GIF BRIEFINGS

Reflecting on the 3rd GIF Advisory Council Meeting Changsha, China: June 2016

Four Countries, Four Common Challenges, One Unique Forum

ABOUT THE GLOBAL INFRASTRUCTURE FACILITY (GIF) AND THE ADVISORY COUNCIL

The Global Infrastructure Facility (GIF) was established in March 2015 as a Partnership Program housed at the World Bank Group (WBG). The GIF provides a global platform to integrate efforts to invest in infrastructure in emerging markets and developing economies (EMDEs), enable collective action among a wide range of partners, and thereby leverage resources and knowledge to find solutions to complex infrastructure financing challenges that no single institution could achieve alone. The GIF provides end-to-end project preparation, appraisal, structuring and transaction support needed to bring well-structured and bankable infrastructure projects to market, with the objective of increasing private investment, in particular long-term finance, in complex EMDE infrastructure projects.

One of the unique features of the GIF platform is the participation of the GIF Advisory Partners who, together with the GIF's donors, multilateral development bank (MDB) Technical Partners and recipient country representatives, constitute the GIF Advisory Council. The GIF Advisory Partners are private investors or entities that represent the voice of private sector infrastructure finance globally, and together hold over $13 trillion in assets under management. They include pension funds, sovereign wealth funds, insurance companies, fund managers, commercial banks and other financial institutions and provide a valuable sounding board for GIF-supported projects and investment programs.

This GIF Briefing summarizes the outcomes of the recent Advisory Council Meeting and provides some of the key lessons learned from the discussions on the challenges facing EMDE countries and most importantly how GIF can help tackle these with high-quality project preparation and structuring assistance, and through the proposed Downstream Financing Window of the GIF.

THE 3RD GIF ADVISORY COUNCIL MEETING, CHANGSHA

In June 2016, in Changsha, China, the GIF Management Unit convened the Advisory Partners for the 3rd Advisory Council Meeting. This meeting provided an opportunity for the Advisory Council to hear from and provide feedback to four prospective country clients of the GIF on their emerging infrastructure projects and programs. The presentations by the governments were supplemented by, and provided context for, Advisory Partner panel discussions which highlighted key trends and issues in the infrastructure finance marketplace.

Presenting at the meeting were the following four countries:

- **Government of China:** The Ministry of Finance's PPP Center presented the country's far-reaching and ambitious PPP program across a variety of sectors
- **Government of India:** The Government of the State of Rajasthan presented its network-wide road building PPP program
- **Government of Kazakhstan:** The Department of Strategic Planning and Analysis presented its complex Almaty Ring Road project (BACAD) and two other proposed road bypass projects
- **Government of Uganda:** The Ministry of Finance and Economic Affairs outlined the challenges of, and some of the lessons learned from, developing a multi-sector program in the country

All four presenting countries focused first on the regulatory environment and sectoral reforms that are under way in order to promote their countries as sound and reliable investment destinations.

China, host of the event, outlined the various institutional and regulatory developments it has made in trying to mainstream PPP as a way of delivering the country's large ongoing infrastructure program. The changes made include:

- Amending budget laws to accommodate PPP models and developing a new specific PPP law.
- National policy statements on PPP and implementation guidelines for government grantors
- Standardized contracts
- Development of the National PPP Center and a supporting PPP Financing Fund
- Development of satellite PPP Units at the provincial level
- Development of a PPP project pipeline

These measures together help demonstrate both the governmental buy-in and readiness of China to attract private investment into its infrastructure sectors. Improvements to the enabling environment also provide an opportunity for easing investor concerns about legal and policy risks, particularly related to land acquisition and environmental clearances, both of which can cause significant delay to project implementation. The challenges around both of these areas were mentioned consistently by all four countries throughout the Advisory Council Meeting.

The State of Rajasthan, Kazakhstan and Uganda all presented highway and bridge programs, offering the Advisory Council an opportunity to contrast the approaches to risk allocation being adopted by the governments: The table below provides a summary of the different characteristics of each of the country's projects/programs and the preliminary approach taken to structuring and allocating key project risks.

COMPARISON OF COUNTRY PROJECTS AND PROGRAMS

	CHINA	INDIA	KAZAKHSTAN	UGANDA
	Hohhot New Airport (One of 8 proposed projects)	**Rajasthan State Highways Development Project**	**Almaty Ring Road Project**	**Kampala- Jinja Expressway**
Country Rating	• AA- S&P • Aa3 Moody's	• BBB- S&P • Baa3 Moody's	• BBB+ S&P • Baaa2 Moody's	• B S&P • B1 Moody's
Regulatory Framework / PPP track record	• Strong government support for PPPs in China • PPP centers set up both at national and local levels • PPP law passed?	• Solid experience with PPPs • Sound regulatory environment. • State highways authority to be established	• First Large PPP Transaction outside the Oil & Gas Sector • Legal framework (law of Concessions) • Established Investment protection	• Solid experience with PPP in the power sector • PPP law established although largely untested. • Strong government support for the project
Concession Term	To be determined	12 Years	20 Years	23 Years
Project Cost	USD 3,178 m	USD 3,000 m	USD 1,100 m	USD 1,200
Anticipated Sources of Funds	• 51% Private Sector • 49% Public (government) finance	• 50% Public Finance • 25% DFIs • 25% Private Sector	• 67% DFIs • 33 % Private sector	• To be determined but will include a mix of DFIs and Private.
Revenue Mechanism	• Availability payment (no link to traffic)	• Availability payment for Capex • O&M subject to performance	Open toll system w/ Flat fee (Congestion charge apply)	Availability Payment
Demand/Traffic Risk	Concession Grantor takes 100%	Concession Grantor takes 100%	Concession Grantor takes 100%	Concession Grantor takes 100%
Foreign Exchange Concerns	Local currency revenue; potential mixed funding of both domestic and international	• Private finance in local currency • Public finance to have recourse to the state government	Government provides partial protection (compensation adjustment for devaluation depreciation in excess of a specified amount)	Government will underwrite 100% of currency risk.

LESSONS LEARNED

Balancing bankability with affordability and risk transfer

All the governments represented at the meeting are striving hard to develop and deliver ambitious projects and programs in a way that can attract long-term private investment. However, it is the challenge of balancing this need for bankability with the equally important considerations of affordability (for users and taxpayers) and adequate transfer of risk to the private sector that is particularly challenging for EMDE grantors. This challenge typically involves tough trade-offs among the financiers, the users and the government.

It is a challenge that the Government of India has tackled in 'real-time' with its huge highway concession program that saw an impressive 241 projects completed between the mid-1990s and 2013. Many of these projects have been successfully implemented with high levels of private investment. However, a number of these projects are also now distressed, with one of the primary causes being actual toll revenues that were far lower than originally forecast. The crystallization of this traffic risk has meant some domestic lenders are now carrying a number of non-performing assets (NPAs) in their transport sector portfolios. In turn this has had a negative effect on lender appetite for similar projects, particularly those exposed to this same risk (e.g. BOT toll projects).

This is the market context within which the Government of Rajasthan is trying now to launch its extensive road program. For many projects within the program, the government would ideally like the private sector to finance the projects against future toll revenues so that the government's direct financial exposure is minimized. However, the government through its detailed preparatory work and preliminary market sounding, has recognized that either traffic flows are too low, or tolls would have to be excessively (and unacceptably) high, for the projects to generate sufficient financial returns to incentivize private investment. Moreover, even where the returns might be acceptable, the market tendency for over-forecasting (the causes of which are many[1]) has led to reduced appetite, de-leveraging, or over-pricing of this risk from lenders.

Faced with these circumstances, the government of Rajasthan has made an important value judgement that for the majority of the projects to be procured under the program, the government will retain the risks relating to traffic and toll revenues and instead the private sector will be remunerated through availability payments. This is a tough trade-off for the government which means it must carefully budget its payment liabilities and establish a robust long-term funding model for the road network that will provide long-term payment certainty for the private sector. It is a judgement that will surrender some budgetary flexibility for the government but it will, hopefully, allow a number of competitive and committed bids to be tabled for the projects, reducing some of the up-front capital burden of the expansion of the network (which for users will remain free at the point of use).

[1] See forthcoming GIF Insights publication on traffic risks in road PPP projects

The GIF has a crucial role to play, alongside its MDB partners, in providing governments with the necessary technical, financial and legal advice that will ensure that they receive an independent assessment of the trade-offs that inevitably occur during this delicate structuring phase of project preparation. By providing this support, the GIF is aiming to allow governments to optimize their decision-making around the design of their projects so that they are able to achieve bankable projects while also achieving the best value for taxpayers and users.

Making the Market for Project Finance

Private investment in infrastructure is not new for any of the countries that made presentations at the meeting. All have track-records of successfully closed projects that were either fully or partially privately financed. However, it is apparent that many of these projects have been financed using corporate sources of finance, and there has been only limited experience of using project finance as a financing mechanism, particularly among domestic lenders. A focus on trying to harness project finance sources in these countries could help to broaden the investor base for infrastructure, increase the total amount of infrastructure finance available, and diversify the lending of existing financiers.

The key advantage of project finance mechanisms is their fixed-asset based nature, which allows financiers to take a fixed charge over the life of the infrastructure asset (or to take at least the long-term contractual rights to operate it and receive revenues from it). This means that financiers are able to lend against the underlying value of the asset rather than seeking separate ('floating') collateral and security against the corporate sponsor that is developing the project. This security is limited in size by the company's other liabilities and existing leverage and the multiple business risks facing these companies over even short time dimensions. Project finance therefore provides an alternative mechanism that does not require full recourse to the often crowded balance sheets of sponsors for what are typically very large projects with large funding requirements and for which relatively high levels of gearing should be possible.

The development of project finance in these countries requires significant banking market development in many respects. Amongst the challenges are:

- The need for domestic banks to access long-term funding sources that match the typically long tenors of project loans
- The investment in the human capital required to arrange complex project finance loans, particularly the managerial capacity to oversee the project due diligence process
- The lack of hedging products and derivatives that allow certain long-term credit risks (e.g. interest rates, inflation etc.) to be managed.

In countries such as China and India, the development of project finance lending is very much under way and international project finance players are already becoming active in the market. However, even in these countries, but even more so in less mature PPP markets such as Kazakhstan and Uganda, governments should not be passive in incentivizing the participation of project finance lenders. One of the key ways in which governments can do this is through incorporating contractual and legal protections into the project agreements, project risk allocations and supporting government legislation that provides specific protection and comfort to financiers. These changes recognize the primacy of project finance lenders as genuine third parties whose only major recourse is to the project, which itself is a 'sunk' asset that has little or no second-hand value (e.g. you can't move a road and sell it to another country!).

Kazakhstan presented its very committed efforts in this respect with the recent amendments to the *'Law of RK'* on concession projects. These legal reforms basically have allowed internationally-recognized commercial principles to be built into concession agreements that will incentivize the participation of project finance lenders and increase the bankability of projects. These include:

- Allowing Direct Agreements to be signed between lenders and the government. Direct Agreements allow the lenders a period of time to step-in, manage and effectively rescue a project if the sponsor (or a major sub-contractor) has defaulted on its contractual obligations. This provides project finance lenders with much-needed time to avoid a full default on the project and suffer subsequent losses.
- Amending compensation-on-termination provisions to align better with international practice. These provisions ensure that lenders at least receive fair value for the works they have already financed and, together with the Direct Agreement, can prevent and disincentivize 'hair-trigger' and sudden terminations of concession agreements.
- Improved dispute mechanism provisions that allow contractual disputes to find ultimate resolution in international arbitration. This helps provide comfort to project finance lenders that any prospective disputes and subsequent termination can be resolved according to international judicial norms.

These kinds of changes in commercial structure are vital in aiding the bankability of projects and securing systematic engagement of project finance lenders. In Kazakhstan's case, the government has been assisted through the transaction advice provided by IFC (a Technical Partner of the GIF). This is an area where the GIF and its Technical Partners will be engaging with governments as they look to prepare and structure their projects successfully with GIF support. For example, in designing funding support to the Government of Rajasthan, one of the key tasks will be to undertake an in-depth market sounding exercise that will scrutinize both domestic and international lender perspectives on the current adequacy of the existing standardized concession contracts in India.

Funding support and credit enhancement mechanisms are crucial

Even with the kind of diligent preparation and structuring that we have just discussed, the inherent risks and underlying financials of many EMDE projects mean that some level of direct funding support and/or contingent credit enhancement is still often required to ensure risks are adequately managed and projects are sufficiently bankable. The Advisory Council meeting was an ideal opportunity to provide the represented governments with an understanding of some of the products available from multilateral and bilateral agencies to assist governments in this respect and to create a debate on where further scaling-up is required. Some of the risk management products presented are outlined below:

- **Viability Gap Financing (VGF):** Many MDBs and bilateral agencies provide low-cost funding support to inject capital subsidies into a PPP project so that the amount of finance needed from the private sector is reduced to a level that can be supported by the project's cash-flows (i.e. so that the project becomes a viable investment). Such a VGF subsidy model was presented by JICA, which can use its Official Development Assistance (ODA) loans for such a purpose. It is also a structure that can be used by all the GIF's Technical Partners through their sovereign lending.
- **Refinancing Risk:** Regulatory headwinds in the global banking sector (e.g. from Basle III) are putting increasing pressure on long-tenor project loans. This is leading to a greater reliance on short-term construction loans (or mini-perm loans) which subsequently need to be refinanced after construction is complete or shortly after operations have begun. The risk of not being able to refinance these loans can create large contingent liabilities for project parties and can make projects difficult sell for equity investors or if absorbed by the government can cause fiscal and budgetary stress. Moody's in its presentation to the Advisory Council Meeting outlined some of the key credit enhancement vehicles which have been used to try to re-start the infrastructure bond market as a core solution to managing this risk through either secondary market bond refinancings (i.e. 'take-outs') or for primary bond

transactions. Bond issuances for infrastructure projects can tap into institutional investors with long-dated investment perspectives. However, these investors require investment-grade ratings which in turn can require significant need for unconditional/irrevocable types of credit enhancement. Moody's presented its review of the EIB Europe 2020 Project Bond Initiative which has provided a subordinated credit facility for bondholders on a range of successfully closed EU projects. These and other more long-standing products, such as IFI partial credit/risk guarantee products, are helping to lengthen tenors and crowd-in different types of investors.

- **Specific Risk Coverage:** Products also exist to protect financiers against more specific but common project risks. For example, political risk (e.g. MIGA's political risk insurance), revenue risk (e.g. EIB's Loan Guarantee Instrument for Trans-European Transport Network Projects (LGTT) and foreign exchange risk (e.g. IFI local currency lending, GuarantCo's guaranteeing of local debt instruments etc.)

While these products and efforts are very much welcome and making impact, there is an emerging consensus (that was also reflected in the Advisory Council meeting) that more needs to be done to scale up these offerings in terms of awareness, geographical coverage and volume if systematic long-term private investment is to help close the infrastructure gap. In response to such demand, the GIF will play a crucial role to fill in some of the gaps. It is currently designing a Downstream Financing Window aimed at creating a flexible credit enhancement vehicle to complement and help scale up many of these existing initiatives and facilities (which are predominantly managed by the GIF's Technical Partners) to increase their reach.

Enabling Environment: institutions, governance and process matter

Finally, while we often focus on the project preparation and financing challenges, it is important not to overlook the importance of EMDE governments undertaking the necessary work to improve the enabling environment for private sector investment in infrastructure. Making important changes to institutions, regulatory processes and governance can significantly reduce perceived counterparty risks that might otherwise reduce private sector appetite in EMDE countries.

In the case of Uganda, the government has drawn lessons from recent experience in private sector participation in energy, railway concessions and tourism to help close the funding gaps for broader infrastructure development. One of the early challenges was inadequate legal and regulatory regimes. Now the PPP Act of 2015 has set out clear principles, procedures, and an institutional framework, including a transparent approval process that the government will follow when contracting with the private sector for a PPP project. The PPP Committee and PPP Unit are in place to manage and regulate PPPs.

Although developing the enabling environment is not a core part of the GIF's mandate, it is not something that it can ignore in its work program. Gaps in the enabling environment, including regulatory weaknesses, low institutional capacity and unclear legal and political processes, may only truly reveal themselves during the preparation of a major complex project. As such, it will frequently be incumbent on the GIF to assist in closing these gaps with timely technical assistance so as to ensure that the projects it is preparing and structuring have as few hurdles as possible and are sustainable in the long-term. For this, the GIF will work closely alongside its Technical Partners and other specialist programs such as the World Bank's Public Private Infrastructure Advisory Facility (PPIAF).

SUMMARY

The Advisory Council Meeting in Changsha was a unique opportunity for prospective GIF government clients to receive genuine market feedback from the world's leading private infrastructure investors on their projects and programs. Such meetings also continue to help the GIF shape its support for the preparation and structuring of bankable projects, while also contributing to the design the Downstream Financing Window.