Financing PPP contracts in economically-challenged economies

1) Introduction

Public Private Partnerships (PPP), were introduced as the Private Finance Initiative in the UK in the early 1990s. This form of government-sponsored procurement was heavily influenced by the concept of project finance which had been used for many years to procure infrastructure, particularly in the energy sector. PPP is now a globally recognised method of government procurement, although its structure and application varies considerably across the many jurisdictions that are currently using it.

Many governments currently face serious economic and financial challenges that have made structuring PPP contracts more difficult. They are looking for innovative solutions to meet these challenges. This paper looks at the current challenges faced by governments, and the second paper in this series looks at how a government can procure economically and socially desirable projects without increasing the debt burden to its balance sheet.

2) Background to and philosophy of PPP contracts

PPP is a public procurement and delivery structure where the responsibility for providing public services is transferred from the public to the private sector for a significant period of time. Where that public service needs investment in property and/or equipment, PPP is also a means of using private finance and skills to deliver capital investment projects traditionally provided by the public sector.

PPP procurement is given various names such as DBFO (Design, Build, Finance, Operate), DCMF (Design, Construct, Manage, and Finance), BOO (Build, Own and Operate), BOT (Build, Operate and Transfer), BOOT (Build, Own, Operate and Transfer) and many others. Whatever the name, PPP involves the private sector in designing and building an asset followed by a significant period when it maintains and, in some case, operates the asset on behalf of government. In most cases the distinguishing feature is that the private sector also provides the financing of the asset and working capital during the life of the contract.

Globally, the movement towards PPP procurement methods has been driven by the need to fund infrastructure projects and/or the need for private sector innovation in the design and management of public sector facilities and infrastructure projects. In emerging economies, the high demand for infrastructure development, coupled with downwards pressures on national budgets, governments are moving towards encouraging the private sector to develop, invest in, and manage public infrastructure.

In return for this activity, the private sector needs to be paid a regular payment (either from users for projects such as tolled highways or from government for social projects where the user does not pay) that covers its ongoing service costs, the repayment of debt and the return on its equity investment in the project. This transforms governments from being owners and operators of assets into the purchasers of services from the private sector.

A primary reason for PPP procurement is to achieve better value-for-money than conventional procurement. The main drivers for value-for-money are:

- **Improved risk management** - more rigorous risk evaluation and transfer to the private sector of those risks it is best able to manage
- **Improved whole-of-life costing efficiency** - design and construction are fully integrated with operations and asset management. Ongoing service delivery, operational, maintenance and refurbishment costs become a single party's responsibility for the length of the contract period
- **Innovation** - wider opportunities and incentives for innovative solutions to deliver services requirements
- **Asset utilization** - reducing cost to government, as a sole user, through more efficient design to meet performance specifications and by creating complementary opportunities to generate revenue from use of the asset by others

3) Traditional structuring

The traditional structuring of PPP projects was developed in the early 1990's and into the 2000's. Financing of such projects tended to be on the basis of 80% debt and 20% equity. In the period since 2008 this structure has been difficult to achieve because this high level of debt is rarely available, and closing PPP deals has therefore become more difficult. In relation to PPP projects, financial institutions have not materially changed their requirements which can summarised as follows:

- The main requirement of any lender, whether it be a provider of traditional bank loans, bonds or other financial instruments, is security of that debt and its repayment. Any lending institution looks first at the credit rating of the borrowing country, company or project and assesses the risk profile of repayment and default. In simplistic terms a lending institution will be looking for a high rating and a good form of security. Borrowers with a low credit rating, which is currently commonplace, will find it difficult to obtain funding for a PPP contract. In addition, it is often difficult for the lender to have security over a good asset in PPP contracts.

- In certain jurisdictions, particularly in the Caribbean region, it has become normal practice for financed contracts to be underwritten by a sovereign guarantee against default. In better economic times governments were often prepared to give such a guarantee. However this is not so in today's economic environment because the sovereign guarantee will be added to the debt burden of the country at a time when governments are trying to reduce the debt burden.

- Another way of meeting the financial institutions' demands is an undertaking to underwrite the repayment stream, rather than providing a full sovereign guarantee. However, current developments in accounting treatment regulations will make it difficult for governments to agree to this, even if the expectation is that the user will pay the majority of the fees, because application of the accounting treatment rules will lead to the government taking on the burden of the debt, which then requires the underlying debt to be recognised as a liability.

4) Economic challenges – high debt burden

It has been shown that emerging economies which have used PPP procurement to deliver new infrastructure have been able to achieve faster rates of growth than others. Many studies now confirm the positive role of increased competition in raising enterprise performance with the implementation of PPP and privatization programmes.

However where the balance sheet is weak and the debt burden is high, PPPs can have an adverse effect on the country's ability to control its debt. This can result in:

- A high debt service burden that diverts public resources away from critical social and productive capital expenditure
- Increased cost of new borrowing through greater perceived market risk of newly issued debt
- Limited fiscal space for counter-cyclical spending that is necessary to avoid deepening the crisis
- Limited financial capacity to respond to and recover from natural disasters
- Constrained ability to borrow limits government ability to leverage private investment through PPP

5) Alternative methods of structuring PPP Finance

In our next article we will explore alternative financing arrangements that will improve the prospects for economically-challenged governments to use PPP procurement to deliver much-needed social and economic infrastructure.

We will discuss the merits of:

- Export credit agencies that act as intermediaries between national governments and exporters to issue export financing. This financing can take the form of credits (financial support) or credit insurance and guarantees (pure cover) or both
- Development finance institutions that provide finance to the private sector for investments that promote development
- Bilateral agencies that provide aid to countries typically to reduce poverty
- Multilateral Development Banks that provide financial support and professional advice for economic and social development activities in emerging economies
- Sovereign wealth funds that allow countries with superior savings rates to export that capital to other parts of the world
- Project Development Funds to provide funding to grantors for the cost of advisers and other project development requirements

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