

FINANCING OF PUBLIC INFRASTRUCTURE ETUI Workshop

**Jane Lethbridge, Director, Public Services
International Research Unit (PSIRU),
University of Greenwich, UK
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AIMS/ OBJECTIVES

Aim

- To examine the financing of public infrastructure and implications for trade unions

Objectives

- To analyse the advantages/ disadvantages of different models e.g. government finance, guarantees, own resources, loans, PPP, etc
- To identify the type of solutions for trade unions to promote

Sections

- Context of public infrastructure financing
- Types of financing – public , private, re-financing
- Rise of project finance
- Alternative forms of financing

PUBLIC FINANCE - TAXATION AND PUBLIC SECTOR BORROWING

- Public sector traditionally provided capital for public infrastructure projects directly from taxation and public borrowing
- Public sector takes risks which private sector unwilling take on e.g. public transport...
- Funding infrastructure stimulates the economy and competitiveness
- Infrastructure projects - high risk at beginning
- Changes in attitudes to public borrowing

PPPs / PRIVATE FINANCE INITIATIVE

- Traditional forms of government procurement – government designs the project and private sector builds it
- Public-private partnerships/ Private Finance Initiative (PFI) – government sets goals of project but private sector develop solutions to meet specification and define outputs needed
- Private sector not only designs, builds but also runs the facility – so private sector bears higher costs of maintenance if poor quality build
- Promotion of public-private partnerships – don't appear on balance sheet so borrowing not visible
- Governments now play facilitating role of infrastructure development to private financing

ROLE OF PRIVATE SECTOR AND GOVERNMENT

Private sector	Government sector
Primary sponsor	Co-sponsor
Major financiers through public-private partnerships	Contribute to equity capital and loan capital
As guarantors or other sureties for other types of transaction	Provide guarantees e.g. against political risk
As insurers	Provide supplies within government control e.g. coal/energy
As purchasers of output	Provide fiscal incentives e.g. tax exemptions
Source: Merna & Njiru, 2002	

TYPES OF CONTRACTUAL STRUCTURES

Operation and Maintenance services	Concession (Public ownership of the facilities)	Concession (private ownership of facilities)	Full privatisation
Management of public facilities by private parties Leasing agreements	Rehabilitation of existing facilities, management and transfer Design, building, management and transfer (service agreements with public administration)	Design, building, own, management and transfer	Asset sales Divestitures
Main risks and relative allocation among involved parties			
Low risk by private sector	Medium private sector risk	Higher private sector risk	Highest risk private sector
PUBLIC-----	-----	-----	-----PRIVATE
Source: Gatti, 2014			

CONTRACTS

- **Fixed private lump sum turnkey contract** – construction for fixed sum by private sector and then provided ready to operate
- **BBO Buy-Build-Operate** Public partner sells public utilities to private partner aiming at further investment. Private sector finances project and operates it as profit making public utility
- **LRO Lease-Rehabilitate-Operate** – Public partner owns and private partners rents existing utilities and finances and operates project
- **BOOT Build-Own-Operate-Transfer / BOT Build Operate Transfer** - private sector finances, builds, operates for a set period – then transfers operation back to state

WHAT IS A PPP/PFI?

- Private sector to design, build, finance and operation (DBFO) of investments in new public infrastructure.
- Consortia of companies – construction, finance, banking, facilities management - bid for PPP/PFI contracts
- PPP/PFI transfers to the consortium specific risks to do with the design, construction and lifetime operation of the assets and economic risks (e.g. economic recession)
- Consortium creates a Special Purpose Vehicle (SPV) to deliver the asset and services in accordance with the contract – covers construction and operation
- Advantages of SPV – if project fails financially – consortium not liable

PPP CONTRACTS

PPP/ PFI contracts made up:

- Unitary Payment, which consisted of an Availability element and a Service element.
- Availability element funds annual capital charges associated with provision by the company or consortium of assets – e.g. roads/ power station/ hospital assets
- Service element funds the cost of providing services, e.g. providing toll road services

SHIFTING RISK

- Aim of PPP - to move risk from public to private sector
- PPP to move project risks (cost overruns to private sector)
- ‘Reward’ to private sector – profit from use of project management skills
- SPV enables consortium to avoid risk of default

BUT

- Long term nature of contracts (30 years +) make rental/ payment costs for public sector expensive and inflexible
- If project fails then public sector still responsible e.g. London Transport

RISE OF PROJECT FINANCE MODEL

- Change from government financing to private sector financing – brings significant changes in the way in which risks are assessed
- Infrastructure finance part of a new ‘asset class’
- Financialisation of infrastructure so that financial products can be bought and sold

NEW TYPES OF INFRASTRUCTURE FINANCE

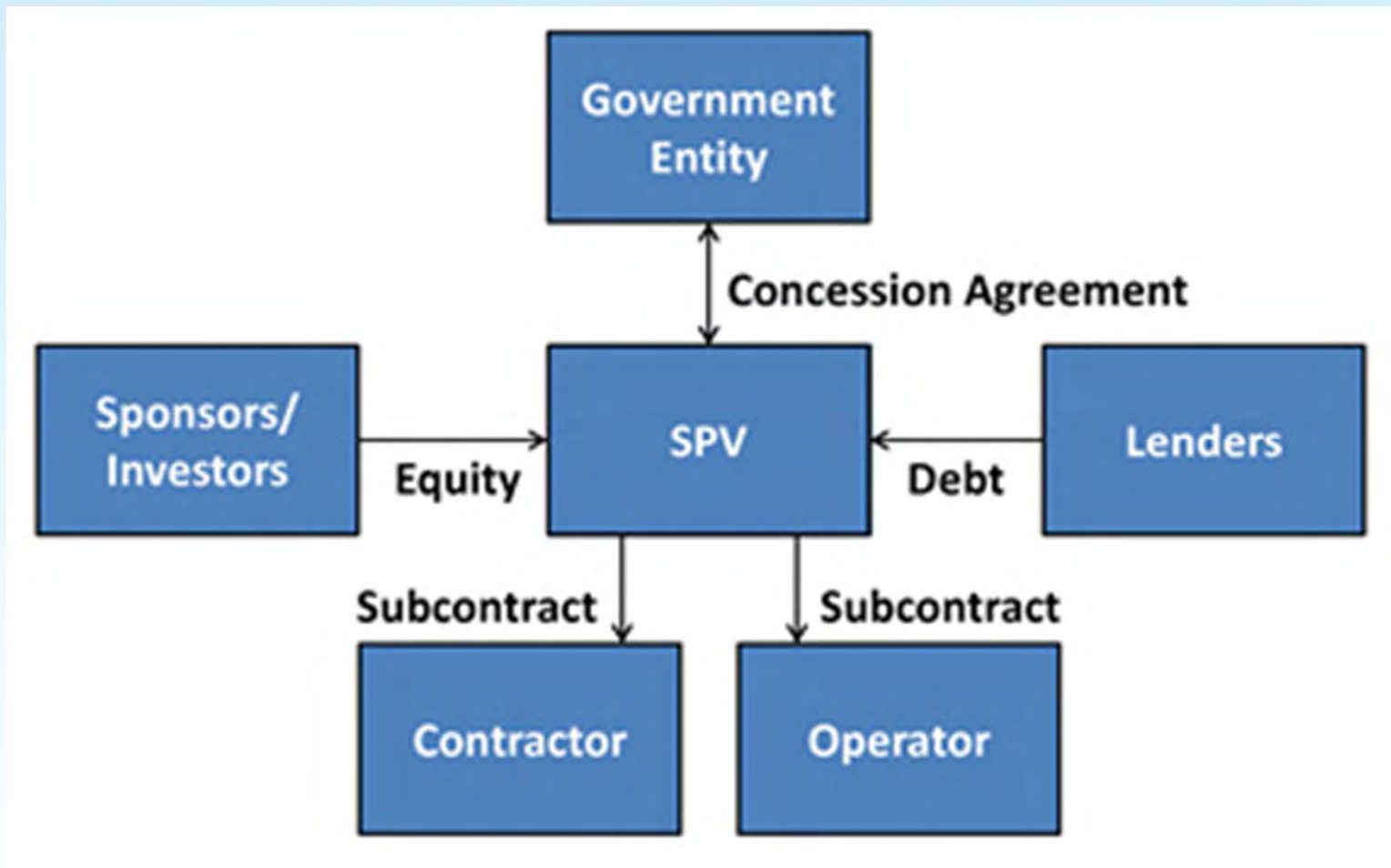
- Financing is not dependent on support of sponsors or value of physical assets involved
- Those providing debt to be repaid first (senior debt) rely on the performance of the project to fund through the revenue stream
- Useful if sponsors don't want to show the financing on their balance sheets or want to avoid condition of incurring debt or when credit worthiness is lacking (Merna & Njiru, 2002)

PROJECT FINANCE

- Each project supported by its own project finance package
- Each project has a legally separate Special Project Vehicle
- Loans dependent on future revenue streams
- Lenders do not have any call on assets of sponsors – only to assets of project

SPECIAL PURPOSE VEHICLE (SPV)

- Can raise equity funds from the public
- But equity is risk capital and subordinate to debt in terms of charge over company assets so will be affected by any financial problems
- New structure of SPV
- Lenders – no recourse to assets of sponsors
- Allows distribution of risks
- Reduces role of government



COMPLEXITY OF SPVs

Promoter is the central point of the SPV

1. Shareholder agreement - Shareholders
2. Loan agreement - lenders
3. Supply contract - suppliers
4. Concession agreement - principal
5. Operation contract – operator
6. Construction contract - construction

TYPES OF INFRASTRUCTURE FUNDS

Listed infrastructure funds – publicly traded infrastructure companies – portfolio of companies and can buy and sell shares – subject to market volatility

Unlisted infrastructure funds - invest directly in range infrastructure projects – usually institutional investors – complex organisations, debt and equity structures

Direct infrastructure investment – pension funds, banks, financial companies buy infrastructure assets or as part of syndicate e.g. a Sovereign Wealth Fund, global finance company (Goldman Sachs) and a pension fund

Indirect infrastructure investment – buy shares in publicly traded construction and facilities management companies involved in PPPs or privatised energy companies

DEBT INSTRUMENTS

- **Borrowing / raising loans** from banks and financial companies
- **PPP capitalisation through debt** - round 90% on debt financing and only 10% on equity financing – highly leveraged – use of bank loans and bond issues.
- Interest charged - “reference rate” (interbank rate) (reflect general market risks) and a loan margin (specific project risks).
- **Commercial loans** – securitised by project assets and dependent on financial strength of borrower – have priority access to debts if default ‘senior debt’
- **Bonds** – long term interest bearing debt instruments – bought by institutional investors (investment funds, pension funds)
- **Sub-ordinated loans** – higher rates of return but secondary to commercial loans so higher risks
- **Debentures** - a bond – undertaking repayment by a specific date - Regular stated payments of interest between date of issue and date of maturity

EQUITY FINANCING

- Ownership interest of common stockholders for project
- Equity total assets less liabilities
- Has claim on assets of project
- Sponsors of equities have highest risk in case of failure therefore have responsibility for funding, developing and managing the project
- Potential lenders – will decide whether to supply debt financing on basis of credibility and financial capacity of sponsor and SPV
- Often construction companies private equity- this can result in high construction costs

NEW SOURCES OF EQUITY FINANCING

- New groups of direct equity investors have started to invest in infrastructure, e.g. insurance companies, private equity funds, **pension funds**
- Infrastructure companies and funds – invest equity into wide range of infrastructure projects to diversify the bulk risk of individual projects – therefore equity is lower risk
- Canadian pension funds – invested direct investment into infrastructure e.g. **Canadian pension funds** (CPPIB, OMERS invested \$9.9 billion and \$9.1 billion in direct unlisted infrastructure equity)
- Australian pension funds invest in infrastructure funds

LACK OF TRANSPARENCY

- Multiple company structure
- Securitisation – an investment fund may securitise part of its future toll road income by selling entitlement to future cash flows to another investment fund in return for immediate cash
- Internal and external fees and charges: charge fees to subsidiaries for management of assets

LACK OF TRANSPARENCY 2

- Revaluing assets – unlisted infrastructure funds will revalue assets annually related to market valuation based on current and future case flow projections
- Re-financing – funds will re-finance project debt to lower costs and increase profits
- Acquisition and sale of assets – a fund may sell part of a portfolio of assets to raise cash to finance repayment of debt on other assets
- Accounting practices – accounting systems only measure money – take selective view of wider corporate impacts and economic, community and environmental impact
- Tax havens – growing number PPPs owned by companies in tax havens – so no taxes paid

RE-FINANCING

- Refinancing – at end of construction phase and ending of construction risks – project can be refinanced by the original lenders at lower interest rates often fixed rates/cheaper loans/ lower risk
- Aim of refinancing is to increase rate of return – by increase level of debt and length of contract
- Refinanced by bank debt or issuing bonds – sold to insurance companies, pension funds – further re-financing very difficult
- Sales of shares of SPV (or consortia company) – gives shareholders increased value once major risks eliminated
- Money used to fund further PPPs or own corporate accounts

RE-FINANCING 2

- Re-financing does not need public sector consent
- UK 2005 Treasury does require consent and now 50/50 split
- Growth of secondary markets investment funds
- Investment funds e.g. Global Solutions (GSL) run prisons and other public services.
- Expansion of market – for benefit of investors not projects.

SECONDARY MARKETS

- Growth of secondary markets of PPPs
- After design, build and construction projects
- As more PPPs complete construction phase, larger number sold on secondary market
- Greater influence of investors on what happens to public sector assets in future

DEBT EQUITY SWAP

- Debt equity swap
- If financial problems can convert to equity
- Therefore reduces debt/equity ratio and also level of debt repayment
- No obligation to pay dividend if not in profit

SALE AND LEASE BACK

- Sell equipment and then lease it back from leasing company
- Power project - promoter can sell and then lease back assets to generate cash

PPPs

1. The private sector doesn't assume risk

- Build assets and stay in working order –
- methods of assessing risk – not assess complexity
- Companies not willing take on risk cheaply

2. PPPs don't guarantee better value for money

- Limited ways of assessing value for money
- Often not compared to public sector comparator

3. The normal public sector option is not always considered

- Wijkertunnel Randstad, Netherlands – public sector option ignored and so higher cost

4. PPPs are not better at finishing buildings on time or on budget than ordinary contracts

1. Apa Nova water project - City of Bucharest/Apa Nova (Vivendi) – faile complete €60m sewer project, 17 increases consumer prices

PPPs 2

5. The rules on PPPs don't ensure complete transparency and can contribute to corruption

6. Any competitive tendering associated with PPPs does not guarantee savings

- High legal and accountancy expenses – due to complexity of PPPs
- Metronet 2.8% of project value = £455 million

7. PPPs do not ensure better design innovations

- Dublin Regional Waste Water Scheme/ Celtic Anglian Water – smells/odours and inadequate design

8. The private sector cannot raise money more cheaply than governments

- Private sector does not get cheaper borrowing rates and differences increased since financial crisis

ALTERNATIVE FORMS OF FINANCING

1. Public spending – supported by progressive taxation policies
2. Infrastructure funds and banks e.g. Infrastructure Australia, Infrastructure Canada – but public private partnerships used
3. Pension fund investment in infrastructure – move from maximising returns to social/ public benefit – role of unions in lobbying for this
4. New taxes and hypothecated funding e.g. US Highway Trust fund – funds from federal fuel tax and other fuel excise taxes
5. Infrastructure and revenue bonds – public sector uses bonds to raise funds for capital investment - use in the US, Asia
6. Joint investment and public-public partnerships – joint ventures between public agencies

HOW TO ENSURE DEMOCRATIC ACCOUNTABILITY?