/quasi equity, advisory, asset management and syndication services and earned fee based income from advisory services, loan syndication, and asset management capitalize on its established knowledge base and credibility in the market. IDFC also developed a project development arm, taking early positions in some project vehicles. By bringing projects through feasibility, structuring, and presentation to bidders, it generated success/development fees from the winning bidders.

The agency invested significant efforts in its early years in policy and regulatory framework changes to facilitate private investment in infrastructure. More bankable infrastructure projects subsequently emerged. IDFC has successfully leveraged the fact that the Government holds an equity stake – without compromising on its commercial orientation.

IDFC began operations with a strong capital base of approx US$400 million. Growth was initially slower than expected. After 6 years of operations, IDFC had a loan portfolio of around US$550 million and growth accelerated. After 8 years, an IPO in July 2005 introduced new equity and allowed early investors to realize their gains. An additional US$525 million equity was raised through an institutional placement in 2007, by which time, the Indian government's stake had fallen to 22 %. Other major shareholders now include Khazanah, Barclays and various Indian institutions.

India Infrastructure Finance Company Limited (IIFCL)

India Infrastructure Finance Company Limited (IIFCL) was incorporated on January 5, 2006 under the Companies Act 1956 as a wholly Government owned Company. IIFCL is a dedicated institution purported to assume an apex role for financing and development of infrastructure projects in the country. The authorized capital of the Company is Rs. 2,000 crore of which, paid up capital, at present, is Rs. 2,000 crore. Besides, the resource-raising programme of the Company would have sovereign support, wherever required.

The Company renders financial assistance through:

- Direct lending to eligible projects
- Refinance to banks and FIs for loans with tenor of five years or more
- Any other method approved by Government of India

Tamil Nadu Urban Development Fund (TNUDF)

An example of a subnational financing intermediary is the Tamil Nadu Urban Development Fund (TNUDF), which attracts private finance for on-lending to local governments for infrastructure projects, and encourages private-sector co-financing of such projects. The TNUDF is answerable to private and public shareholders, moving investment decisions away from the normal state decision-making process. However, TNUDF has not mobilized private investment in the manner anticipated, due mainly to the abundant public, subsidized funding available, making private finance too expensive and therefore less attractive.[3]

See also IFC SmartLessons, an awards program to share lessons learned by the International Financial Corporation (IFC) during development-oriented advisory services and investment operations.

Project Development Funds

In the UK, arguably one of the most efficient PPP market in the world, advisory costs during project development average 2.6 per cent of project capital costs. Advisory costs in lesser developed PPP markets run even higher. The large amount of upfront costs for procuring PPP projects, in particular the cost of specialist transaction advisers often meets with strong resistance from government budgeting and expenditure control. But quality advisory services are key to successful PPP development, and can save millions in the long-run. Therefore, funding, budgeting and expenditure mechanisms for project development are important to a successful PPP program, enabling and encouraging government agencies to spend the amounts needed for high quality project development.

The government may wish to develop a more or less independent project development fund (PDF), designed to provide funding to grantors for the cost of advisers and other project development requirements. The PDF may be involved in the standardization of methodology or documentation, its dissemination and monitoring of the implementation of good practices. It should provide support for the early phases of project selection, feasibility studies and design of the financial and commercial structure for the project, through to financial close and possibly thereafter, to ensure a properly implemented project. The PDF might focus on specific sectors or projects in a region or nationally, but needs to have a broad scope to address the different forms of PPP to respond to sector needs. The PDF may provide grant funding, require reimbursement (for example, through a fee charged to the successful bidder at financial close) with or without interest, or obtain some other form of compensation (for example, an equity interest in the project), or some combination thereof, to create a revolving fund. The compensation mechanisms can be used to incentivize the PDF to support certain types of projects.

Below are some of the project development funds/ facilities developed by governments:

South Africa Project Development Facility

Africa's Project Development Facility (PDF) is a single-function trading entity, created within the National Treasury in accordance with the Public Finance Management Act. Its primary function is to support governmental entities with the transaction costs of PPP procurement. The PDF collaborates with the Department of Provincial and Local Government's Municipal Service Partnerships Unit, provides funding for the preparation of feasibility studies and procurement of service providers, and may consider funding the costs of procuring the project officer. Support from the PDF can only be acquired if the project receives support from the National Treasury's PPP Unit.

The PDF recovers its disbursed funds either in part or in full as a success fee payable by the successful bidder at the financial close of the project. The risk of the project not reaching financial close is taken by the PDF in all cases other than an institutional default.

India

Project Development Fund of IL & FS

India Project Development Fund (IPDF) was introduced by IL&FS towards funding project development expenses of large infrastructure projects, primarily in surface transport, ports, water and power infrastructure. IPDF meets all project development costs and takes on the development risk upto financial closure.

IPDF is the first private equity fund in India for project development funding covering:

- Project Design & Techno-Financial Feasibility
- Environmental, Social & Market Studies
- Establishing Contractual Framework

European Union Funds

European Union (EU) Funds are an important element of European infrastructure finance. The European Commission makes funds available to EU Member States under either the European Regional Development Fund, the European Social Fund or the Cohesion Fund. Incorporating EU Funds into a public-private partnership (PPP) structure poses some challenges. The materials below provide guidance on how to combine private finance in a PPP structure with EU funds:

- Combining Cohesion and Structural Funds with PPPs in EPEC PPP Guide, European Expertise Centre (EPEC)
- Poznan Waste-to-Energy Project, Poland Using EU Funds in PPPs Case Study, European PPP Expertise Centre (EPEC), June 2012

- EU Funds in PPPs - Project Stocktake and Case Studies, European PPP Expertise Centre (EPEC), June 2012

- Using EU Funds in PPPs - explaining the how and starting the discussion on the future, European PPP Expertise Centre (EPEC), May 2011

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[1] Some of this is supported by output based aid – for more on this, see www.gpoba.org which is a facility that supports output based solutions

[2] For further discussion of this issue, see Irwin, Government Guarantees: Allocating and Valuing Risk in Privately Financed Infrastructure Projects (World Bank, 2007)

[3] Krishnan, "Tamil Nadu Urban Development Fund: Public-Private partnership in an infrastructure finance intermediary" (World Bank, 2007).

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