RE-303

EVALUATION OF THE BANK'S DIRECT PRIVATE SECTOR LENDING PROGRAM 1995-2003

Office of Evaluation and Oversight (OVE)

Inter-American Development Bank
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Annexes and appendixes on the following topics are available on the OVE Intranet page: http://ove/oveIntranet/DocumentInformation.aspx?DOCNUM=425390&Cache=False&Library=ongoingwork.xml

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ABBREVIATIONS

ALIDE	Asociación Latinoamericana de Instituciones Financieras [Latin American Association of Development Financing Institutions]
BNDES	Banco Nacional de Desenvolvimento Econômico e Social (Brazil)
CAF	Andean Development Corporation
CRA	Risk Assessment Office
CS	Case study
DIs	Development institutions
DSCR	Debt service coverage ratio
EBITDA	Earnings before interest, taxes, depreciation, and amortization
EBRD	European Bank for Reconstruction and Development
ECG	Evaluation Cooperation Group
ERR	Economic rate of return
ESIR	Environmental and Social Impact Report
ESMP	Environmental and Social Management Plan
GDP	Gross domestic product
GN	Documents on general matters
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
IIRSA	Initiative for Regional Infrastructure Integration in South America
IMF	International Monetary Fund
IPPs	Independent Power Producers
LAC	Latin America and the Caribbean
LIBOR	London Interbank Offered Rate
MIF	Multilateral Investment Fund
MTOP	Ministry of Transportation and Public Works
NGOs	Nongovernmental organizations
OPRCOST	Operational Cost System
OVE	Office of Evaluation and Oversight
PP	Problematic projects
PPMR	Project Performance Monitoring Report
PPP	Puebla-Panama Plan
PRI	Private Sector Department
PRIS	PRI official database
PSCC	Private Sector Coordination Committee
RE	Documents of the Bank’s Evaluation System
SAR	Semiannual Supervision Report

Foreword

In 2001 the Bank's Board of Governors authorized the Board of Executive Directors to "*raise the ceiling on private sector loans and guarantees to 10% of the amount of loans and guarantees outstanding*" (document AB-2148-1). Resolution AG-9/01 (December 2001) entitled "Lending to the private sector" states that *"**The Board of Executive Directors shall direct the Office of Evaluation and Oversight to complete, within three years of the date of the approval of this Resolution, a review to determine the developmental effectiveness and additionality of private sector activities relative to other Bank activities**."* That evaluation became one item in OVE's Board-approved 2004 work plan. This report formally fulfills the aforementioned mandate.[1]

The evaluation team's work throughout 2004 included a thorough review of 55 projects which represent 82% of private sector approvals and 91% of signed projects. In field visits to five countries the evaluation team viewed projects that were at various stages, representing over 65% of approvals. It also looked at more than 300 projects identified by the Bank, most of which ultimately were not financed, and a database was compiled on deals closed by other comparable finance providers and in the financial markets generally. The team surveyed sponsors, finance partners, and regulators in all the countries in which the Bank was directly backing private sector projects and interviewed Private Sector Department (PRI) and other Bank staff. Meetings were held in-house and outside the Bank with political and regulatory authorities, user representatives, NGOs, sponsors, lenders, comparable institutions and other relevant actors. In all, more than 500 individuals were contacted to gain a clearer understanding of the perspectives of the main stakeholders in this private sector program of the Bank.

The proposed work plan and evaluation methodology that OVE developed specifically to fulfill the above-mentioned Board mandate were presented to the Bank's Management for consultation and discussion before work started in May 2004 and were available thereafter on OVE's Intranet site. PRI's ready cooperation was instrumental in this exercise, assigning staff for liaison and coordination of the various facets of the evaluation work and providing full access to paper and electronic files, information systems, and all of its management, professional, and administrative personnel. As a result the evaluation team was able to keep to the timetable and produce the evaluation with the depth of analysis sought.

The report is divided into four chapters with supporting annexes numbered to match each chapter: (i) strategy mandate and evaluation questions; (ii) brief overview of the context and market trend analysis; (iii) summary of consolidated project evaluation findings, and (iv) findings and recommendations.

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[1] Some preliminary findings and comparisons with other Bank products were included in the OVE report "Instruments and Development: An Evaluation of IDB Lending Modalities" (document RE-300).

EXECUTIVE SUMMARY

In 2001 the Board of Governors authorized the Board of Executive Directors to "*raise the ceiling on private sector loans and guarantees to 10% of the amount of loans and guarantees outstanding*" (document AB-2148-1). OVE was directed to conduct an evaluation of the Bank's private sector activities within three years. In fulfillment of that requirement, this report assesses the Bank's performance in pursuing that mandate, which was not confined to an evaluation of any one department but encompassed the Bank's program overall. At a juncture when the Bank's Board and Management are exploring organizational options for direct private sector financing, the information and assessments provided in this report might enrich the reflection and decision process. However, OVE was not asked to evaluate organizational alternatives so that issue falls outside the report's purview.

The Bank's authorization to lend directly to the private sector dates back to 1994 at a time when the State's role in infrastructure was being pared back, the region was opening the door to private participation, and there was a dearth of long-term finance on offer. Because of its particularities the infrastructure sector is one that warrants long-term financing and involvement of development institutions like the Bank: (i) it requires huge investments in fixed assets; (ii) infrastructure investments have long-maturity returns; and (iii) most infrastructure ventures involve essential utilities for the public and for business activity that have strong competitiveness and poverty-reduction potential, usually are regulated, and are subject to political considerations having to do with service coverage, access cost, and monopoly power.

Consequently, the original intent of the direct private sector program[2] was to adapt the Bank's operational structure and modalities to a new "business model" for the region's infrastructure sector. After assembling a team of seasoned professionals the Bank did not take long to establish itself as a pioneer and prominent player in the infrastructure finance market, notably in the energy and road transportation subsectors.

A review of private sector activity to date shows that limited use has been made of the authorized operating capacity. Between 1995, the year its first operation was approved, and year-end 2003, the Private Sector Department (PRI) tallied 60 project approvals (net of cancellations) funded with approximately US$2.848 billion in "A" loans and guarantees and US$3.246 billion in syndicated "B" loans and co-guarantees, for investment projects costing a total of US$15.908 billion. This level of activity is below the 10% raised ceiling and never surpassed the original 5% ceiling.[3] At year-end 2003 amounts outstanding for private sector operations were 3.5% of aggregate Bank loans and guarantees outstanding.

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2 References herein to the "private sector program" are to the Bank's program of direct lending to the private sector pursuant to the 1994 Eighth Replenishment mandate.

3 Loans and guarantees to the private sector as a percentage of total loans and guarantees outstanding excluding emergency loans.

The program's peak period was 1999-2000 with over US$1 billion in commitments. The year 2001 marked the start of a downturn—matching developments in the rest of the market—with annual averages of barely US$300 million. Though there are a variety of reasons for this decline a central explanation is that the private sector program mirrored the private financing cycle generally, as this report will explain. The prime consideration here for purposes of PRI's future is that it may take some time to get back to previous infrastructure investment volumes and the vehicles will likely differ from those employed over the past decade (with less foreign involvement in both investment and financing and perhaps more public-private partnering).

Because of their infrastructure shortcomings many countries in the region are losing competitiveness and missing out on chances for growth. Current infrastructure investment levels are low and there will not be enough public investment to be able to reverse that trend. Fresh investment capital is needed to help close the huge gaps in services available to vast sectors of the region's population. Improvements clearly are needed in reforms fostering private participation in infrastructure to strike a balance between public and private interests and boost private investment in the region. Key requirements in this respect are strengthened legal protection and sound regulatory environments to foster investor confidence in the sector and also unlock the institutional funds that are being amassed in a number of local financial markets.

From a private sector standpoint the chief appeal of working with the Bank has been the combination of amounts, tenors, and rates available through its program, which are not easy to find in the market, and the implicit assurance or "comfort" its involvement affords that the State or regulatory agencies will not engage in arbitrary acts. The offsets to this "comfort"—the extra costs of working with the Bank—are processing and approval times longer than the private sector is accustomed to, high front-end costs, additional outlays and delays to satisfy social and environmental requirements, and the long time it usually takes to make needed in-process changes to a project.

However, the premises that originally endowed the Bank with certain competitive advantages, at least partially, have been eroding because of changing markets and the ineffectiveness of political and regulatory risk insurance, a situation that offers new possibilities and presents challenges in terms of types of intervention. For one thing, given the huge pools of money accumulating in pension funds and other finance institutions in some parts of the region the argument that countries have a dearth of funding avenues is losing some force. Maturity extension being still embryonic and limited the challenge is to develop instruments and a framework of conditions in which such resources can be channeled into long-term ventures. Having captured that trend in the late 1990s, the Bank developed a partial credit guarantee program and closed the first operation in 2001. Though this is still a low-volume activity line the Bank was a pioneer among multilateral agencies in this sphere. Second, when parties confronted with adverse regulatory policy moves looked to the implicitly afforded "comfort" referred to above they found the Bank's effectiveness to be lacking. The dissatisfaction this triggered among some investors and finance partners is by no means unique to the Bank: other development finance agencies have run up against the same problem. That dissatisfaction came at a time when foreign investors were retreating from some sectors (energy, for instance), sometimes in the wake of parent company problems or strategy shifts. Similar situations have been observed in international commercial banks, for which cofinancing via the "A/B loan" program has lost some of its appeal. This new environment is opening up possibilities for other kinds of interventions, primarily to catalyze a channeling of pools of funds being amassed in local capital markets, but it also presents stiff challenges, as will be discussed in this report.

The Bank's operations contributed significant social and environmental additionality. Generally speaking, the Bank's involvement in a project carried with it an assurance that the operation would be executed following standards that may be generally recognized nominally in all the countries but often are all but ignored in practice. The Bank's value added is particularly notable in the early design stage and in ongoing monitoring work that is essential to effectively apply these measures. Nevertheless, sponsors question this additionality because of the attendant cost and time issues—an area that could be improved—and the Bank's indecisiveness in some cases when third parties lodge objections on social or environmental impact grounds.

The demand picture in the region today is different from a decade ago. Sweeping privatization programs are either complete or have been put on hold owing to opposition from different quarters. Today the private participation process is most in evidence at the subnational level, in areas yielding marginal returns and/or in participation formats that entail no transfer of ownership (e.g. management contracts). The trend now is toward a scaling up of public sector moves in the form of regulatory and business climate improvements and development of simple, transparent finance vehicles that afford assurances of future public sector outlays to improve coverage in underserved areas and mobilize private investment capital. Given the changes unfolding in the region and across the world the likely future scenario is an increase in participation of local investors, pension funds, or other domestic finance sources. In this environment the Bank will have to take on a greater role in improving credit quality, to catalyze the use of such funds for long-term investments. Any increase in operations also will hinge on a pickup of growth rates in the region and on renewed interest and confidence on the part of international investors and finance providers.

The Bank's inefficient response, in the form of high transaction costs and slow response times, curtails prospects for operations with smaller countries and smaller-scale transactions and indirectly fosters adverse selection. The high per-project costs to sponsors (averaging US$1.4 million) and their unpredictability and the issue of lack of control of these costs were noted in the evaluation. Furthermore, the slow and cumbersome project approval procedure that requires roughly the same number of steps as a public sector operation is taking fully 66% longer to complete than in comparable institutions. These protracted processing times also bespeak the lack of a common diagnostic and the different visions prevailing in the Bank's public and private sector areas, as will be discussed further on in this report. Though the two years it takes to move a private sector project from eligibility to first disbursement may be half as long as for a Bank-funded public infrastructure project this is still longer than a private sector clientele expects. This is why a large percentage of identified projects end up being diverted to other lenders even if the operations were well along in their processing or had even been approved. High transaction costs are a negative in other ways as well: (i) they dampen prospects for operations in Group C and D countries; (ii) they lessen competition, since many local and mid-sized operators do not have the financial strength to be able to wait; (iii) they heighten the risk of adverse selection, and (iv) they create the perception that take-out financing is being provided to sponsors of already completed project works.

One feature of Bank private sector activity in recent years has been a scaling up of project promotion and origination work, taking in more countries and dedicating more professional staff time to these tasks. But clients do not see the Bank as being strongly proactive. According to the survey their contact with the Bank came about because they or their financial advisors approached the Bank when their projects were relatively instrumented. The evaluation also revealed that in only one in five operations involving concession tendering did the Bank come on the scene before the concession award and offer financing to all the competitors.

In terms of effectiveness, a cardinal lesson coming out of this evaluation is that the Bank has been most successful when its efforts have focused on producing a demonstration effect. In roughly a decade of private sector operations the Bank provided funding for approximately 283,000 new water and sewer service connections, close to 7,000 MW in installed electric capacity, 1,019 km of power transmission lines, one million new electricity service hookups, 950 km of roads and highways, 7,372 km of gas pipelines, telephone connections for 93,000 new subscribers, and five new berths in two new commercial ports.[4] However, given the magnitude of the region's investment needs, Bank-backed works projects have and will continue to have a limited direct impact. Thus, demonstration effect is perhaps the most significant ingredient that can do the most to make up the existing shortfalls. What the Bank can accomplish directly will be limited to the size of its operations unless these are accompanied by other activities that end up demonstrating that investing in infrastructure is good business. In other words, Bank-funded projects can, by way of example, spontaneously attract other local and international players along with local and international capital.

One notable feature of Bank-backed private sector projects is that in one in every three such ventures the Bank was an innovator, i.e., the project was the first operation with private enterprise in the sector or subsector in question. In one in four operations the Bank did not just innovate but exerted a positive demonstration effect with the project as well. The Brazil-Chile-Uruguay toll road cluster is a prime example. As local financial markets develop across the region there is an increasing need to build this kind of credibility to attract financing, offering solid precedents of investments that can come to fruition unchecked by opportunistic political intervention, shifting regulatory frameworks, weak regulators, or macroeconomic instability.

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[4] To give some idea of the magnitude of these measures: only 7 of the 26 borrowing member countries have over 7,000 MW in installed electric capacity; one million electricity connections is roughly 80% of the connections in place in a country the size of Costa Rica; and 283,000 water service connections represent about 80% of Panama City's water system hookups. The detailed table in section 2-B of Annex III includes comparisons as to installed capacity in the region, utility service shortfalls, and investment demand.

For the most part, Bank-financed projects executed by the private sector were brought in on time and on budget and the vast majority of them are delivering the promised services to an acceptable standard of quality. This is a significant achievement, particularly if we compare this showing to what frequently happens in public sector infrastructure operations. The exceptions are projects prompted by sector crises (e.g. energy) or in the communications sector in which the Bank has not developed core competency and outcomes have been very poor.

The evaluation found serious coordination weaknesses within the Bank for private sector work. Though "coordination" was seen to have improved since 2001 with PRI's frequent participation in programming missions, this coordination is more formal than real. Specifically: (i) the degree of coordination varies a great deal from one Regional Department and sector to another; (ii) there is little effective synergy between the different parts of the Bank; (iii) there frequently are different, even contradictory, visions of the Bank's role in a country, creating friction, inefficiency, and conflict; and (iv) PRI is not fully tapping many of the Bank's resources and, with the occasional exception, PRI's own wealth of hands-on experience is not being fed back to the rest of the Bank.

Though in theory it ought to be possible to improve synergy between the different parts of the Bank the absence of a common diagnostic and shared vision is an impediment to such coordination and rationalization moves. One coordination advance on the institutional front was the late-2002 resumption of operations of the Private Sector Coordination Committee after eight years of virtual inactivity since its establishment. That body, made up of representatives of different Bank-related actors including the IIC and the MIF, harmonizes criteria, for instance declaring project eligibility. But this is a modest advance relative to the challenges of improving coordination and harnessing potential work synergies.

There are serious shortcomings in ex post monitoring and evaluation of projects. This is contributing to the distancing and lack of trust between the Bank's public and private sector sides, which has impeded coordination and synergies between the two "cultures." Though ex ante calculations are done of private sector projects' economic rate of return—a practice that has fallen into disuse in the rest of the Bank—there is a major weak point in this regard: not enough emphasis has been placed on using that analysis as a basis for action. A further concern is the absence of an in-process monitoring system to gather data on private sector projects' development achievements which would be compatible with systems in use elsewhere in the Bank. This is one reason for the perception in the rest of the Bank that private sector projects are standalone transactions rather than interventions that are helping to address development problems in a specific Bank-targeted sector in a country.

Major weaknesses are evident also in the area of risk monitoring and management, even with the improvements brought in recently with the creation of the Private Sector Credit Risk Assessment Office (EVP/CRA) which is independent of PRI. The following are the principal problems observed: (i) lack of current, readily accessible financial information to be able to track project performance over time; (ii) a rather uninformative risk rating system that lacks granularity and forward vision; and (iii) no consistent and/or in-depth analysis of the quality of a loan's underlying security or of a project's own credit quality.

A notable feature of the Bank's private sector work is its conservative approach in generating operations backed by adequate guarantees. This has been put to the test in challenging circumstances. When macroeconomic downturns have triggered problems, for instance, the Bank has had the backing of credit guarantees of the principal sponsors so recovery levels were good. And since traditional infrastructure investment finance—which involves services that are essential to the public and to business activity—was the business concentration, recovery prospects were strong. This was not the case for projects in more dynamic sectors like communications, where there was one outright write-off.

One final requirement is stronger accountability and communication with the Board and with the broader LAC community. Though the Bank's Management has formally fulfilled the Governors' 2001 mandate to report periodically to the Board on the state of the portfolio these reports are offering a highly aggregated picture of portfolio condition and performance. The reader does not come away with a clear idea of the portfolio's characteristics, risks, or prospects or find data on the market or on requests in process or turned down. This is largely because the report's optic is the quality of guarantees in place, not project performance. Likewise, the evaluation found no evidence that successful experiences or noteworthy achievements are being publicized to foster a positive image of private sector infrastructure contributions, by PRI or other departments. As for information disclosure requirements, particularly on environmental and social impacts, all the documents in question are on the Bank's Web page but in three out of four projects the document is not in the language of the country where the project is sited, so the exercise is of limited usefulness. With regard to the public consultation requirement, the review done of Environmental and Social Impact Reports found that 80% of them contain no reference to consultation process outcomes or mention if there was any opposition to the project and how objections (if any) were dealt with.

In the evaluation team's assessment a series of measures would be recommended to improve the program's operation, in light of the weaknesses observed, changes in the market, and the Bank's non-integrated approach to the private sector. The following is a summary of the recommended actions, which are elaborated on in chapter IV of this report and Annex IV.

1. Retailor the work strategy to the changing market

This will entail: (i) **more proactive** operations development work to address the more decentralized, scattered demand in the region today where greater support is needed to put together a transaction; (ii) **caution when working with new sectors**, one requirement being a plan to develop capacity in those areas before broaching them; the main focus should be infrastructure-related sectors (e.g. logistics) and public utilities, making sure that conditions are such as would warrant Bank involvement, the Bank has demonstrated competitive advantages by virtue of its knowledge base, and loan recovery prospects are strongest; (iii) **promoting partial credit guarantees** and other interventions in local capital markets to familiarize local institutional investors with long-term finance to the private sector; (iv) **developing local currency finance vehicles**; (v) **exploring intervention modalities that are less procyclical** vis-à-vis the finance market; (vi) **actively fostering wholesale finance avenues (e.g. funds)** as a way of extending coverage and lowering transaction costs; and (vii) making more use of products featuring a combination of **fixed and variable yields (e.g. "upside kickers")**.

2. Make demonstration effect a focus of private sector work

Endeavor to maximize the demonstration effect through a strategy that combines interventions and improved communication with key market players, eliminating the "instrument-based" response to emergencies or crises which can compromise future investments by exerting a negative demonstration effect. Going forward, strategic thinking could be geared toward: (i) replicating models that have worked well in one country in other parts of the region, tapping in-house experience and expertise; (ii) targeting new operations to a discrete set of subsectors to achieve learning, critical mass, and exemplars to spark other investments; (iii) development of investment products and vehicles for the delivery of infrastructure and other public utility services; and (iv) publicizing successful ventures and positive experiences to counter the negative perceptions of private sector involvement in some critical sectors and attract local capital market players.

3. Improve coordination and make more efficient use of in-house resources

The Bank should explore ways of forging an institution-wide shared vision, starting with a common diagnostic and effective division of work to seek out synergies in intervention approaches and feedback on experiences. Action is needed to get beyond the contradictory visions that are creating friction and wasting opportunities to deliver support to countries at a time when public-private partnering is needed more than ever to improve regulatory and institutional frameworks and develop competitive, transparent mechanisms to boost and expedite private participation, in order to bring utility services to more of the region's underserved population. Implementation of the new Private Sector Strategy approved in 2004 and subsequent development of country strategies that organize work around a common vision is creating an opportunity to move forward with coordination improvements.

4. Shorten approval times and lower transaction costs

It is imperative that approval procedures be streamlined, speeded up, and standardized. It is taking too many steps to process a Bank operation and too long, on average, to close a transaction. This leaves the Bank at a competitive disadvantage vis-à-vis other institutions that have similar objectives and forestalls access for projects, particularly in Group C and D countries. The results can include: (i) projects diverted to other institutions; (ii) high costs per closed transaction; (iii) adverse selection; (iv) exclusion of local sponsors who have less financial strength and are unable to secure bridge financing while they wait for the Bank, and (v) take-out financing. Another item that needs revisiting is the option adopted at the outset of outsourcing the bulk of due diligence work, particularly on the legal side, in order to make it more affordable for smaller projects and sponsors.

5. Strengthen risk management

Risk management needs strengthening in several areas in particular: (i) improve ex ante financial modeling; (ii) keep financial information current and readily accessible so project performance can be tracked over time; (iii) improve the risk rating system, providing information with intermediate gradations and more particulars about a project's status and prospects; (iv) strengthen the analysis of each loan's underlying security; (v) analyze and monitor latent portfolio risks such as rates, currencies, and oil prices with a view to keeping an adequate balance to control exposure; and (vi) strengthen the supervision area, which has a heavy workload.

6. Improve evaluability and communication

Urgent measures are needed to improve evaluability, particularly for development effectiveness determinations. With a better evaluability framework could come more active communication, which is one area in need of particular attention for purposes of in-house and external actors alike. There is a pressing need, for instance, for an image refurbishment and better communication and management of expectations, and a spelling out of what the implicit "comfort" that comes with Bank involvement can and cannot do. But a first necessary step would be meaningful internal coordination improvements and a reduction of transaction costs, to satisfy direct clients (private parties) and the ultimate clients (countries).

I. Background

A. Direct lending to the private sector: a Bank action mandate

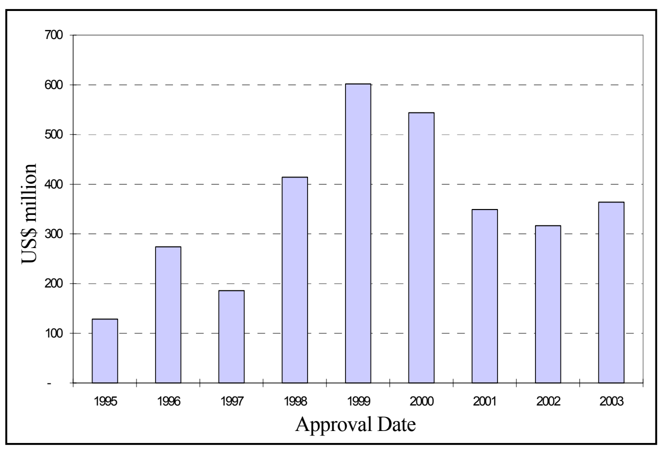
1.1 **Direct Bank lending to the private sector has its origins in the early 1990s when the region was in the throes of change and it was difficult to secure financing for recently privatized infrastructure sectors.** In particular a case was made for Bank lending directly to private parties without government guarantees *"for infrastructure projects of recently privatized entities which cannot be financed on appropriate terms, either because these agencies lack a track record of successful commercial operations or because the country's capital markets are not sufficiently developed to provide longer term finance ... provided that, in each case, the Bank's participation is critical to mobilizing substantial additional private financing."*[1]

1.2 On the basis of that rationale the 1994 Eighth Replenishment agreement directed that this new lending product *"be limited to a percentage of the Bank's total lending portfolio [5%], so as not to jeopardize its credit rating; at the outset, this support would be targeted exclusively towards the financing of investment in infrastructure and public utility projects providing services generally performed by the public sector."* As discussed in Annex I, in 2001 the Governors raised the authorized ceiling to 10% of total outstanding loans and mandated two new work focuses: capital market development and facilitation of financing for the Group C and D countries.

B. Private sector lending activity

1.3 **Between its first operation in 1995 and year-end 2003 the Private Sector Department (PRI) tallied 60 project approvals, net of cancellations, for a total of US$2.848 billion in "A" loans and guarantees and US$3.246 billion en syndicated "B" loans and co-guarantees**, for investment projects expected to cost US$15.908 billion in all.

Figure 1.1. PRI project approvals 1995–2003



1.4 **This operational activity is well below the raised 10% ceiling** and never surpassed the 5% original limit. Since their 1999 peak of approximately US$600 million approval figures have been declining. At year-end 2003 outstanding private sector operations were 3.5% of aggregate IDB loans and guarantees outstanding.

1.5 **The bulk of loan approvals were for infrastructure, largely for energy and transportation projects, pursuant to the original mandate. The Bank's first capital market development initiative was in 2001.**[2] Annex III, section 1, contains a complete list of the operations.

Table 1.1. Private sector loans and guarantees 1995-2003 (US$ million)

Sector	Number of projects	Loans and guarantees	%	Total cost of projects
Energy	33	1,761.1	62	10,398.2
Transportation	13	607.5	21	3,156.3
Water	6	172.5	6	862.3
Communications	4	167.0	6	595.9
Capital markets	4	140.2	5	895.0
Total	**60**	**2,848.3**	**100**	**15,907.7**

Source: PRIS

C. The core evaluation questions

1.6 **As was noted earlier, in December 2001 when the Board of Governors mandated an increase in the private sector ceiling from 5% to 10% it directed that a review be conducted of the program's operation.** Accordingly, OVE was directed to complete *"within three years ... a review to determine the developmental effectiveness and additionality of private sector activities."* In fulfillment of that requirement this evaluation report assesses Bank performance in delivering on the aforementioned mandate which encompassed not any one Bank department but the Bank's private sector program overall. To discharge its mandate OVE organized the evaluation around five core questions.[3]

- What was the magnitude of **the shortfall in infrastructure services delivery and financing** and how much did the Bank accomplish, by way of its **"direct private sector loans or guarantees" product, to improve the situation**?

- What degree of **additionality** has the "direct private sector loans or guarantees" instrument contributed relative to other available financing and to the way in which private money is put into infrastructure investment?

- What **risks** were encountered in pursuing the objectives sought and how were the risks managed?

- How well has the "direct private sector loans or guarantees" product been **coordinated** with and **synergies** harnessed with other Bank, IIC, and MIF interventions?

- To what extent were **operations structured such that achievement of a loan's or guarantee's anticipated development and additionality benefits would be ascertainable**?

1.7 **At a juncture when the Bank's Board and Management are exploring organizational options for direct private sector financing the information and assessments provided in this report might be useful in the decision process.** However, OVE was not asked to evaluate organizational alternatives so that issue falls outside the report's purview.

II. SUMMARY OF THE CONTEXT ANALYSIS AND MARKET TRENDS

A. Principal context issues and observed demand changes

2.1 Because of space constraints this section discusses only the highlights of a detailed context study and examination of changes in the operating framework for the Bank's infrastructure and capital market development work. The full detailed study is in Annex II.

2.2 **The Bank's authorization to lend directly to the private sector dates back to 1994 at a time when the region, faced with a dearth of long-term finance avenues, began opening the door to private participation.** Because of its particularities the infrastructure sector is much in need of long-term finance and involvement of institutions like the Bank: (i) it requires huge investments in immovable assets; (ii) infrastructure investments have long-maturity returns; and (iii) infrastructure ventures involve utility services that are essential for the public and for business, usually are regulated, and are subject to political considerations having to do with coverage, access cost, and monopoly power.

2.3 **The massive volumes of private investment mobilized in the region were not enough to counter cuts in government investment spending in the wake of macroeconomic stabilization and fiscal adjustment processes.** Though modest gains in infrastructure endowments and services have been documented in some areas, vast segments of the population are still underserved. Competitiveness gaps with the Asian countries in this sphere are widening.

2.4 **Though a series of events over the last 10 years have altered this market context there still is a need and ample scope for the Bank to act if it can adapt its intervention modalities and remedy a number of weaknesses observed in this evaluation.**

2.5 **One issue is that the initial expectations of some foreign investors who had gone into the region prospecting for growth opportunities never materialized, and it became clear just how vulnerable private investment was to macroeconomic and financial market fluctuations in the region and to regulatory policy shifts.** At the start of the present decade these foreign investors also were dealing with complicated situations in their home markets triggered by energy crises (in California, for instance) or corporate governance scandals, which left them even less keen to continue investing in the region, if they elected to stay in the region at all (e.g. Enron and Worldcom). In this environment there has been a move to consolidate infrastructure services players in the region and bring in prominent local groups. Growing finance opportunities in local capital markets are being tapped as well: in 2003, for instance, domestic structured bond issues in LAC—an insignificant vehicle in the region as recently as 1998—for the first time approximated cross-border issues.[4]

2.6 **In the 1990s banks in the developed countries were the leading private finance providers. Following a string of financial crises in emerging markets most of these institutions have elected to scale back their LAC exposure.** The banks in those countries that decided to stay active in the region are operating extremely cautiously, in most quarters focusing on financial advisory services and facilitating local capital market access. Many countries in the region that put through pension and insurance industry reforms now have a considerable pool of institutional savings in search of investment outlets. This opens up significant financing opportunities; the challenge is to develop instruments that satisfy those systems' requirements and afford assurances of acceptable financial performance.

2.7 **Improvements in regulatory agencies and climates have not kept pace with the surge in private investment; the reform and institution-strengthening agenda remains unfinished.** Despite some significant strides there still is great uncertainty for private agents as far as contract compliance is concerned. The weakest points are fledgling regulatory agencies and still-unstable rules particularly governing pricing, dispute settlement, financing of low-income segments' access, rising taxes, and regulations addressing the coexistence of publicly and privately owned providers.

2.8 **One threat to country efforts to bolster private sector participation is the negative view of a growing share of the public, stemming from the judgment of a lack of transparency in privatizations, rate adjustments, and the fact that population segments that previously received services at no cost now are being asked to pay for them.** This has had a strong influence on political actors, who have begun to explore other alternatives. Consequently, governments are taking a more gradual approach and looking to private participation models that attract less resistance, such as concessions or management contracts rather than asset sales. Countries also are exploring possibilities of boosting public sector investment and operations but given today's fiscal discipline imperatives and the state of the countries' debt there are no indications of any trend reversal. One notable development has been the strong demand for public-private partnerships, though it still is not clear how sustainable such partnerings are or whether this move will capitalize on the experience gained in legal and financing mechanisms essayed since the 1990s.

2.9 **Two other 1990s watchwords in LAC were decentralization and regional integration—twin political-economic processes that redrew the infrastructure project demand profile in many parts of the region.** As part of decentralization programs much of a nation's infrastructure base that a decade earlier had been in central government hands was either privatized or is today the responsibility of thousands of municipalities and hundreds of subnational governments. This creates a challenge by virtue of the sheer number of geographically scattered actors, and exacerbates regulatory problems. On the regional integration front, moves to deepen trade integration have given birth to physical integration ventures like the Initiative for Regional Infrastructure Integration in South America (IIRSA) and the Puebla-Panama Plan (PPP) in Central America, which pose the challenge of harmonizing regulations and competition regimes to make supranational infrastructure projects workable. To keep up with these demand shifts the Bank needs to be more proactive and make sure that its public and private sector sides work in concert.

B. Bank activity compared to other private sector development finance institutions and the financial markets

2.10 **The Bank's direct operations with the private sector have made it a prominent player in private sector infrastructure finance, especially among the development institutions (DIs) that operate in the region.** Together the DIs accounted for just over 20% of total financing mobilized to the private sector.[5] From 1995 until partway into 2003 PRI contributed 1.9% of total financing and roughly 5% of the aggregate finance mobilized.[6] Within the multilateral development community the IDB (via PRI) shared the lead with the IFC—an impressive achievement when one considers that PRI approved its first project in 1995 whereas the IFC has been operating since 1956. Brazil's Banco Nacional de Desenvolvimento Econômico e Social (BNDES) heads the overall list as the development agency with the largest regional share as well (6.4%), especially by dint of its role as finance provider for the late-1990s privatization process.

Table 2.1
Private infrastructure project finance: Development institution market share and leveraging (1995-2003)
(percentage of total financing and amounts in US$ million)

	Direct lending	% (1)	Total finance	% (2)	Leveraging (3)
IDB (PRI)	2,384	1.91%	6,201	4.98%	2.60
IFC	1,681	1.35%	5,881	4.72%	3.50
CAF	212	0.17%	1,150	0.92%	5.42
OPIC	827	0.66%	2,990	2.40%	3.62
BNDES	3,865	3.10%	8,003	6.43%	2.07
EIB	303	0.24%	443	0.36%	1.46
EBRD	80	0.06%	80	0.06%	1
MIGA	-	-	578	0.46%	NA
CDB	-	-	5	0.00%	NA
Total devt. inst. (DIs)	(a) 9,352	7.51%	(b) 25,275	20.29%	2.70
Total (incl. rest of market)	14,524		(c) 124,546		8.58

(1) (Direct lending by the institution)/(c)
(2) (Total finance mobilized by the institution)/(c)
(3) (Total finance mobilized by the institution)/(Direct lending by the institution)

(a) Total direct loans approved by the DIs listed.
(b) Total financing mobilized by the DIs listed.
(c) Total loans and guarantees (DIs+ rest of market).
Source: Compiled by OVE from the OVE Project Finance Database.

III. PROJECT ANALYSIS FINDINGS

3.1 **This chapter gives a consolidated account of the findings of OVE's detailed evaluation of Bank private sector projects,** referencing the evaluation dimensions addressed in the methodology adopted (relevance, effectiveness, risk management, efficiency, coherence, additionality, and evaluability), as explained in the Methodology Annex (Annex I).

A. Relevance

3.2 **The analysis found the private sector program to be highly relevant both in terms of the sectors in which it operates and the importance of the individual transactions.** More specifically: virtually all the projects were in sectors where the utility services gap was considerable and 80% of the projects themselves made a significant contribution, owing to the magnitude of the investment, to the subsector in which they were executed.

3.3 **Private sector operations' relevance was particularly marked in small economies, in which the Bank has been scaling up its work in the last three years.** More projects are being identified in the Group C and D countries specifically, their total having risen from 25% of total projects identified in 1995-2000 to 38% in 2001-2004. These countries' share of total approvals has climbed as well, from 18% to 30% over that same interval. These numbers attest to the increasing diversification of private sector work and more attention to the smaller economies, in which the relative impact of a given operation can be greater.

3.4 **Infrastructure has been the program's central focus, in keeping with the Bank's original mandate. In practice operations have been heavily concentrated in the energy and transportation sectors, which account for 83% of total direct resources approved.** The subsectors that have come in for most backing are power generation, transmission and distribution and toll roads and, to a lesser degree, ports. Interestingly, the Bank has had less of a presence in the communications area—one of the chief private investment targets in the region—since there has been more financing on offer in that sector.

3.5 **It was precisely in the communications sector—where the Bank had little experience and could not respond as quickly as the market—that there were problems with approved projects.** These operations had several things in common: (i) a business dynamic with more competitors; (ii) technology intensive businesses whose assets depreciate more quickly than in traditional infrastructure services; (iii) scant installed capacity and knowledge about this sector in the Bank to be able to avert and monitor risks; (iv) the Bank's relatively slow response capability, which can lead to adverse selection; and (v) no cofinance providers prepared to work with the Bank and weak structuring of operations. With respect to these poorly performing projects OVE was told by the PRI management team that it had been a strategic decision in the Bank's senior management that interventions in this area be limited to the most "difficult and high development impact" operations.

B. Effectiveness

3.6 **The object of evaluating the private sector program's effectiveness was to measure achievement of objectives in two major dimensions: the program's development effectiveness generally and its effectiveness at the level of an enterprise taking part in a Bank-funded project.** The measure of the program's effectiveness from a development standpoint is its ability to identify and remedy the market failures that made the Bank's intervention necessary, especially to demonstrate that the private investments were viable, attracting operators and financing to narrow the infrastructure services gap for the population at large and for businesses. The focus of the transaction-level effectiveness assessment is a project's financial performance and whether, and to what extent, the financial results were satisfactory for both the investors and finance providers.

3.7 **The analysis of the evaluated projects' development effectiveness indicated that, in the aggregate and on balance, they have had a positive effect.** The evaluation team rated approximately two thirds of the projects high or moderately high for effectiveness because they had opened the way to more private investment flows and long-term financing, primarily to make up infrastructure service shortfalls.

3.8 **The innovativeness level of Bank-funded private sector projects is high: one in three operations was the first transaction with a private agent in the respective subsector in a country.** In a similar percentage of operations the project was the first to feature multilateral agency participation or backing—a clear testament to the Bank's pioneering role. This also goes some way toward explaining the regulatory problems encountered, since some of these sectors had only recently begun to open up. A final innovation indicator is that one in five projects was using finance instruments hitherto untried in the country.

3.9 **In a number of projects this innovation strength translated into a substantial demonstration effect. Massive volumes of private capital were leveraged for the infrastructure sector, with replications in subsequent investments.** Approximately one in four projects expedited or spearheaded a given subsector's opening up to other private sector agents. Likewise, one in four operations helped spur local capital market development. Commendable as this contribution is, there still is ample scope to connect operations more into local markets, boost local investor participation, and foster local currency financing vehicles.

3.10 **The lesson taught by successful experiences that were highly effective by dint of their demonstration effect is that a medium-term commitment is needed on the Bank's part. In the larger countries that effect was magnified by financing a "critical mass" of projects whose result was, on balance, positive.** The ingredients that went into these accomplishments were work to foster development of operators and attract more investment and interest from finance providers, satisfied consumers, and a government keen to build on successful ventures. The road project cluster in Brazil, discussed in Box 3.1, is a case in point.

Box 3.1. A highly effective project cluster: The Brazilian state roads program

Budget strictures since the mid-1990s have left Brazil with limited resources to improve its roads and highways. Since the public coffers were strained the states of São Paulo and Rio de Janeiro launched a highway concession program in a bid to attract private investors. PRI financed five highway projects in these two states, with total investments equal to one quarter of transportation investment and covering 8% of the 8,190 kilometers put out to concession.

Though not all these ventures yielded high returns the program can be credited with two major accomplishments: it helped consolidate a core group of companies with solid road business know-how and it showed that the road concession business can be attractive. Brazil's new government is launching an ambitious concession program in which some of the companies interviewed are interested in competing. Meanwhile, various other state governments are following São Paulo and Rio de Janeiro's lead. Brazil's roads program has impacted the capital market as well, having shown highway concessions to be bankable investments especially if an investor goes into a diversified set of concessions. One of the most successful concession ventures has consolidated its operations under a single enterprise and offered shares on the stock exchange; it now is readying a long-term bond issue. Another business group that also received Bank funding is apparently preparing to follow suit.

3.11 **A quantitative review performed by OVE referencing a large private infrastructure finance database yielded findings consistent with those of the project-specific analysis work, evidencing the existence of a demonstration effect in the Bank's activities.** Using an explicative model of private infrastructure investment in the region[7] this empirical study established the existence of a significant positive coefficient: when there has been a direct Bank private sector project in a given sector in a country other financial institutions then are more likely to finance projects in the same sector and country (full study in Annex III, section 2).

3.12 **However, since not all the projects had a beneficial impact such as a demonstration effect the Bank needs to be very selective in its interventions, particularly in small economies.** Though OVE rated 64% of the operations it reviewed as having a high or very high impact on the country's business climate, in one fourth of those cases, said impact was negative.

3.13 **According to the project analysis findings 1 in every 10 operations was a Bank response to an energy crisis (particularly involving thermal power generation), with negative outturns for investors and lenders.** Undertaken in exigent circumstances and in inadequate, unstable regulatory environments, these operations ran into serious problems, with negative outcomes for sponsors, lenders, and governments. Such circumstances thus call for other kinds of instruments that can address such situations promptly and not jeopardize the demonstration-effect potential of the Bank's intervention in its direct private sector operations.

3.14 **The evaluation found that, on the whole, Bank-backed projects have delivered the agreed infrastructure on schedule and for the most part the public and businesses are receiving acceptable-quality services.** In terms of product delivery, most (88%) of the project works have been completed, 10% are still in construction, and 2% are finished but not yet operational. On the service delivery side the majority (53%) of projects are within or ahead of service production or capacity use projections but a sizable percentage (33%[8]) are operating below projections for one of two main reasons: either the demand was overestimated or a lack or shortage of inputs of some kind is impeding operation of these services as originally envisaged. In every case, however, the services on offer were satisfactory, meeting the respective regulatory standards.

3.15 **After nearly 10 years in operation the private sector program has funded some 283,000 new water and sewer connections, roughly 7,000 MW of installed electric capacity, 1,019 km of power transmission lines, one million new electricity hookups, 950 km of roads and highways, 7,372 km of gas pipelines, telephone connections for 93,000 new subscribers, and five new berths in two new commercial ports.**[9] However, this represents a small percentage of installed capacity in a region with such enormous coverage and capacity shortfalls, as discussed in section 2 of Annex III, and the gains represented by the additional capacity the Bank has delivered were modest vis-à-vis the importance of an enabling regulatory environment and projects exerting a positive, investment-spurring demonstration effect.

3.16 **On the question of timing of Bank interventions, the analysis of private sector projects revealed the great majority to have been well-timed politically and macroeconomically but less so from a regulatory standpoint.** In close to half the projects (44%) there was some regulatory issue or other stemming from situations of: (i) limited coordination with pertinent areas elsewhere in the Bank to foster a sound regulatory framework and/or (ii) existence of a set of projects outside the regulatory framework and doing nothing to help improve it.

3.17 **Beyond the three effectiveness measures discussed above—demonstration effect, achievement of physical objectives, and project timing—is a fourth that in theory encapsulates an operation's effectiveness: its economic rate of return. This indicator should convey the sum total of the project's costs and benefits to society at large and provide a conclusive diagnosis of what the investment has done to improve economic welfare.**[10] In by far the majority (85%) of the projects reviewed by the evaluation team an ex ante economic analysis had been performed, with anticipated rates of return averaging 20%.[11] According to the team's estimates, one quarter (26%) of the projects appear to be falling short of the expected return rate and perhaps another quarter (23%) are achieving it.[12] It is too early for conjectures about the other operations.

3.18 **The second "effectiveness" category examined was the effectiveness of individual transactions, to gauge projects' outcomes for sponsors and for the Bank.**

3.19 **In a typical project the sponsor or its financial advisor performs the ex ante financial analysis. The modeling done for this purpose presents problems when it comes to simulating other scenarios.** The models are detailed in the extreme—enough in some cases to serve as budget control sheets rather than just an analytical tool. Unfortunately this makes the models too "heavy" to run simulations and/or readily compare different scenarios. A compounding problem is the generally poor (if any) documentation, which makes it hard for an external observer to verify the model's logic and gauge whether it operates correctly. A review done as part of the evaluation revealed basic consistency problems in some models when the team tried to run simple simulations.[13]

3.20 **The way that the exchange rate is dealt with in sensitivity analyses appears to be unrealistic; this issue warrants special attention given what happened in the region.** Simulations frequently assume a one-time currency devaluation, usually in the 10%-30% range, typically in year 1 or year 2 of the project. This assumption is not borne out in practice: over the last 12 years the 6 countries receiving the largest volumes of Bank private sector program funding saw their currencies depreciate 12.5% annually, with a standard deviation double that figure. In cumulative terms, between 1997 and 2003 the currencies of Argentina, Brazil, and Colombia (to cite three examples) depreciated over 100%.

3.21 **On average, ex ante calculations had put project financial rates of return at 18.7%; in about half the projects the actual return is trailing the estimate.**[14] According to a thorough financial analysis of a sample of projects, cashflow generation performance is far behind the projections.[15] A first surprising finding here was that there is little readily accessible comparable data on the performance of key variables that depict the financial health of an investment over time. The data are scattered and it is no small task to consolidate and compare them. A second finding is that in the majority of projects (even those termed "successful") the EBITDA or operating cash flow being generated is significantly below the estimates.[16]

Table 3.1. Cashflow generation: actual versus projected

EBITDA Actual/Projected

	1998	1999	2000	2001	2002	2003	CUMULATIVE
BRAZIL a/							
TRANSPORT	222%	66%	93%	61%	46%	45%	56%
ENERGY				47%	-88%	99%	30%
TOTAL	222%	66%	93%	58%	2%	65%	49%
PERU b/							
ENERGY			107%	116%	111%	83%	143%
URUGUAY c/							
TRANSPORT	36%	26%	23%	27%	5%	14%	20%
OTHER							
ENERGY A d/			81%	105%	107%	NA	98%
ENERGY B e/				1%	80%	-21%	19%
ENERGY C f/				109%	101%	104%	106%
ENERGY D g/	44%	45%	NA	NA	NA	NA	49%

Cash Flow Actual/Projected

	1998	1999	2000	2001	2002	2003	CUMULATIVE
BRAZIL							
TRANSPORT	702%	78%	78%	72%	58%	51%	66%
ENERGY				-345%	-23%	92%	0%
TOTAL	702%	78%	78%	8%	29%	65%	49%
PERU							
ENERGY			93%	112%	-21%	103%	86%
URUGUAY c/							
TRANSPORT	119%	77%	83%	47%	15%	26%	58%
OTHER							
ENERGY A			NA	NA	NA	NA	NA
ENERGY B				NA	NA	NA	NA
ENERGY C				172%	232%	218%	197%
ENERGY D	NA	NA	NA	NA	NA	NA	NA

a/ Five energy projects and five highway projects. Data incomplete for almost all of them. Comparison done only for periods for which projected and real data at hand. If data missing, not counted. Three projects missing some 2003 data.
b/ Two energy projects; fairly complete data for both.
c/ Two transportation projects, only one with complete data. No original projections for the second.
d/ Information only for three of six years and only comparable for EBITDA. No figures for 2003.
e/ Information only for three of four years and only comparable for EBITDA.
f/ Iinformation only for three of four years.
g/ Information only for four of eight years, only EBITDA. No figures for 2003. Cumulative includes 1996-1999.

3.22 **Investment quality in the private sector portfolio was moderate, influenced notably by projects affected by the Argentine crisis.**[17] In close to half (47%) of the signed projects evaluated one or more positive covenants were not being performed. For the most part this likely has to do with annual reports or reporting requirements. Though this does not necessarily affect credit quality the aforementioned figure is clearly higher than desirable. Just under a third of the loans (29%) are not performing one or more financial covenants—an equally undesirable showing. Negative covenants (debt ratios, dividend payments, asset purchases or encumbrances, guarantees of third-party debt, etc.) are not being fulfilled in a quarter (24%) of the loans. Serious breaches were observed in one in four projects—payment arrears, court-ordered collection or restructuring, particularly in the case of Argentina. This is a high ratio when one considers that (i) these are cases of extreme default and (ii) a fixed-income portfolio with moderate spreads leaves scant margin for error.

C. Risk management

3.23 **The risks that came up most frequently (arising in half the projects) were those of a regulatory and policy nature, as discussed elsewhere in this report in**

the section on additionality. In one in three projects there were occurrences of technical risk as well—something not observed in other project finance analysis exercises.[18] Typically these were construction-related contingencies that came up at the start of the project. The mitigation measures in place in most of the operations were able to avert or contain delays and cost overruns. This analysis points up the importance of continual monitoring, beyond the initial construction period, since this kind of operation is vulnerable to external events and the consequences of a drawn-out approval procedure that heightens the risk of adverse selection.

3.24 A set of interrelated issues are important considerations in an analysis of risk incidence and management in the private sector portfolio. Chief among them are the credit guarantee package, the information system on portfolio companies' financial reporting, in-house risk scoring of individual investments, some latent portfolio risks, and the creation of an independent risk assessment unit.

1. The package of credit guarantees

3.25 **One feature of the Bank's private sector work is the conservative approach it has demonstrated in generating operations backed by adequate guarantees. This has been put to the test in challenging circumstances.** When macroeconomic downturns have created problems, in Argentina for instance, the Bank has had the backing of credit guarantees of the principal sponsors so recovery levels were good. And since the operations concentration was infrastructure investment finance which involves services that are essential to the public and to business activity, recovery prospects were strong. This was not the case for projects in more competitive sectors, where recoveries were far inferior. Indeed, one operation was written off, the first such occurrence in the Bank's direct private sector program.

2. Corporate financial reporting system

3.26 **The financial information system of the companies that make up the Bank's private sector portfolio is very uneven, unstandardized and generally poor. There is no one place to go for electronic data on basic financial statements for most of the companies from a project's outset.** To reconstruct this kind of series which are essential to track and understand an investment's performance, the evaluation team had to assemble data from a variety of sources, with the attendant risk of error. Much of the information is not current or contains large gaps.[19] For a private sector portfolio the size of the Bank's, quarterly financial statements from the outset of a project are crucial. These need to be readily retrievable and analyzable when the data are exported to any commonly used platform. Audited quarterly and annual statements should be at hand within 90 and 120 days after quarter-end and year-end, respectively.

3. Internal risk rating system

3.27 **There is room for improvement of three facets of the current in-house risk scoring system: more refined gradation, consistency of financial criteria, and a forward vision.** On the matter of gradation, the system now in use has four categories: "Impaired", "Watch List", "Satisfactory" and "Excellent." The two extremes are self-explanatory; the other two ratings are insufficiently informative of a loan's anticipated trend condition. Furthermore, the decision to downrate a loan from "Satisfactory" to "Watch List" is a hard one to take since it signals a significant deterioration in the portfolio, whereupon more resources have to be committed to monitor the operation more closely. As for financial risk criteria, a "Satisfactory" rating often provides a sense of security that is not supported by reality and occasionally is arbitrary.[20] In current practice, if the security appears to be solid, i.e., the "size" of the guarantors is substantially larger than the capital committed in the project, the operation is rated "Satisfactory" rather than "Watch List" even if it has problems. While this may be reasonable it is risky and uninformative since many commitments like the ones sponsors assume when they guarantee all or part of the Bank's loan may not appear on their balance sheets.[21] A third way to improve the risk rating system would be some form of forward opinion of the kind the international rating agencies provide.

4. Latent risks

3.28 **The evaluation team found no indication of any Bank effort or system to measure the private sector portfolio's vulnerability to exogenous changes that affect large "blocks" of loans.** By its very nature the private sector program focuses on a handful of sectors which all are exposed to the same risks, so the risks in various facets of the portfolio correlate quite closely. Oil prices are the most obvious example in a portfolio that is 83% invested in the energy and transportation sectors. Interest rate increases, which can simultaneously affect two thirds of the portfolio, are another risk: a return to 1999-2000 LIBOR levels would double the interest costs of the variable-rate loans in the Bank's private sector portfolio,[22] negatively impacting a number of loans that currently have acceptable debt service coverage ratios (>1.2–1.5).

5. Creation of an independent risk management unit

3.29 **A positive development observed in the evaluation is Management's move to strengthen risk management capacity in keeping with the Governors' 2001 recommendations.** Toward the end of 2002 the Bank created a Private Sector Credit Risk Assessment Office (EVP/CRA) independent of PRI which reports directly to the Executive Vice President. In operation since the first quarter of 2003, this office currently has a staff of four. From the outset it has participated in all committees that involve Bank private sector projects, reviewing every proposed operation, evaluating PRI investment officers' risk analyses, guarantee structures, proposed interest spreads, and estimated returns. In June 2004 Management established a Special Operations Committee to analyze, discuss, and recommend significant actions for problem loans. Members of this committee, chaired by the Executive Vice President, are the Finance Manager, General Counsel, Manager of the Private Sector Department, Regional Operations Manager, Chief of the Office of the Presidency, and Chief of the Private Sector Credit Risk Assessment Office.

D. Additionality

3.30 **Additionality is a fundamental feature of the Bank's private sector program, comprising as it does a set of "competitive advantages" of the Bank for this kind of interventions. It is described in terms of value added by the Bank's contribution to enhance a project's long-range sustainability prospects or its development benefits, as defined in document GN-2172 approved by the Board.** Matching the outline of that document the evaluation team did a thorough analysis of four forms of additionality: (i) financial, (ii) environmental and social, (iii) regulatory and policy, and (iv) corporate governance enhancement. An analysis was done of the value added by the Bank in operations preparation, comparing with the original proposals and with comparable transactions arranged in the market. Actual implementation performance was compared against sponsors' and co-lenders' expectations.

1. Financial additionality

3.31 **Because of the limited long-term credit on offer in the region and its underdeveloped capital markets the additionality of Bank operations was especially prized in the purely financial sphere.** Over 90% of sponsors surveyed said they look to the Bank because it can supply funds at tenors that they cannot secure on local financial markets. The absence of other concrete financing options was cited by half the sponsors as being relevant or very relevant in their decision to work with the Bank. In a very significant number of projects—three in four—the Bank's repayment term was longer than borrowers could have obtained in the markets where the project was operating, according to comparisons with information on deals transacted in those markets. On average, for the same transaction the Bank's repayment period has been 19 months longer than what private co-lenders were offering under the Bank's umbrella.

3.32 **The analysis of Bank loan tenors and tenors in the rest of the market revealed a narrowing of the gap between the two as average market tenors have increased.** Between 1995 and 2003, 90% of the Bank's loans had repayment terms of eight years or longer, compared to just 31% of private sector loans. Except in the last two years, the Bank's average loan maturity remained relatively unchanged whereas market maturities increased slowly but steadily. In 2002 both Bank and market maturities increased; in 2003 the trend turned around, average market maturities having lengthened significantly while Bank maturities became shorter,[23] taking the differential to its narrowest.

3.33 **Another feature of the financial additionality of the Bank's private sector program is its leveraging capacity, though it still has a very limited role in**

domestic resource mobilization, notably of pension funds and resources of other institutional investors. In half the projects mobilizable local financial resources were identified prior to the operation and in every case these materialized. The majority of local participants are development banks (37%) or other local commercial banks (48%) followed at some distance by pension funds (26%). There definitely is room here for the Bank to step in and take financial leadership with innovative capital market operations to fill in some of the existing gaps.[24] As discussed in the previous chapter and documented in Annex I, pension and insurance fund pools offer tremendous long-term investment prospects.

3.34 **There is no clear trend in resource mobilization. This coincides with the sharp reduction in infrastructure lending to the region, which in turn attests to the Bank's cyclical behavior, following the finance market.** Up until 2002 resource mobilization appears to have climbed steadily but the figures plunge in 2003-2004. On average over that entire period every dollar lent by the Bank generated US$2.40 in other lending; every dollar in guarantees generated US$1.90 in loans. The leveraging ratio for guarantees climbed considerably in recent years with the structuring of partial guarantees: in 2002 and 2003, on average, every dollar in guarantees generated US$4.40 and US$3.50, respectively, in loans.

2. Social and environmental additionality

3.35 **The evaluation team found that Bank involvement in a private sector venture prompts improvements in corporate behavior, raising standards and awareness of environmental, social, and workplace safety issues at the local level.** Forty-two percent (42%) of sponsors interviewed acknowledged that they had approached the Bank for the sake of "image" or "reputation." Half of them perceive the Bank's oversight of environmental, labor, and social aspects as something positive and image-enhancing for the company. But there is some ambiguity here: an even higher percentage of the sponsors queried (76%) also see the Bank's social and environmental requirements as a major obstacle to project preparation and execution. According to the evaluation findings the work and measures needed to satisfy environmental and social eligibility conditions held up project structuring and approval in 16% of operations.

3.36 **The Bank's role on the environmental and social impact side is particularly welcomed by the co-lenders surveyed, 66% of whom said that Bank involvement improved the social and environmental features of the respective projects.** The Bank unquestionably plays a fundamental role in the development of projects' Environmental and Social Management Plans (ESMPs), in defining programs under those plans, and in the adoption of international standards, social programs, and workplace health and safety standards. This form of Bank additionality is important as well for the involuntary resettlement processes that form part of some infrastructure megaprojects. The systematization of compliance tracking and monitoring, especially since 1998, has reinforced this contribution.[25]

3. Additionality in regulatory policy risk mitigation

3.37 **The chance to protect against regulatory policy risks is one of the prime reasons why both sponsors and financial partners want the Bank to participate in their projects.** That was the top consideration for 63% of co-lenders and ranked second (after the financing dimension) for 79% of sponsors—an indication that there still are weak points in the region's regulatory and institutional frameworks despite reforms and privatization advances. The fact that there is some public sector connection in half the projects evaluated, whether as sponsor, supplier or buyer, suggests that private participation is still inconclusive and there remains a significant element of regulatory policy risk.

3.38 **The above-mentioned responses notwithstanding, most sponsors and co-lenders gave the Bank's regulatory policy risk mitigation an unsatisfactory rating.** According to the survey data this was the opinion of over half the sponsors (55%) and co-lenders (63%), their original expectations—what prompted them to approach the Bank in the first place—not having been met.[26] This was confirmed by information elicited during the OVE team's country visits and talks with sponsors and co-lenders. Interestingly, that view is shared by close to half (48%) of the non-PRI Bank staffers surveyed, who feel that the Bank's effectiveness in remedying regulatory problems is "poor" or "moderately poor." Only 17% of PRI interviewees concur. However, the PRI management team told OVE that the Bank had not just an active role but a leadership role within the multilateral community during systemic crises such as the Argentina and Dominican Republic episodes.

3.39 **According to the evaluation findings half the signed projects had been affected by regulatory policy events and, once those situations materialized, the Bank took action in only one in three cases.**[27] When it did act its effectiveness was limited: in only 40% of such events was the outcome favorable. In other words, a positive outcome was achieved in fewer than 15% of the problem cases.[28] In some instances the Bank did not react as problems gestated so their solution was put off. Because of this late-stage Bank intervention it was much harder to resolve the issues and, just as serious, sponsors lost confidence in the Bank's ability to resolve them. In small economies Bank participation in projects in any given industry where there were opposing interests at work in different segments generated conflictive positions that limited its scope of action. Elsewhere the reason for its ineffectiveness was a lack of direct contact with the pertinent government agency or authority and perhaps the reality of being unable to affect political decisions. In more widespread situations like the Argentina crisis there also are reports of other development agencies' failure to help resolve problems, which is one powerful reason for the declining demand for political risk insurance.[29]

3.40 **One issue about which the Bank needs to be very careful in this sphere is the potential for conflict of interest when the Bank is simultaneously a "political and regulatory risk mitigator" for private companies and lenders and "impartial advisor" to the government.** In an ideal world (with perfect sponsors, projects, and regulatory frameworks) there should be no real conflict of interest since, in the long run, obeying sound regulations will benefit sponsors and society at large. But in the short run or in less ideal scenarios there is a potential for conflicts of interest that could hurt the Bank's image as well as create friction among staff in-house, particularly when there is no shared diagnostic or strategies. Institutions such as the Asian Development Bank have addressed this eventuality in their private sector development strategies,[30] having understood that when the agency is lending to an operator its impartiality—or at least its image—as a policy advisor could be compromised. In the IDB's case, a sizable percentage of the Bank officials (38%) and PRI staffers (32%) surveyed during the evaluation think that this type of conflict exists. In some scenarios if the Bank were to actively exercise its role as defender of a concessionaire's interests it could be seen to be favoring one role over the other, seriously affecting perceptions of the Bank down the road.

4. Corporate governance additionality

3.41 **The issue of corporate governance has been coming in for increasing attention in the projects reviewed, echoing market trends, but the Bank needs to take particular care in some operations.** Project finance being the typical infrastructure project funding format, prudential management is a must in related-party transactions where companies that ultimately will have dealings with the project are usually shareholders in the lending companies. This is not a *per se* negative element provided that: (i) there are suitable mechanisms for arm's length transacting with the related parties; (ii) the transaction's merits and drawbacks relative to other "untied" possibilities have been determined; and (iii) the Bank's role in reviewing and/or approving the transaction is clear. Though the majority of projects contain adequate mitigation measures the evaluation team identified one in every five operations it reviewed as requiring extra care in operations monitoring and assembling information on experiences to structure future transactions.

E. Efficiency

3.42 **In their analysis of efficiency indicators the evaluation team focused on the time it takes to develop Bank interventions and what it costs.** Specific items looked at were the project generation and processing process, how quickly the Bank responds to sponsors' and co-lenders' needs, analysis and transaction costs both for sponsors and for the Bank, the Bank's project generation and processing agility, and the leverage effect of Bank resources.

3.43 **Though the Bank has scaled up private sector project promotion and origination work in recent years, taking in more countries and increasing professional staff time devoted to these tasks,[31] in clients' view the institution has not been very proactive.** According to the data processed the Bank initiated contact in just 6% of private sector projects; fully 35% of operations were sponsor-initiated. In the other cases it was another sponsor, the country authorities, a co-lender, or the sponsor's financial advisor who brought the project to PRI. In the case of cofinance providers the survey confirms that only 34% of projects were PRI-initiated. Many of the co-lenders had already been involved in the venture.

Forty-two percent (42%) of non-PRI Bank interviewees engaged in infrastructure work think that PRI should "increase its business generation capacity."

3.44 **This "nonproactiveness" in business prospecting was apparent also in projects that came out of tendering processes: in just one in five operations in which concessions were bid out did the Bank (by way of its private sector program) come on the scene before the concession was awarded and offer financing to all the competitors.** Generally, then, the Bank's program is coming into the picture after a concession is awarded, thereby ceding the associated business prospects to other agencies. This late-stage intervention also creates more difficulties for the countries and subsequently for the Bank itself, which has had no input when tender concession documents were being developed to be able to generate bankable projects. In several projects that it visited the evaluation team observed social and environmental impact problems created when elements not addressed in accordance with later Bank requirements (e.g. public consultation, environmental impact assessments) had to be redone, adding to the cost and holding up the project. The benefit of an early announcement of the Bank's interest in participating in financing a concession is that this lowers the risk perception and can help make the process more competitive and more transparent. Ultimately this translates into benefits for the population at large.

3.45 **In its review of private sector project processing times the evaluation team found that 25 months, on average, elapse from the time a project is declared eligible until the date of its first disbursement. Though this is half the average time it takes to process a Bank-financed public sector infrastructure operation it is 66% longer than in other multilateral organizations.[32] This is far longer than a private sector clientele is prepared to wait and far short of the expectations the Bank itself has created (see Web site).[33]** Furthermore, it is taking at least four months on average from the date the Bank first responds to a sponsor who has approached it until the project is pronounced eligible.[34] This whole protracted process is a serious constraint for private sector loans tied to investment projects, most of which entail specific undertakings with the government, a regulator or some other agency, particularly for sponsors without the equity backing or access to commercial bridge loans to be able to deliver on construction commitments. The fact that in the average works project the construction work is complete a few months after the contract is signed would indicate that work began well before the contract signing date, creating a perception of a takeout financing arrangement.[35]

Table 3.2. Bank response time (months)

FROM	UNTIL	Max.	Private sector average	Public sector average - infrastructure
First contact	Eligibility	43	4	NA
Eligibility	Loan Committee	29	9	26
Loan Committee	Approval	21	7	2
Approval	Signature	21	6	8
Signature	First disbursement	19	3	13
First disbursement	Technical completion	41	6	NA

3.46 **Since the Bank's private sector projects execute much more briskly than its public sector operations its responses have to be quicker.** For instance, within 18 months after the first disbursement private sector projects are 80% disbursed, the bulk of construction work is complete and services are operational. Public sector infrastructure projects are only 20% disbursed within that same time span.

3.47 **The approval process for private sector projects—similar to the stages for a public sector operation—is substantially more cumbersome than in other development agencies that work with the private sector.** To move a project through these internal steps staff have to spend a great deal of time preparing for committees, so the in-house costs end up almost on a par with public sector operations.[36] A comparative analysis of IDB, EBRD, IFC, and IIC private sector operations approval processes shows that though a project passes through the same stages in all these agencies (eligibility, preliminary approval, final approval), the other institutions typically require a single committee at each stage, whereas a Bank project proposal moves through anywhere from three to five committees in a given phase. An important consideration here is that the difficulties in this protracted exercise stem also from the lack of a shared diagnostic and the different visions prevailing in the Bank's public and private sector areas, an issue discussed in section E of this chapter.

3.48 **It is evident from an analysis of the more than 300 direct private sector projects the Bank identified for processing that the number of processing stages and inevitable attendant delays prompted many prospective sponsors to turn to other sources of finance or simply give up on their attempt to put together a project.**[37] The evaluation team found that because the Bank's process is so cumbersome nearly one in three project sponsors is opting for alternative financing avenues or giving up on the project even before learning whether it is eligible. Even more worrisome, in close to half the projects that are declared eligible and on which work is proceeding, consuming Bank staff's time and sponsors' money, the sponsor elects to back out. Even after projects are approved one fifth of sponsors decline the Bank's loan and secure financing elsewhere. An important sidebar here is that it took a considerable research effort on the evaluation team's part to come up with these findings, there being no readily available information on what happens in the process or the reasons for turning down a project or its fate. This impedes institutional learning and makes the process opaque.

3.49 **The sponsors and co-lenders surveyed confirm that the speed of the Bank's response was a problem. This poses a risk of adverse selection.** A large percentage of sponsors (63%) and co-lenders (50%) rated the Bank's loan approval, structuring, and disbursement speed as "poor" or "moderately poor."[38] Broadly speaking this suggests that clients see the Bank as an organization that is not prepared to do what it takes to adapt to the private sector dynamic. This was confirmed by the PRI staff interviewed, two in three of whom felt that the Bank will have to improve its response or run the risk of taking on only operations that have nowhere else to go.[39]

3.50 **The second major theme in the efficiency analysis was high transaction costs—US$1.4 million, on average—that are passed on to sponsors, there being no evidence of any systematic move to contain these costs.** When the Bank launched its private sector program it opted for a work model that outsources the bulk of technical due diligence, particularly legal, engineering, environmental, and economic work. Other multilateral organizations afford greater certainty about the maximum these processes will cost (frequently including the use of hard caps), and they reduce the cost to sponsors by doing expensive components in-house—legal and engineering work, for instance. When the evaluation team compared Bank costs to those of similar institutions it found the latter to be significantly lower, mostly because of the international legal advisory services component.

Table 3.3. Actual analysis costs and sponsor perception of costs[40]
(US$, paid by sponsor)

	Average US$	Standard deviation US$	Sponsor perception	
			Expensive and Very Expensive	Normal
Economic analysis	61,600	44,468	48%	52%
Engineering analysis	108,400	144,892	59%	41%
Local legal counsel	189,400	155,499	64%	35%
Environmental analysis	165,000	144,145	69%	31%
International legal counsel[41]	911,700	832,917	94%	6%

3.51 **The combination of the sluggish pace of project processing and high analysis costs are a major barrier to entry for those sponsors (usually local) who do not have the financial strength to make it through to the end, as well as a serious constraint for prospective smaller-scale projects.** From this standpoint, transaction costs are directly impacting the pursuit of the mandate received from the Governors in 2001 to scale up activity in the Group C and D countries. Given the key-services outsourcing option it is noteworthy that there is no centralized record of the costs of these services by project, nor are systems already in place in the Bank being used (e.g. the CONDAT system) to record hirings of individual consultants and consulting firms, or even PRI's own PRIS system.[42] This precludes any comparative analysis of service quality and cost. Moreover, no feedback is sought from clients on the services' quality, effectiveness, etc.

3.52 **Overall, the Bank's modus operandi ends up being very expensive for the client and, in the absence of hard caps, it adds another element of uncertainty.** In practical terms this has affected working relations with sponsors, who feel that the Bank is making no particular effort to contain costs. The fact that in 80% of cases where a firm is commissioned to do social and environmental due diligence, including development of the project's monitoring work plan, the same firm goes on to provide the monitoring services only serves to magnify the sponsors' perception.[43] In the majority of operations the attorneys, independent engineers, and insurance consultants engaged for due diligence also are hired for the project's in-process monitoring.[44]

F. Coherence

3.53 **Because there is no common diagnostic within the Bank regarding private sector work, in practice many projects developed by PRI are perceived elsewhere in the Bank as commercial transactions with no development dimension.** The following are some salient findings of the staff survey: (i) other parts of the Bank are relatively unfamiliar with the Bank's private sector work and its outcomes; (ii) that work is very negatively perceived; and (iii) PRI is perceived as working fundamentally to make private concessionaires' ventures profitable. This has repercussions: (i) it increases the possibility of PRI and other sectors of the Bank having conflicting interests after a project is developed; (ii) when a conflict of interest does arise it creates a dilemma for dealings with the country; and (iii) the storehouse of experience amassed under one roof is not being tapped.

3.54 **One advance on the programming front is PRI's increasing participation in programming missions since 2001. However, only 25% of private sector projects were anticipated in the country program.** Overall there appears to be little country-level coordination between PRI projects and public sector projects or technical cooperation work (primarily MIF operations). Except in isolated instances or when support was provided to address a crisis there is no indication of any consistent effort to arrange exercises in which these sectors of the Bank could share experiences and lessons learned from past operations, to coordinate efforts to tackle sector or country issues.

3.55 **The process to have an operation declared eligible reveals the tension existing between PRI work and the rest of the Bank.** According to the evaluation team's analysis four months went by on average between first contact and Programming Committee declaration of a project's eligibility. However, for countries where there are more widely differing views, especially in the smaller countries, an eligibility confirmation takes double that time.

3.56 **A thorough analysis of private sector interventions revealed limited coordination with other Bank operations and little cross-tapping of experience and knowledge generated by the rest of the Bank and by PRI itself to help advance countries' development objectives.** The evaluation team observed no complementarity or synergy between the Bank's PRI and non-PRI operations[45] and no consistent indication of sequencing of operations to start out with a sector reform (legal, regulatory, and institutional frameworks) and culminate in, or in the final stage be supported by, private sector transactions.[46]

3.57 **A further example of this limited coordination and capacity use is the case of the Country Offices, which usually are far removed from the private sector transaction development and administration exercise.** This leaves the Bank's image particularly vulnerable in the countries because when an environmental, financial, corporate governance or other issue arises which impacts society and public opinion the Country Representatives and their teams might appear ill-prepared to assist or respond quickly and appropriately. From a transaction standpoint this lack of communication could mean missed opportunities for the Bank to promote its activities, seek out new concession investment avenues, enhance dialogue with the authorities, monitor risk, and so on—these being key facets of the Bank's business model for its private sector work.[47]

3.58 **The fact that in 50% of private sector projects there is some direct connection with a state entity, whether as provider, off-taker, or perhaps even project co-sponsor, is another reason why closer collaboration between PRI and the rest of the Bank is so important.** In other words, though a project may formally be a "private sector operation" there will be a close tie-in to the country's public sector—hence the need for fluid dialogue and open cooperation with that state agency counterpart in the Bank's public sector area.

3.59 **One advance observed on the institutional front is the active operation of the Private Sector Coordination Committee (PSCC). Such a committee had been envisaged since the Eighth Replenishment in 1994 but it was late 2002 before it began operating with any frequency** as a forum for strategy and operational coordination of all Bank-related private sector activity, including IIC and MIF work. The evaluation team noted evidence of concrete PSCC moves to resolve issues in PRI problem projects and help clarify eligibility criteria regarding previously resolved matters. The committee also has coordinated progress and performance measurement report preparation for the Private Sector Action Plan in the Group C and D Countries. Since 2003 responsibility for private sector project eligibility determinations rests with this committee rather than the Programming Committee.[48]

G. Evaluability

3.60 **Projects' evaluability in terms of economic development impact was one focus of the analysis work, to ascertain to what degree indicators of market failures had been identified and how these were tracked to be able to determine the**

Bank's contribution to remedying them. This is important because commercially viable private projects with positive rates of return can be financed by the Bank or by the private sector itself; simply substituting Bank finance for private finance does not provide a developmental benefit.

3.61 **In the individual rationales offered for most Bank-backed private sector operations there was insufficient evidence of market failures such as would warrant the Bank's involvement.** Usually projects were justified in terms of additionality, focusing on what the Bank would contribute via the proposed operation but not referencing what was happening in the market or comparing with other operations in the sector and/or country. The evaluation team found limited analytical back-up of data analysis, for instance of commercial transaction databases, to more clearly explicate the Bank's role in supporting a given intervention and to what extent it is "pushing the edge" to help remedy market failures. Moreover, there usually is no clear account of how the intervention fits into a sector and/or country program.

3.62 **One distinctive feature of private sector operations compared to those developed elsewhere in the Bank is that economic rate of return (ERR) is estimated for virtually all private projects (98%).[49] However, this calculation did not appear to be a major decision factor**, the evaluation team having found no evidence of any project being turned down because of its ERR.[50] This scant attention to economic return carries through into project implementation where there is very limited tracking of ERR-affecting development variables. The model used to come up with ERR was ascertainable in only half the operations reviewed—though when information on the ERR methodology was at hand the method usually was adequate.[51] In 70% of projects the information needed to recalculate ERR was or is not being compiled; in 26% of operations only partial information has been gathered. This means that just 4% of projects have complete enough data to be able to judge whether the ERR is attainable, making it virtually impossible with the information at hand to re-estimate a project's economic rate of return.[52]

3.63 **Only a third of projects provided for an external evaluation, though a significant change is evident in this respect in the last three years.** External evaluations are proposed in fully 89% of the projects approved in 2001-2003, a huge increase from 8% in the preceding period. In the vast majority (79%) of projects the evaluation methodology is set out but there is less clarity about who is responsible for gathering the necessary data, and only 53% of projects specify a priori who is to perform the evaluation. Just 15% of projects require the evaluation to be done by an independent entity and a minute percentage of them (5%) allocate budget funds ex ante for that work.

3.64 **Another evaluability constraint is that the Project Performance Monitoring Report system (PPMR/PRI) has yet to be implemented**. This system, a basic tool with which to measure private sector operations' development effectiveness, has been in development for a long time, with interruptions, since it was requested in the Bank's Programming Committee in 2002. A proposal was finally presented in April 2004 but the system has still not been implemented. Consequently, in a recent report rating multilateral agencies' adherence to common evaluation practices for private sector operations[53] the Bank came out lowest.[54]

3.65 **The evaluability picture at the transaction level is better than at the development level, as well as far superior to what is observed in the rest of the Bank's projects. One piece of project due diligence is a thorough financial analysis, looking at specific ratios and targets (debt service coverage, rate of return, etc.).** Some of these elements become contract covenants to be fulfilled in the project; these also determine, inter alia, the pace at which guarantees are released. Much detail is known about the activity being financed and the project's private sector participants. If the Bank is only a minority lender (the typical scenario) most of the detailed specification is done in line with the expectations of the private finance partners, who demand a rate of return calculation as a condition for proceeding with the loan. Private sector projects thus clearly specify the anticipated future returns of the lending, and score higher than all other Bank instruments on this measure of instrument effectiveness.[55]

3.66 **The foregoing notwithstanding, the Bank's monitoring by way of Semiannual Reports (SARs) is variable and the reports contain repetitive information, do not analyze financial variables consistently across the different projects and, for any one project, do not systematically compare actual data against original projections.** Accordingly, changes occurring in a project often are slow to be reflected in these monitoring reports,[56] making it harder to pick up (and hence start addressing) a problem early on. Nevertheless, the evaluation team observed a significant improvement in information management and analysis in the case of projects with the severest problems requiring attention from PRI's Special Assets Unit (PRI/SAU).

3.67 **As for information being generated, there are no systematic data on the project selection exercise, on what prompts sponsors to lose interest in Bank financing, or on processing times, contacts, or prospective clients' responses.** The evaluation team found no indication of any effort to compile and keep up information on the project selection process—information that could be very useful in understanding which are the problem areas, process bottlenecks, areas in which demand is on the rise, successes and failures, possible biases toward a given type of projects or countries, reasons why sponsors lose interest in the Bank, and so on. Such an analysis could enrich the Bank's private sector work and give it tools to improve its performance going forward, enhancing its private sector responsiveness and accountability to the Board.

3.68 **The lack of evaluability of projects also limits the possibility of management improvements**, making it hard to objectively appraise staff contributions and/or impute staff accountability and hence limiting chances to learn from successes and mistakes. Though staff can be evaluated annually it is difficult to come to consistent conclusions without an objective, predefined framework.

3.69 **Another item that stands out in the evaluation findings is the absence of a systematized approach to monitoring and evaluation of development indicators and financial variables that includes a centralized database with time series by project and enabling cross-comparisons of project data.**[57] The development of the PRIS system instituted in 2001 marks a major move to concentrate in a single platform all private sector project data from the earliest in-house development stage through to approval, implementation, and long-range monitoring. But this information tool, which has such valuable potential, is being severely underutilized and undermaintained.

3.70 **One observation on the matter of information disclosure, particularly of potential environmental and social impacts, is that though the Bank posts the respective documents (ESIRs) to its Web page, three out of four such documents are not in the language of the country where the project is sited, thereby limiting the usefulness of the exercise.**[58] As for information on public consultations, 80% of the ESIRs reviewed during the evaluation contain no mention of consultation process outcomes or of whether objections were received about the project and, in that scenario, how they were dealt with.

3.71 **Though Management has formally fulfilled the mandate received from the Governors to report periodically to the Board on the condition of the private sector portfolio there are some weak points in these quarterly reports owing to evaluability shortcomings.** Consistent with the above-discussed evaluability deficiencies and with a reporting approach that looks at project credit quality from the standpoint of solidity of security rather than project performance, these reports supply a very aggregated picture of the state of the portfolio and operations performance. The reader does not come away with a clear idea of the characteristics of the portfolio, its risks and prospects, market trends, or requests the Bank has considered and ultimately turned down.

IV. FINDINGS AND RECOMMENDATIONS

A. Findings: Answers to the core evaluation questions

1. ***What was the magnitude of the shortfall in infrastructure services delivery and financing and how much did the Bank accomplish, by way of its "direct private sector loans or guarantees" product, to improve the situation?***

4.1 **The direct impact of Bank-financed works projects is modest relative to the region's enormous investment needs. Consequently, demonstration effect is the most significant and most promising ingredient for making up observed gaps and attracting the interest of private operators and local finance markets. The evaluation team found the chief benefit produced by the Bank's direct private sector activity to be the successful experiences and demonstration effect achieved in some sectors and countries.** One of the main lessons taught by these experiences is the importance of creating a virtuous circle: a sound regulatory environment, a rational regulator insulated from politics, and a set of transactions that can demonstrate that investing in infrastructure is good business. Paradoxical though it may seem, the Bank's greatest accomplishment would be to involve itself in a subsector that, down the road, would be able on its own to attract other local and international players who in turn would secure local and international financing. Hence, the real gap to be managed is the credibility gap, to instill confidence that investments will come to fruition unchecked by opportunistic political interventions, shifting regulatory frameworks, weak regulators, or macroeconomic instability.

4.2 **In a relatively short time span the Bank has mobilized a considerable volume of funds, a sizable portion of which has helped finance pioneering operations in a country or sector and/or has been delivered via innovative instruments. In the process the Bank has become a leader in infrastructure finance in the region.** This comes out in comparisons with other multilateral agencies: in the last four years the Bank worked with the private sector in more countries and delivered more financing to sectors underserved by the market. Among the multilaterals it accounted for 47% of financing mobilized for the energy sector, 46% for the water and sanitation sector, and 18% in the transportation sector.[59] In other sectors such as communications it had less of a presence. The Bank has had a somewhat special place in the long-term lending niche but its intervention model is coming up against significant market changes. Specifically, banks appear to be losing interest in the classic A/B loan financing format so that model is losing currency. In these circumstances and given the development of resources in domestic capital markets, the Bank's partial credit guarantee program launched three years ago can do a great deal to open local financing avenues.

4.3 **Overall, Bank-backed projects were brought in on schedule and on budget; the vast majority are delivering the promised services**. This is a signal accomplishment particularly if this performance record is compared with what frequently happens in the public sector. Even so, after close to 10 years of operations the aggregate installed capacity provided by projects the Bank has financed via PRI represents a small percentage of installed capacity and only modest inroads in attending to the vast numbers of the region's population who still are without some essential utilities, as noted elsewhere in this report.[60] The Bank has done much to enhance productive sector competitiveness conditions; its social welfare impact is less distinct. The lack of measurement of development indicators associated with those two concepts makes any more precise assertion difficult. The absence of project impact monitoring is one of the program's chief shortcomings.

4.4 **The most problematic projects were concentrated in the communications sector, which lies outside the Bank's core competencies, and the (thermal) power sector when operations had been a response to a crisis, arriving late and with major failings owing to regulatory shortcomings.** The evaluation findings are: (i) in-house capacity and competitive advantages need to be carefully analyzed before going into nontraditional sectors, and (ii) since operations prompted by an energy crisis respond to different criteria they call for different intervention modalities that will not jeopardize the intervention instrument.

2. ***What degree of additionality has the "direct private sector loans or guarantees" instrument contributed relative to other available financing and to the way in which private money is put into infrastructure investment?***

4.5 **From a private sponsor standpoint the chief appeal of working with the Bank is that the program offers a combination of amounts, tenors, and rates that is hard to secure in the market.** Clients also approach the Bank because they see the program as carrying with it an implicit assurance or "comfort" that the State or regulatory agencies will not engage in arbitrary acts. The offsets to this "comfort"—the cost of working with the Bank—are the institution's drawn-out approval process, high front-end costs, additional outlays and delays to satisfy environmental and social requirements, and the long time it typically takes to make needed in-process changes to a project. The high per-project costs to sponsors (averaging US$1.4 million) and their unpredictability and the issue of lack of control of such costs came out clearly in the evaluation. Furthermore, in the Bank's slow and cumbersome project processing procedure a private sector operation goes through roughly the same number of steps as one with the public sector and many more than projects in comparable institutions. This dampens prospects for doing business in Group C and D countries because of the high fixed costs, fostering adverse selection and, because the process takes so long, making takeout financing necessary.

4.6 **The evaluation confirmed the strong financial additionality in the Bank's private sector program, this being the program's paramount feature for alleviating problems of amount, tenor, and rates for borrowers.** This combination is found rarely, if at all, in local capital markets, especially for project finance. International commercial banks have been generally reluctant to lend on these terms unless they are partnering with a multilateral lending agency.

Occasional bond offerings of companies in the region with tenors comparable to the Bank's have been well-received in the global market but this avenue has proved more difficult in the case of infrastructure utilities, except in the telecommunications industry and a handful of power utilities. The Bank is a very prominent provider of long-term finance: in the last five years, for instance, though it may have supplied just 3% (approximately) of financing for LAC, that is fully 22% of total financing provided at tenors longer than eight years.

4.7 **The program's additionality was pronounced in the social and environmental spheres.** In certain loans the fact that the Bank was involved afforded assurances that a project would be executed according to local and international standards that are recognized in all the countries but frequently not adhered to in practice. The Bank adds this kind of value in the early design stage and, perhaps most important, in ongoing monitoring work and compliance reinforcement throughout a project's life span.

4.8 **The issue of corporate governance has been coming in for increasing attention in the Bank's project work, echoing trends in the markets, but the Bank needs to proceed carefully in related-party transactions.** Though most of the projects have appropriate mitigation measures in place, in one in five of the operations reviewed the evaluation team identified the need for special attention to potential issues in that area, especially in operations monitoring and assembling information on experiences to structure future transactions.

4.9 **The additionality the Bank provides by affording "comfort" against arbitrary acts or acts outside a subsector's regulatory framework is one of the chief attractions for sponsors and the main attraction for cofinance providers, but in practice it is very ineffectual. This has been disillusioning for sponsors and/or co-lenders, depending on the project.** Backed up by solid guarantees, the Bank's fiduciary role has taken precedence over the risk of directly dealing with arbitrary acts. These cases spotlight the apparent conflict of interest between the Bank's activity as sponsors' "financier" and lender and "advisor" to governments. The Bank's ineffectiveness in the role of forestalling breaches or arbitrary acts by authorities and the aforementioned appearance of conflict negatively affect the Bank's positioning in the private sector and PRI's profile in the rest of the Bank.

4.10 **In sum, the premises for certain of the Bank's competitive advantages have been eroding at least in part owing to changing markets and the low effectiveness of political and regulatory risk insurance.** For one thing, with the considerable pools of money accumulating in pension funds and other finance institutions in some countries the argument that there is a dearth of funding avenues is losing some force. Since maturity extension is still embryonic and limited the challenge is to develop instruments and a framework of conditions in which such resources can be channeled into long-term ventures. Having captured that trend in the late 1990s, the Bank developed a partial credit guarantee program and closed the first operation in 2001. Though this is still a low-volume activity line the Bank has pioneered multilateral agency efforts in this sphere. Second, when parties confronted with adverse political or regulatory moves looked to the implicitly afforded "comfort" referred to above they found the Bank's effectiveness to be lacking. The dissatisfaction this triggered among some investors and lenders is by no means unique to the Bank: other development finance agencies have run up against the same problem. That dissatisfaction comes at a time when foreign investors have been retreating from some sectors and international commercial banks are less keen on co-lending under the A/B loan program. Burgeoning local capital markets offer new possibilities for Bank interventions to catalyze flows of resources toward a project's financing, for instance currently using the partial credit guarantee program. However, this is a different environment with more players, so it calls for a strong proactive effort and a variety of country instruments.

3. ***What risks were encountered as the objectives sought were pursued and how were the risks managed?***

4.11 **A variety of risks came up in the Bank's private sector projects (construction, cost, contract performance, regulatory, devaluation, etc.). However, the Bank has demonstrated a conservative approach to generating private sector business with adequate guarantees, which has been put to the test in challenging circumstances.** When macroeconomic downturns caused problems, in Argentina for instance, the Bank had the backing of credit guarantees of the principal sponsors so recovery levels were good. And since the operations concentration was infrastructure investment finance, which involves services that are essential to the public and to business activity, recovery prospects were strong. Recoveries were inferior for communications sector operations; indeed, one project was written off.

4.12 **Serious weaknesses are evident also in the area of risk monitoring and management, though the recent creation of an independent risk assessment unit marks an important step forward.** The following are the principal problems observed: (i) lack of current, readily accessible financial information to be able to track project performance over time; (ii) an uninformative risk rating system lacking in sufficient gradation and prospective vision; (iii) little in-depth analysis of the quality of a loan's underlying security or of credit quality of a project itself; and (iv) the increasing difficulty the current Supervision Unit, which is small for the size of the portfolio, is going to have in monitoring the portfolio as it grows and matures.[61]

4. ***How well has the "direct private sector loans or guarantees" product been coordinated with and synergies harnessed with other Bank, IIC, and MIF interventions?***

4.13 **Though "coordination" appears to have improved since 2001 with PRI's frequent participation in programming missions this coordination is more formal than real.** Specifically: (i) the degree of coordination varies a great deal from one Regional Department and sector to another; (ii) there is little effective synergy between the different parts of the Bank; (iii) there frequently are different, indeed contradictory, visions of the Bank's role in a country, creating friction, inefficiency, and conflict; and (iv) PRI is not fully tapping many of the Bank's resources (e.g. sector knowledge, studies, Country Office network) and, with the occasional exception, PRI's own wealth of hands-on experience is not being fed back to the rest of the Bank.

4.14 **One coordination advance on the institutional front was the late-2002 resumption of operations of the Private Sector Coordination Committee after eight years of virtual inactivity since its inception.** That body, made up of representatives of all Bank-related actors including the IIC and the MIF, is now harmonizing criteria, coordinating efforts when a crisis erupts in a country and, since 2003, declaring private sector project eligibility. Though in theory it ought to be possible to improve synergy between the different parts of the Bank the absence of a shared vision is an impediment to such coordination and resource rationalization moves.

5. ***To what extent were operations structured so as to be able to ascertain achievement of the development and additionality benefits sought by way of "direct private sector loans or guarantees" and accountability in that regard?***

4.15 **Evaluability is the program's weakest point. There is no system of project-specific development indicators for consistent operations tracking. Only in the most recent project documents are there mentions of the need for evaluations.** Indicators as to methodology, objectives, etc., are included as well but specific commitments and responsibilities are not planned or spelled out. Some additional weak areas are research and dissemination of successful experiences and lessons learned; specific measures are needed to bolster that work. Evaluation elements, like the economic analysis, are being put into project documents as something that has to be there but there is no evidence that these are considered as having intrinsic value and no use is made of them subsequently.

4.16 **There are weaknesses in accountability and communication with the Board and with the broader LAC community.** The format and content of periodic reports to the Board are not very informative and are tightly focused on portfolio credit quality defined as the quality of underlying security and not projects' intrinsic financial quality. Likewise, the evaluation found little evidence that successful experiences or major achievements are being publicized as a way of fostering a positive image of private sector infrastructure contributions. As for information disclosure, particularly on environmental and social issues, all the documents in question are posted on the Bank's Web site but three in four of them are not in the language of the country where the project is sited, so the exercise is of limited usefulness. With regard to the public consultation requirement, the review done of Environmental and Social Impact Reports found that 80% of them do not mention consultation process outcomes or say if there was any opposition to the project and how objections (if any) were dealt with.

B. Recommendations

4.17 **The evaluation identified a series of vulnerable areas in the Bank's work that would call for major changes in its activities going forward.** The following is a summary of recommendations on the main and most pressing issues, which are developed in Annex IV.

1. Retailor the work strategy to a changing market

4.18 Adjustments are needed in a number of areas to keep up with observed changes in the demand profile and in how the Bank is responding: (i) do **proactive** business prospecting and project development work to address today's much more decentralized, geographically scattered demand where greater support is needed to put together a transaction; (ii) **proceed cautiously when working with new sectors**, with a central focus on infrastructure-related sectors (e.g. logistics) and public utilities, making sure that the conditions in place warrant Bank involvement and where the Bank's knowledge gives it demonstrated competitive advantages and loan recovery prospects are strong; (iii) promote **partial credit guarantees** and other local capital market interventions to familiarize local institutional investors with long-term private sector finance; careful operations analysis is a must since this modality is more complicated than the A/B loan format, requiring dealings with multiple security holders in problematic situations; (iv) develop **local currency financing** vehicles; (v) explore **intervention modalities that are less procyclical** vis-à-vis the finance market; (vi) actively foster **wholesale vehicles** as a way of extending coverage and lowering transaction costs, for instance debt funds, backed by managers with solid local contacts and/or roots and with good local and global sales and promotion capacity; and (vii) make more use of **products featuring a combination of fixed and variable yields (e.g. "upside kickers")** in which the Bank or other coinvestors benefit if a project's cashflow exceeds a predetermined level.

2. Make demonstration effect a focus of private sector work

4.19 **One of the key lessons coming out of this evaluation is that the Bank has achieved success when it has concentrated a critical mass of operations in a subsector with the aim of producing a demonstration effect.** The result of such successful ventures has been the spontaneous attraction of capital. This is the most powerful of the Bank's developmental impacts. Intervention targets have to be very carefully selected since if operations fail the negative demonstration effect can be powerful as well. Indeed, bad experiences with interventions in response to energy crises have pointed up the risks in using the instrument in such circumstances and the need for other kinds of mechanisms to better address such situations. Going forward, strategic thinking could be geared toward: (i) replicating models that have worked well in one country in other parts of the region, tapping in-house expertise and experience; (ii) targeting new operations to a discrete set of subsectors to achieve learning, critical mass, and exemplars that will spark other investments; and (iii) develop investment products and vehicles for the delivery of infrastructure and other utility services, including mobilization of public funds to take service to underserved market segments, working closely with the Bank's public sector area to explore potential public-private partnerships. Transparency of the public obligations generated and competition for service delivery will be prime considerations here.

4.20 **Publicize successes and positive experiences in order to counter the negative perceptions of private sector involvement in some critical areas and attract local capital market players.** There is a vast store of economic and sector studies buried in files as well as specific examples of successful experiences that can be used to publicize and promote best practices, attract business, and encourage governments to concession out and privatize services. Financially successful ventures (e.g. road and highway projects) also should be promoted in local capital markets and carefully adapted to new subsectors and markets.

3. Improve coordination and make more efficient use of in-house resources

4.21 **The Bank should explore ways of forging an institution-wide shared vision, starting with a common diagnostic and effective division of work to seek out synergetic intervention approaches and feedback on experiences.** Action is needed to get beyond the contradictory visions that are creating friction and wasting opportunities for country support at a time when public-private partnering is needed more than ever to improve regulatory and institutional frameworks and develop competitive, transparent mechanisms to boost and expedite private participation to make up public utility delivery shortfalls.

4.22 **Implementation of the new Private Sector Strategy approved in 2004 and subsequent development of country strategies that organize work around a common vision is an opportunity to move forward with coordination improvements.** Once a concerted vision had been worked out for each area of action, with due regard to regulatory framework, private sector presence, and capital market maturity, a work program or framework agreement could be devised for all parties' activities in which both PRI and the rest of the Bank could operate independently.[62]

4.23 **Another frequent situation that calls for especially tight collaboration between PRI and the Bank's public sector areas is when there exists a direct connection by virtue of a minimum payment guarantee, or a contract with a State agency that is acting as provider, off-taker, or perhaps even project co-sponsor.** In other words, though a project may formally be a "private sector operation" there is some close connection to the country's public sector. A relationship of this kind was observed in 50% of projects—hence the importance of fluid dialogue and open cooperation with that state agency counterpart in the Bank.

4. Shorten approval times and lower transaction costs

4.24 **It is imperative that the approval procedure be streamlined, speeded up, and standardized.** It is taking too many steps to process a private sector operation and too long, on average, to close an operation. This leaves the Bank at a competitive disadvantage vis-à-vis other institutions that are pursuing similar objectives. The result often is: (i) projects diverted to other institutions; (ii) high transaction costs per closed operation; (iii) adverse selection; (iv) exclusion of local sponsors who have less financial strength and are unable to secure bridge financing while they wait for the Bank; and (v) take-out financing. Another area that needs revisiting is the option adopted at the outset of outsourcing the bulk of due diligence work, and formulas should be sought to lower transaction costs to make them more competitive and affordable for smaller-scale projects and sponsors, so the program will be accessible to Group C and D countries. Annex IV discusses some alternatives in this regard.

5. Strengthen risk management

4.25 **Risk management needs strengthening, from an operation's analysis stage right through to supervision.** Actions needed in particular are: (i) improve ex ante financial modeling; (ii) keep financial information current and readily accessible to be able to track project performance over time; (iii) improve the risk rating system, providing information with intermediate gradations and more particulars about a project's status and prospects; (iv) strengthen the analysis of each loan's underlying security; (v) analyze and monitor latent portfolio risks such as rates, currencies, and oil prices with a view to keeping an adequate balance to control exposure; and (vi) bolster the supervision area, which has a heavy workload.

6. Improve evaluability and communication

4.26 **Urgent measures are needed to improve evaluability, particularly for development effectiveness determinations.** Apart from calculating ERR a system of project-specific development indicators needs to be generated for consistent tracking over the life of the project; this can improve the rest of the Bank's knowledge of the institution's direct private sector work. The "quality at entry" protocol developed for private sector projects in 2003 by the Office of the Executive Vice President of the Bank has yet to be implemented; its institution could mean a major advance for evaluability. The ex post evaluation requirement should be systematized, as should the inclusion of indicators, methodology, development and transaction objectives, etc. One necessary adjunct will be to plan and identify responsibilities and specific commitments. Equally important is research and dissemination of achievements and lessons learned, systematically documenting why operations were dropped and cancelled, to be able to improve processing efficiency and generate more institutional learning.

4.27 **With a better evaluability framework could come a stronger emphasis on communication, which is crucial for in-house and external actors alike.**

Particular focuses of attention should be expanding on the project performance data reported to the Board, information on requests in process, cancellations, and market trends, and external dissemination of relevant information to produce a demonstration effect. Moves also are needed to improve external communications targeted to a prospective client base that today is much more disperse than in the past decade, managing expectations about what the Bank can offer and what may not be achievable (e.g. in terms of political and regulatory umbrellas) and how long it may take the Bank to respond (e.g. citing more realistic timelines than those currently publicized). This effort should be a key piece of a more proactive program of new product offerings in local markets. A more proactive program should also include prospecting for opportunities at the subnational and supranational levels and in sectors associated with areas in which the Bank has been working and has competitive advantages. In new areas, the Bank should have a specific plan to achieve capacities in a timeframe consonant with the anticipated level of activity.

ENDNOTES

[1] Background documents on the Eighth General Increase in Resources of the Bank, CS-2620-9, 18 June 1993.

[2] The evaluation team did not analyze the sole Private Sector Department export finance operation approved in 2003.

[3] Annex I sets out the basic assumptions derived from the strategy mandates and the methodology used. Details of the evaluation proposal containing that information were presented to Management in May 2004 and have been available since then on OVE's Intranet site.

[4] *Latin Finance*, July 2004. "Corporate Bonds: The Decline of Plain Vanilla" in reference to cross-border and domestic structured bond issues in LAC 1998-2003, using Fitch Ratings as a source.

[5] It was decided to use mainly the Projectware/Dealogic database to compile the tables in this section. Apart from being one of the few sources of information on private infrastructure investment finance in the region that database has the advantage of providing detailed information on operations' different financing tranches and thus enabling a more detailed comparison of each agent and the market overall.

[6] The Bank's role was even more prominent among the DIs considered: PRI disbursements accounted for over 13% of direct loan disbursements.

[7] *Regulators and Private Sector Participation in Infrastructure* (Pragal, 2004).

[8] This figure falls to 31% if Argentina is excluded.

[9] To give some idea of the magnitude of these measures: only 7 of the 26 borrowing member countries have over 7,000 MW in installed electric capacity; one million electricity connections is roughly 80% of the connections in place in a country the size of Costa Rica; and 283,000 water service connections represent about 80% of Panama City's water system hookups. The detailed table in Annex III, section 2-B, contains comparisons as to installed capacity in the region, utility service shortfalls, and investment demand.

[10] This assumes that the analysis has addressed all relevant factors and has somehow translated them into a common monetary unit. In other words, the analysis should take in all externalities and spillover effects that are not directly included in the project flows.

[11] This parameter is consistent with World Bank data that estimated infrastructure project ERRs of 19%-29% in the 1982-1992 period. Cited by Easterly and Servén in *The Limits of Stabilization*, 2003.

[12] Based on a comparison of financial projections (original vs. actual) and data on physical indicators (vehicle traffic, energy sales, etc.).

[13] By way of illustration, in the financial model for a highway concession project, a 100% reduction in traffic in each of the first four years of operation pushes the project's financial return down from 22.9% to 13.2%. With 100% less traffic in the first two years the project's return is 14.5%. In a hydroelectric plant model the formula for calculating return on investment and return to sponsors is inoperative. In the model of an electric transmission project and another toll road project changes in what should be associated variables (e.g. price and quantity) do not alter the final result (or value of sales).

[14] Other factors examined along with the obvious consideration of financial outturn for sponsors included quality of initial analysis, outcomes compared to original expectations, credit quality for the Bank, and risk management and materialization.

[15] Includes all operative energy and transportation projects in Brazil (11), Uruguay (1), Peru (2), Honduras (1), Costa Rica (1), and the Dominican Republic (1).

[16] The EBITDA—earnings before interest, taxes, depreciation and amortization—is a commonly used measure of financial performance to compare companies with different capital structures and under different tax regimes.

[17] If Argentina is factored out the percentages of unfulfilled covenants were 42% for positive covenants, 19% for negative covenants, and 21% for financial covenants. These figures were calculated from a review of the latest SAR available for each project evaluated by OVE's evaluation team.

[18] In “When Projects Fail: 10 Years of Rated Project Finance Debt at Standard & Poor’s,” July 2004.

[19] The evaluation team did not have audited 2003 statements for a number of projects in which they had sought to deepen the financial analysis. In some instances there was an income statement and balance sheet but not a cashflow statement, which is essential for credit control.

[20] The lack of granularity in the rating scale is a serious problem. The evaluation team identified a number of projects that would warrant closer scrutiny than a project rated “Satisfactory” would call for.

[21] A recent Wall Street Journal article (22 September 2004) points out that despite the post-Enron drive to improve accounting standards U.S. corporations still have billions of dollars of lease obligations that they are not listing as liabilities. For example, in its recent bankruptcy filing US Airways reported liabilities of only US$3.15 billion; it did not show US$7.39 billion in lease commitments.

[22] The average spread in the portfolio is 338 basis points; one-year LIBOR is 1.45%. A return to a 6.5% LIBOR would mean a rate hike for the majority of PRI clients from 4.83% to 9.88%.

[23] PRI loans include a grace period, which is not a feature of every private sector loan. Consequently, the difference in length of the two kinds of loans involves more than a simple difference in tenor.

[24] Document GN-2196-1 of 23 April 2002 analyzes and identifies limitations of the A/B loan program and proposes adjustments whereby greater use could be made of other products like partial credit guarantees.

[25] These environmental and social considerations as well as transparency and participation requirements are elaborated on in Annex III.

[26] This percentage does not include the responses of sponsors and co-lenders of impaired projects, which were not included in the survey, as spelled out in Annex III, Section 6.

[27] Examples of these problems are outlined in Annex III, Section 3, with a breakdown according to whether events stemmed from political or strictly regulatory considerations. Also included are summaries of what happened, the impact on the project, whether or not the matter was resolved, how the company handled it, whether or not the Bank participated, and what the result of its action was. The reference here to the Bank taking action means active steps taken (communications, meetings, etc.) with the respective authorities.

[28] It should be noted that in cases in which the Bank provided explicit political or contractual risk insurance, the latter was honored in full.

[29] Demand for political risk insurance was muted in 2003 (3 of 19 issuances), a trend that can likely be traced to the Argentina debacle when default experiences in political risk cover transactions spotlighted the product’s limited protective ability and the high correlation with sovereign risks. Extracted from *Latin American Structured Finance 2003 Year in Review and 2004 Outlook*, 2004.

[30] http://www.adb.org/Documents/Policies/Private_Sector/private0302.asp

[31] According to data supplied by PRI the number of countries targeted for promotion work climbed from 13 in 2001 to more than 20 in 2004, staff time dedicated rose from 117 days in 2001 to 157 in 2003, and operations and syndication area staff are attending more conferences.

[32] In the IIC’s 24 infrastructure projects an average of 15 months elapsed between project eligibility and first disbursement (40% shorter than for PRI projects). Another comparable multilateral agency reports 40% shorter times for its infrastructure projects: 13 months from eligibility to signature, compared to PRI’s 22 months.

[33] The times shown in Table 3.3 are at odds with PRI’s Web page assertion that “*When the project’s contractual structure is substantially negotiated, and the main project contracts are ready to be signed and executed, the Bank can carry out the project's due diligence without delays. In this case, a transaction can in principle reach financial closing within six months from its initial presentation to IDB*.”

[34] Dates of initial Bank response or first contact are not exact since they are based on incomplete file evidence that is not logged in the information systems.

[35] The general public would expect that a loan coming into the country would launch a works project in the country, not finance the head office of a bank that supplied bridge financing. However, from a credit standpoint for the Bank the risks in the project’s initial (construction) phases are diminished.

[36] A comparison of PRI project costs and costs of Bank infrastructure projects generated over the same interval shows the average cost per public sector project to be US$403,345 versus US$410,562 for private sector projects. (Source: OPRCOST system)

[37] Section 7 of Annex III contains the full analysis.

[38] Among the kinds of IDB requirements cited as potentially "Very Important or Moderately Important" obstacles to a project's implementation are Environmental (77%), Reporting (68%), and Public Consultation and Disclosure (43%).

[39] This impression is consistent with the earlier-mentioned response of many sponsors, 42% of whom answered that PRI was their only financing option.

[40] Legal and environmental costs take in monitoring as well as due diligence.

[41] According to the Legal Department these costs apply to all co-lenders and the legal conditions they require to be included in projects, which pushes up the cost of some operations.

[42] The Legal Department informed the evaluation team that it is pursuing moves to lower transaction costs on the legal side and also is keeping a record, for that department's internal use only, of costs by project and by law firm engaged. The Legal Department also reported that it had recently taken action to control costs. Among other activities, it: "(i) revised the selection criteria and process for outside counsel; (ii) surveyed the performance of firms; (iii) held meetings with over 80 law firms that have expressed an interest in representing the IDB and at each one emphasized the IDB's emphasis on effective cost-management; (iv) drafted a new form of the Request for Proposal for international counsel, emphasizing staffing, the team's experience, and cost controls; (v) retained new law firms and phased out inefficient firms; (vi) revised and enforced the conflict of interest guidelines; (vii) drafted new forms of Retainer Letter for international and local counsel, emphasizing cost issues through earlier warnings, billing against estimated amounts, and incremental and cumulative billing; (viii) developed a new tracking mechanism for costs; (ix) required caps for due diligence and document production phases; (x) conducted informal 'audits' of fees once deals are completed; and lastly, (xi) last fall, worked with an outside consultant specialized in the delivery of legal services to develop an action plan regarding further measures to control costs."

[43] From 1995 to 2003, in 37 projects consultants had been hired for due diligence and for monitoring work. In 80% of them (30 projects) the same consultants were engaged for both tasks.

[44] Legal Department and PRI representatives told the evaluation team that these are frequent practices in private sector projects and a more efficient way to manage the services.

[45] For details see Annex II which contains a special analysis for Mexico, Brazil, Argentina, and the Dominican Republic. One finding of the analysis of the project selection exercise is that in committees in which explicit PRI-Bank coordination/cooperation should be happening it tends to be a matter of form and not very operationally effective.

[46] Though this would be the ideal sequence, the reality is admittedly more complex. Institutional reforms take time and run into opposition from sectors that would rather maintain the status quo. In the interim the country has to resolve pressing physical needs, which requires investment and financing. If the private sector is brought in before reforms are consummated and uncertainty is still pervasive: (i) projects end up costing the country more because there are fewer parties interested in competing for them (and those that do decide to come in apply a discount rate commensurate with the uncertainty); and (ii) the parties that become involved seek to reduce risk, and the approaches they adopt could complicate the sector's future transition to a competitive model.

[47] The survey of Bank staff points up the potential for cooperation: two in three interviewees say they have detected "high" or "moderately high" demand for private participation in infrastructure services.

[48] Since 2003 the matter of private sector project eligibility has dominated Private Sector Coordination Committee agendas. Some interviewees felt that this is diverting attention from more strategic issues and those pertaining to coordination with the other institutions (IIC and MIF).

[49] This included only projects that do require ERR estimates. In 8 of the 55 projects no ERR is presented, but 6 of the 8 are guarantees or corporate loans—types of operations in which ERR cannot be calculated because they do not necessarily entail a specific investment project.

[50] PRI's criterion was that the project have an ERR of over 12%. In none of the over 200 projects turned down or dropped was a too-low ERR identified as the reason. In fact PRI approved one operation with a 10.8% ERR (GU-0151) and two with 12% ERRs (DR-0136 and PE-0210).

[51] The methodologies used for hydroelectric projects in Brazil compared with thermal power alternatives, which is not technically recommendable for the economic analysis.

[52] In electricity sector projects, for instance, the evaluations frequently use a stochastic simulation of the system's operation so it is very difficult to re-estimate the project return without detailed modeling (historical operating data would have to be combined with a simulation of future-year system projections). For transportation concessions detailed data would be needed at a minimum on pre-project and post-project operating and maintenance costs of the different vehicles, traffic statistics, etc.

[53] "Second Benchmarking Review of ECG Members' Evaluation Practices for Their Private Sector Investment Operations Against Their Agreed Good Practices Standard," Walter I. Cohn & Associates, Draft, September 2004.

[54] The IIC figures separately; it scored significantly higher.

[55] "Instruments and Development. An Evaluation of IDB Lending Modalities." OVE, RE-300, September 2004.

[56] The thermal power projects in Brazil are a case in point. Despite the problems encountered there still has been no improvement in information management and these projects have yet to be placed in the "Watch List" category. Meanwhile, the considerable improvements posted in the other thermal project, in Mexico, have not yet been reflected in the respective SAR.

[57] To be able to track projects in the same area and in the same country for example, such as roads in Brazil or electricity generation in Mexico.

[58] A check revealed, for instance, that 73% of 30 available Environmental and Social Impact Reports (ESIRs) are in English, which is not the official language of any of the countries comprising the sample.

[59] As a percentage of overall investment the Bank's share is 6.3%, 16.1% and 5.1% respectively.

[60] According to evaluation team estimates these projects helped fund at least 283,000 new water and sewer system connections, one million new electricity hookups, telephone service for 93,000 new subscribers, 950 km of roads and highways, 7,372 km of gas pipelines, five new berths at two commercial ports, 1,019 km of power transmission lines, and nearly 7 GW in installed electric capacity. These figures were compiled with some difficulty, counting project by project; some numbers are based on guesstimates because there had been no tracking of the investment's impact.

[61] For instance, the evaluation team was told that because of staffing constraints SARs for projects rated "Satisfactory" are being produced less frequently.

[62] Where two markedly different visions persist a single vision should prevail. The simultaneous operation of "twin visions" hurts the Bank's external image and impairs dealings between the different parts of the institution. It would be preferable for PRI or the Bank's public sector area to be exclusively "in charge" of a sector/country than to have two sides of the institution putting out contradictory messages.