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Theme 228

INFRASTRUCTURE FINANCING

PART II

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SIB STUDENTS' ECONOMIC FORUM

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THEME 228 : INFRASTRUCTURE FINANCING -PART II

In developing economies, the government sector played a key role in developing physical and social infrastructures. Private sector may not be willing to invest in infra projects which require huge outlay of funds. Commercial profitability may not the sole criterion for setting up infra projects. Social cost benefit analysis is done to judge viability of the projects where overall economic benefits – social rate of return - are taken into account. Some infrastructures may account for more of social rate of return than private rate of return and in such cases, infrastructure provision may be unprofitable and private enterprises may not come for investment. Thus the poor may be deprived of essential infrastructural services. The private monopolies may be reluctant to invest in projects which require long gestation periods and long pay-back time. Also the private sector may not bestow adequate provisions for environmental consequences and safety issues. It would be difficult for private firms to have a nationwide and long-run planning on infrastructure constructions. Thus it may sound that only governments are dispensed to provide infra services. But budgetary constraints and fiscal deficits have necessitated private sector participation in infrastructure financing. Also technical and managerial competency of the private sector will be valuable inputs in the infrastructure management. In many advanced countries, private companies have built and operated infrastructures from the beginning of the economic development, though gradually governments became the main provider of infra services.

What is meant by Public Private Partnership (PPP) mode of infrastructure financing?

The slow pace of growth in infrastructure due to paucity of funds led to the need for alliance between the public and the private sectors. The private sector participation ensures better deliveries of public infrastructures like roads, bridges, water supply and sewerage projects, ports and airports. The presence of the public sector ensures certain concessions, and mitigation of some of the risks. Thus, the combined capital and intellectual resources of the public and private sectors can result in better, more efficient services.

A PPP refers to contractual arrangement between a government agency and a private sector to set up infrastructure project. There will be greater private sector participation in the delivery of public infra projects. There will be concession agreements which lay down the performance obligations to be discharged. The private sector in the PPP model assumes greater role in planning, financing, design, construction, operation and maintenance of public facilities. The project risk is transferred to the party best positioned to manage the same.

The PPP model has been used to finance many projects in India, including the dedicated freight corridors on Delhi – Howrah and Delhi-Mumbai routes, Greenfield airports in Bangalore and Hyderabad, modernization of the Mumbai and Delhi airports, and second phase of the National Highway Development Program. Now state governments also use the PPP model for upgrading urban infrastructure including urban roads, mass rapid transit systems, urban water supply systems etc.

What are the benefits of the PPP model of infra financing?

The PPPs have succeeded in addressing infrastructure shortages. The PPPs provide new sources of capital for public infrastructure projects. Such projects progress on schedule and within the budget, since the payments in PPP projects are better aligned to meet the project objectives. The PPP projects often lead to cost savings in several forms such as lower construction costs, reduced life-cycle maintenance costs, and lower costs of associated risks. The savings typically result from innovation in design and better defined asset requirements. Further, the PPP projects result in better customer services. Since PPPs rely on user charges from customers for revenue, there will be strong incentive to provide superior customer service.

PPP projects command various efficiencies such as allocation efficiency, production efficiency, and economic and social efficiency. Private participation ensures more effective allocation of resources and completion of projects against performance standards. The projects may be completed in less time and this will lower overall cost. Innovative production techniques will be employed and social benefits will accrue faster as projects are completed faster.

What are the common models of PPP?

The PPPs operate in various models such as Build Transfer (BT), Build-Lease-Transfer (BLT), Build-Transfer-Operate (BTO), Build-Operate-Transfer (BOT), Build-Own-Operate-Transfer (BOOT) etc. Under BT model, the private partner designs and builds the facility and on completion, the government procures and operates. Under BLT model, after the construction, the facility is leased to the public sector and after the full payment of lease, the asset is transferred to the public sector. Under BOT, the facility will be built and operated for a specific period by the private partner, after which the public sector assumes operating responsibility. Under BOOT, the private partner finances, builds and operates facility for a specific period of time and then ownership goes to the public sector. The different innovative models are employed dependent on the economic and other technical factors.

What is the role of commercial banks in infrastructure financing?

The major issue of bank lending to infra projects relates to asset –liability mismatch of banks and this constrains the ability of banks to extend finance to long-term infra projects. The banks with short-term liabilities cannot finance long-term assets. However, the share of bank credit to infra projects has gone up from 13 percent of the industrial credit in 2000 to 33percent of the industrial credit in 2009. The infrastructure lending will be a challenging task for the commercial banks. The exposure norms - the maximum permissible lending to a borrower as percentage of capital funds of the bank - have been relaxed in case of bank lending to infra sector. For single infra projects, the ratio is 20 percent as against 15 percent in the case of lending to normal projects. For group concerns, the ratio is 50 percent of capital funds as against 40 percent in other cases of lending.

The RBI has extended a number of regulatory concessions to banks to prop up infrastructure financing. It has relaxed the single and group borrower limit for infra projects. The banks are permitted to extend finance for funding promoter’s equity where the proposal involves acquisition of share in an existing infrastructure company. The banks are permitted to issue long-term bonds for financing infrastructure. The banks can invest in unrated bonds of infra companies. The interest rate futures were introduced to manage interest rate risks more efficiently, especially in the wake of asset-liability mismatches in case of infra financing. Introduction of repos in corporate bonds and credit-default swaps are meant to deepen corporate market. The banks are allowed to enter into ‘take-out financing’ arrangement and build up capital for ‘take-out’ exposure in a phased manner. ‘Infrastructure NBFCs’ are being introduced as separate entities for financing infra projects. Also, refinancing through the SPV (IIFCL) has been allowed to leverage bank financing for the PPP projects. In respect of road/highway projects under BOT model, annuities and toll collection rights will be treated as tangible security for bank lending. In case escrow mechanisms for cash flows are put in place, provision for sub-standard loans will be lower. Further, banks can classify their investments in non-SLR bonds in infra companies, having a minimum residual maturity of seven years under the held-to-maturity (HTM) category, which will not require ‘mark to mark’ (MTM) requirements.

What is meant by ‘Take-out’ financing in the context of infrastructure lending by banks?

Take-out financing is a method of providing finance for longer duration projects by sanctioning medium term loans by the banks. After the initial fixed period, the loan will be taken over by another financing institution. The loan can be again off-loaded after stipulated periods. This method prevents any possible asset-liability mismatches of the financing banks. The institutions engaged in long term financing such as IDFC agree to take out the loan from the books of the banks financing such projects after the fixed period, when the project reaches certain previously defined milestones. Thus the original lender participates in the long term project (15-20 years) by granting a medium term loan (5-7 years). The original lender receives payment of the loans from the second lender who has taken over the loan.

The RBI has allowed banks ‘take-out’ financing route through external commercial borrowings for loans to infrastructure sector. Thus ‘take-out’ financing through ECB is aimed at refinancing of rupee loans disbursed by domestic banks to the borrowers in infra sectors such as seaport, airport, roads, bridges and power sectors. The domestic banks will take the risk in the initial years and then the foreign lenders can take-out loan with a sense of comfort as the projects are on stream after the initial project risks are over. The take-out has to take place within three years of the scheduled commercial operation date and the loan should have a minimum average maturity period of seven years. The risk weights and provisioning requirements on the loans will be dependent on whether the take-out is unconditional or conditional. In short, the take-out financing facilitates participation of commercial banks with their shot-term funds in the long-term financing of infra projects.

Common Models of Public Private Partnership (PPP)

Build – Transfer (BT): The private partner designs and builds the facility as per the requirement set by the government. After completion of the project, the govt. assumes operation and maintenance. This method is also called Design – Build.

Build-Lease-Transfer (BLT): The private sector builds the project and after completion leases to the public sector who operates the facility. On completion of the lease period, the asset is transferred to the public sector at no additional cost.

Build-Transfer-Operate (BTO): After building the facility, it is transferred to the public sector. But it will be operated by the private sector for a specified period. This method is also known as Design-Build-Operate (DBO).

Build-Operate-Transfer (BOT): The private partner builds, operates and maintains the facility for a specified period. Then the operating responsibility is transferred to the public sector. This is also known as Design-Build-Operate-Maintain (DBOM).

Build-Own-Operate-Transfer (BOOT): The private sector builds and operates the facility for a specified period of time after which ownership is transferred to the public sector.

Build-Own-Operate (BOO): The private entity is granted the right to finance, build, operate and maintain the project. The private sector retains ownership of the project.

Design-Build-Finance-Operate/Maintain (DBFO/M): The private sector designs, builds, finances, operates / maintains the facility under a long-term lease. After the lease term, the facility is transferred to the public sector.

India's first international container transshipment terminal (ICCT) that would be completed at Vallarpadam, Kochi is viewed as a success of public-private partnership (PPP) mode of building infra projects. The project is a near 50-50 partnership between Dubai Ports World (DP World) and the Government of India, investing through the Cochin Port Trust. DP World has a 30-year BOT agreement with the Port Trust for the project to be commissioned in three phases.

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in