The trouble with public-private partnerships

Trusted Sources > India > Sustaining Growth **30 Jan 2008**

Overview

The Indian government has set ambitious targets for infrastructure investment not only from its own resources but also from its expectations from the private sector. Despite much talk over the formation of public-private partnerships to facilitate private investment in the infrastructure sector, the government has been relatively slow in creating an environment that facilitates the inflow of private funds.

It is still too early to estimate how much infrastructure investment will ultimately come from private sources, but government officials admit that their targets are too aggressive. To be sure, more money is flowing into the sector as the rapidly growing demand for infrastructure services in India's booming economy creates new business opportunities. Airports, roads and ports where some degree of standardisation and regulation is being imposed will remain the safest bets and also the most popular in terms of the number and value of projects implemented.

Context

The government's US$494 billion target for infrastructure spending in its current five-year plan (ending in 2012) factors in private investment of US$147 billion or 30 per cent of the total. That is almost double the share of 18 per cent accounted for by private investors during the previous five-year period. The government is counting on a greater number of public-private partnerships (PPPs) to help achieve this aim but although there is much talk, the general sense among private developers and financiers is that not enough action is taking place on the ground.

According to government data reported in July 2007, 224 PPP projects totalling US$17 billion were under way and another 76 projects worth US$8.5 billion were in the pipeline. Between 2006 and January 2008 the Public-Private Partnership Approval committee approved 40 projects worth just US$170 million. (Click here for a state and sector-wise distribution of PPP projects) The numbers so far do not bode well for meeting the government's investment spending targets, as infrastructure projects typically have a long gestation period and US$30 billion of private investment is required every year on average to achieve the overall target. The problem is much like that of other developing countries such as Brazil, where investors are ready to put their money into viable opportunities but there are not enough worthwhile projects to go round.

Progress so far

Federal government agencies such as the Planning Commission and the Finance Ministry have been taking steps to encourage PPPs. These include:

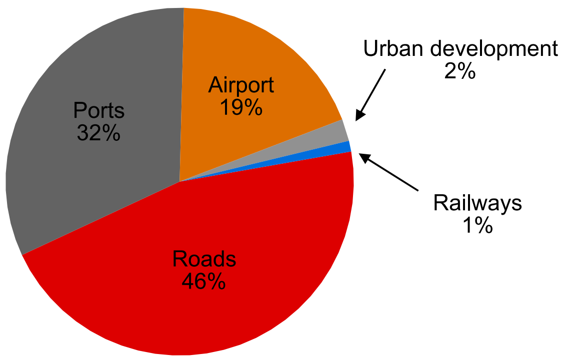
- finalising model concession agreements (MCA) for road and port projects and preparing draft proposals for other infrastructure sectors to provide an appropriate framework for risk sharing between public authorities and the private sector;
- creating a special unit for PPPs within the Finance Ministry to administer PPP proposals and coordinate activities;
- initiating a Viability Gap Funding (VGF) scheme in August 2005 to give an upfront grant of 20 per cent of the PPP project's cost to help make it economically viable, with the government or statutory entity that owns the project allowed to give another 20 per cent;
- setting up the India Infrastructure Finance Company Ltd (IIFCL) in March 2006 to provide long-term financing for up to 20 per cent of the project cost either directly or via refinancing banks and financial institutions;
- launching the India Infrastructure Finance Initiative by the Infrastructure Development Finance Company, IIFCL, Citigroup and Blackstone to deploy US$2 billion in equity finance and US$3 billion in debt for infrastructure projects;
- establishing the India Infrastructure Project Development Fund with a US$25 billion corpus to meet up to 75 per cent of the project development cost as an interest-free loan.

However, the effectiveness of these measures has been suboptimal so far compared with the targets. Although the Planning Commission drafted MCAs for each of the major infrastructure sectors in 2005, the drawn-out process of obtaining bureaucratic approvals from various ministries has meant that only the agreement for roads and - as of January 2008 - the one for ports have been finalised.

The road sector is now considered a relative success story in India's infrastructure modernisation programme but it took many years to reach its current state. A concession agreement for highways was put together as early as 2001 but was later revamped to address issues such as land acquisition. In 2006 a new improved MCA with a better framework for build-operate-transfer (BOT) projects was finalised, under which the National Highways Authority of India (NHAI) completes 80 per cent of the land acquisition. It also protects lenders in case of default by the promoter, protects the promoter against the creation of competing facilities, and clearly delineates the responsibilities of the government and the promoters. Since 2006 nearly 66 projects have been awarded on a BOT basis.

The differences among the sectors and states on implementing PPP projects are due to varying degrees of political will and commitment on the part of the concerned authorities. The NHAI, which is the nodal agency for development of highways under the Ministry of Shipping, Road Transport and Highways, has been proactive in awarding concession contracts for roads. The ministry has also encouraged PPPs in major ports, while the state governments of Gujarat and Andhra Pradesh have pushed ahead with the development of smaller ports that fall under their jurisdiction.

PPP project share by sector (in per cent)



Source: PPP cell, Ministry of Finance.

The missing links

For the sector as a whole, progress is still slow. In the first two years of the VGF scheme the government granted approval to 23 proposals with estimated funding of just US$683 million while IIFCL has so far approved 64 credit proposals worth US$3.8 billion. In an interview with the "BusinessStandard" in August 2007 an IIFCL official said that since its inception in March 2006 IIFCL has disbursed only US$105 million against approvals for 57 projects amounting to US$3.2 billion although disbursals will pick up in the latter part of these long-gestation infrastructure projects. For their part, government officials argue that the lower that expected VGF disbursals are because projects are more robust than previously anticipated.

Limited access to long-term financing from non-government resources due to the absence of a well-developed debt market is also constraining the increase in PPP projects. However, most private sector participants believe that the availability of money is not the problem; too much money chasing too few projects is the main issue. Other factors hindering the growth of PPP in India include the absence of a regulatory and policy framework governing PPP projects. There is a great deal of contractual ambiguity and overreliance on protracted legal procedures to handle any conflicts that may arise between the concerned authorities and private sector partners, a problem compounded by the lack of independent regulators and adjudication authorities. Contract enforcement is another cause for concern, even orders by the Supreme Court sometimes proving hard to implement on the ground.

Few infrastructure sectors apart from telecom have moved to establish regulatory frameworks conducive to fostering private investment. The Telecom Regulatory Authority of India was set up by a legislative action back in 1997 and the Act was then amended in 2000 to establish a telecom disputes settlement and appellate tribunal. No other infrastructure sector yet has a similar regulatory framework, and we believe the success of India's telecom sector in terms of growth and private investment opportunities is partly attributable to this. In contrast, the Ministry of Railways and the Airports Authority of India (AAI) play the role of both operator and regulator, which sometimes leads to a conflict of interests. However, the relatively progressive Ministry of Civil Aviation managed to push the Airports Economic Regulatory Authority (AERA) bill through the Cabinet in May 2007. Although the parliament has yet to pass the bill, its eventual implementation will lead to the creation of an independent regulator to set tariffs and other charges for aeronautical services and monitor performance standards of airports as well as to the establishment of an appellate tribunal to adjudicate disputes.

The general absence of such strong institutions has resulted in messy disagreements between the government and private sector participants in some prominent PPP projects. The Delhi airport privatisation programme, for instance, landed up in controversy after the Delhi International Airport Ltd (DIAL) - a consortium led by the GMR Group - decided to form a subsidiary to develop the land around the airport. DIAL's new arm plans to charge private builders a high deposit (totalling around US$700 million) and treat it as a cost while lowering the rent, thereby reducing the revenue due to AAI (which is supposed to receive 45.9 per cent of DIAL's revenue). A disapproving Ministry of Civil Aviation finally referred the dispute to India's attorney general, who recently gave a judgment in favour of DIAL. Although the airport modernisation programme had already hit air pockets due to political opposition to privatising more airports, such disputes could make the government even more hesitant to invite more private developers into public projects.

The process of obtaining approvals from various ministries and government departments is cumbersome, and private investors have faced long delays in acquiring land for the projects and getting regulatory clearances. However, the government is trying to get its act together on this front by clearly allocating responsibility for individual projects to different agencies. The MCA for roads makes the NHAI responsible for acquiring land for highways while for the 4,000-megawatt ultra-mega power projects, the Power Finance Corporation, a central government agency, completes all regulatory clearances and approvals - including land acquisition - before putting the projects out to bid in order to enhance their appeal to private investors.

India's broader problem of a shortage of skill labour extends to the infrastructure and public sectors. There simply are not enough trained personnel in the government to conceptualise PPP projects. On another level, a changed mindset allowing greater private participation and private control of public projects has yet to come about in the bureaucracy.

States vary

Broadly the commitment on infrastructure of key central government officials and departments - led by the prime minister, the Finance Ministry and the Planning Commission - have provided much-needed impetus to the growth of business opportunities in the infrastructure sector. However, much of the work needs to be done by state officials on whose ground the PPP projects have to be implemented.

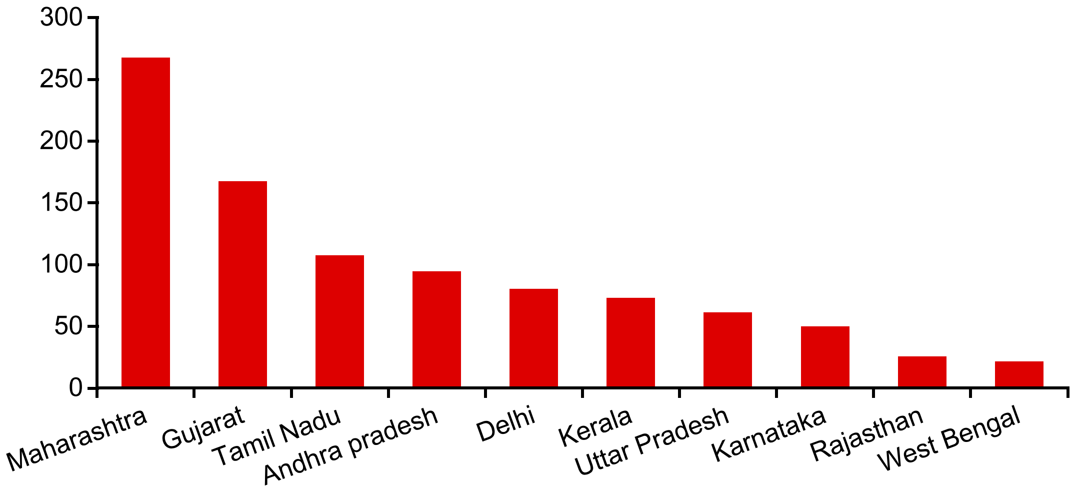
At the behest of the central government, 22 states have set up PPP cells which are responsible for the approval of PPP projects and for coordination between various departments and ministries. Some state governments such as Gujarat and Andhra Pradesh have passed legislation or put together policies to encourage private investment.

State policies on infrastructure

State	Action taken
Gujarat	Gujarat Infrastructure Development Act (1999) amended in 2006 to facilitate greater private sector participation
Andhra Pradesh	Infrastructure Development Enabling Act (2001) to facilitate greater private sector participation
Punjab	Punjab Infrastructure Act (1998, 2002) to develop an appropriate regulatory framework for private sector investment
Karnataka	State infrastructure policy includes making the Infrastructure Development Department responsible for funding project studies. The Infrastructure Development Corporation of Karnataka undertakes project development activities
Orissa	Introduced a PPP policy in 2007 and is in the process of developing an Infrastructure Development Fund responsible for conceptualising projects before offering them to private investors
Rajasthan	Has set up the Rajasthan Infrastructure Development Fund with an initial corpus of US$500,000 contributed by HDFC Bank, Infrastructure Leasing & Financial Services and the state government. The Rajasthan government also made further investments of US$6 million in the fund
West Bengal	Announced its policy for infrastructure development through PPPs in August 2003

The performance of PPPs has varied across states and among different sectors within a state. For instance, Gujarat and Andhra Pradesh both have an enabling legislative environment that has encouraged private participation in sectors such as roads and ports while other major coastal states such as Karnataka and Maharashtra still need to put similar policies in place.

Share of PPP projects by state (in billion rupees)



Source: PPP cell, Ministry of Finance.

Centre-state relations and political power struggles can also play a role in the success of projects. For instance, Uttar Pradesh Chief Minister Mayawati Kumari announced in September 2007 the construction of a US$10 billion expressway connecting the western and eastern extremes of the northern Indian state, raising concerns in the NHAI about the adverse effect it will have on the toll collections of a section of its Golden Quadrilateral highway which runs parallel to the planned expressway. Mayawati's announcement of a second large airport project in Greater Noida - a satellite town of New Delhi - has caused similar worries about DIAL's new, expanded Delhi airport currently under construction. The GMR Group is opposing the Greater Noida airport, fearing it may hurt its revenue and passenger streams. GMR, however, will have the first right of refusal if it chooses to bid for the Greater Noida airport and its price quote is up to 10 per cent less than that of the highest bidder.

Trusted Judgements

The government must promote more projects

Ajay Khanna, deputy director general, and **Bidisha Ganguly**, consultant, Confederation of Indian Industry

PPPs are the new mantra of the government's 11th five-year plan. In India, conceptualising these projects requires charting new territory and there is a lot to learn. But there is no other way to go about funding infrastructure projects if the government wants to meet its investment targets. As far as the road sector is concerned, there is wide acceptance of the MCA among private investors. But other sectors are facing various issues. For instance, the plan to develop 35 non-metro airports is facing land acquisition issues.

What is needed is a good quantity of bankable projects. Although banks in India are flush with money, there is no capacity in the states or at the centre to structure PPP projects. The state must come up with these projects as infrastructure is a public good, but many officials do not know how to make the change in mindset for working with private companies. The government has undertaken this training for its officers but as on date, it does not have a shelf of bankable projects.

Ministries need to streamline their working

Gajendra Haldea, adviser on infrastructure, Planning Commission of the Government of India

The increase in investments may be slower than anticipated. To be sure, project approvals have gone up and the government is more focused, taking steps such as creating standardised documents for infrastructure projects. Most big measures are in place but the regulatory system has to be reformed and the award process has to be streamlined. Some of the issues that need to be addressed are development of pension and insurance funds as well as tax reforms.

Still, equity investors are in abundance. The shortfall in targeted funding from the private sector could be because enough projects are not offered. The challenge mostly lies with the government and its policies. Incumbent ministries don't want to let go. It is a process of change and takes time. Issues like environmental clearances also slow down business. Investments will be driven by the pressures of economic growth and will happen. The question is whether the government will be able to create the required speed.

An integrated approach to infrastructure is required

Arvind Mahajan, executive director, KPMG Advisory Services - Infrastructure

The Gujarat Infrastructure Development Act enables PPPs in that state and the Gujarat Infrastructure Development Board plans infrastructure projects in an integrated manner. They have built ports as they believe in port-led industrialisation and in developing special economic zones. They have also been fairly proactive in terms of creating concession agreements for ports and roads. Gujarat has been a success story, and now more investors are coming in.

There is a need to integrate the efforts. Each ministry is trying to individually learn how to handle PPPs. But these projects are interlinked in some sense. For instance, a railway connection to and from ports may be missing or there may be the need to link a freight corridor with an industrial corridor. In the integration of port and road projects, land acquisition rights become important, otherwise there are significant delays. Environmental clearances are also required in advance. All the projects must be "cooked" well before they are offered to investors. The ultra-mega power projects are a success because all these issues were cleared before they were bid out. Power purchasing agreements with the states were also drawn up prior to the bidding process.

Wrap

A substantial increase in private investment depends on further government initiatives

As our trusted sources point out, private investment in infrastructure is not being held back due to inadequate funding but rather due to a shortage of well-conceptualised projects. The potential for PPP projects exists across all infrastructure sectors, from rail freight corridors to urban water supply. But the legislative and regulatory environment in many areas is still intimidating for private investors.

The government's strong focus on infrastructure has helped to iron out some of the issues, such as the standardisation of concession agreements for the road and port sectors as well as the tabling of the AERA bill in parliament. However, despite federal pressures to move forward, there are bureaucratic barriers from state governments and specific ministries. For example, the Ministry of Railways has been slow to adopt PPPs as an investment model. Its much-publicised dedicated freight corridor project connecting north India to the eastern and western coasts is likely to allow private developers only in non-operational areas such as track building. Private investment is also likely to remain low in urban infrastructure, where local governments are in charge and safeguards for private investment are insufficient.

Given that India's infrastructure is so vastly underdeveloped and underfunded, there is much scope for investment, as we highlighted in our recent publication on urban water supply. However, investors must carefully examine both the economic sectors and the states where progress in PPPs is likely. Investors will find a more favourable and cordial environment in states such as Gujarat, Andhra Pradesh, Karnataka, Rajasthan and Tamil Nadu, where the local governments have been proactive in attracting private investment.

With the finalisation of MCAs for roads and ports, these sectors have acquired a relatively higher degree of standardisation and transparency in the investment process. The expected establishment of an independent regulator for airports will help boost investment in that sector. The government is expected to standardise the concession agreement for airports as well as that for urban metro trains in the next three-four months while the MCA for state highways is now ready. Other pockets of interest include the big power generation projects where the government handles land acquisition and the required clearances for investors.

However, private investment will remain limited in other areas of the power sector, such as transmission and distribution where regulation is weak and vested interests high. Even in roads, ports and airports, coordination between ministries is needed for the success of PPPs, as KPMG's Mahajan correctly notes. Our analysis of the port sector in our recent publication Growth Derailed shows how infrastructure bottlenecks threaten to lead to port congestion and reduce the amount of capacity-building investment that can be absorbed.

Next tests:

1. The finalisation of model concession agreements for sectors such as airports, urban infrastructure and state highways.

2. The passage of the Airports Economic Regulatory Authority bill in parliament and the establishment of similar regulatory institutions for other infrastructure sectors.

3. Increased activity by state governments for creating an enabling framework for PPPs.

Relevant Companies

Name	Description
GMR Infrastructure (NGMR IN)	Developing a greenfield international airport in Hyderabad and Delhi international airport. Also has interests in road and power projects.
Reliance Power Ltd (NRPWR IN)	Involved in construction and operation of power plants
Tata Power (TPWR.IN)	Tata group electricity utility and power equipment builder.