

**Roles for the
Private Sector, Governments and
Multilateral Creditors in
Latin American Private Infrastructure**

Antonio Vives
and
Martin Chrisney

Foreword

There is growing consensus in the countries of Latin America and the Caribbean about the importance of the efficient management of infrastructure services, not only for economical but also for social reason. During the Eighties, most countries in the region were burdened by sizable fiscal deficits and triple-digit inflation, which crippled their capacity to invest and distorted the allocation of resources away from productive economic uses. Confronted with this situation, many governments saw private participation in infrastructure as a means to increase efficiency in the provision of services and support fundamental fiscal reform with privatization receipts and future tax income from privately run companies.

It was also widely recognized that a greater private-sector role would free up resources that could then be used to address more pressing social problems and investments in areas that are not attractive for private sector participation. For these reasons the changes we have witnessed in the provision of infrastructure services in the Latin American and Caribbean region are likely to be permanent, rather than temporary.

The changes observed in the economic situation of the region during 1995 should not be extrapolated. It is true that growth fell from 5% in 1994 to 0.6% in 1995. But excluding Argentina and Mexico, which went through severe recessions, growth in the rest of the region fell only from 4.9% to 4.6%. Peru and Chile grew at rates in excess of 7%, Mexico fell 7% and Argentina 2.5%.

Even though investment only rose 0.3%, there were substantial increases in Colombia, Peru and Brazil. In spite of the crisis in Mexico and, to a lesser extent, Argentina, international reserves fell by only US\$3 bn. Inflation continued to decline. For the typical country, it fell from 12.8% to 10.5%, down from 128% in the early 1980's.

We feel that 1995 was a correction. We continue to believe that the fundamentals are strong. The Mexico crisis was a severe

test for the economies of the region that was successfully weathered. It did show the vulnerability to external shocks, the potential volatility and the need to deepen the reforms. But it also pointed out that the reforms in place in the region have been effective in preventing the deepening and widening of this type of crisis. The reaction of the economies was very different from that of a similar shock in 1982, which led to the debt crisis of the Eighties.

Although there has been an expansion of sources of capital for infrastructure in recent years, there are still innumerable problems in closing deals. Several reasons contribute to this. In terms of financing, most capital markets in the region are incomplete and instruments to finance the large needs and the long terms needed are not available. This creates a dependence on foreign capital and multilateral financing and, as most revenues are in local currency, points to the need to develop the local capital markets. Furthermore, given the perceived risks in long term commitments of capital and the relatively recent history of government support for private infrastructure, both the equity and foreign debt tend to be of a short-term nature, looking for an early exit. Governments and multilaterals can contribute to create an environment where the private sector feels more confident.

Another set of problems relate to the needed public/private partnership to put together the deals. By their nature, infrastructure projects are a public service and public sector involvement is necessary. Furthermore, given the size and complexity of the projects, there are many more actors involved, including the private sector, commercial and investment bankers, multilaterals, nongovernmental organizations, etc., each with its own set of priorities and objectives which must be made convergent. These objectives relate both to the avoidance of risks and the capture of benefits. There is a significant body of literature devoted to risk mitigation and allocation between the parties, but little discussion has been advanced on the allocation of benefits. If projects are to be sustainable in the long run, there has to be agreements between all parties on the sharing of the efficiency gains, particularly if they happen to have been underestimated in the award of the project. By the same token, similar arrangements must be made for the sharing of costs arising out of changes in the rules of the game, for instance tightening of environmental and safety regulations. Regulatory frameworks must be clear and stable, but sufficiently flexible to adapt to the changing circumstances, professionally managed and independent of political pressures.

Given the complexity, the number of actors and the desires to avoid risks and capture benefits, the actual closing of deals is expensive and takes a long time. To complicate matters, given the relatively recent evolution of private infrastructure finance in the region, there is limited experience and a tendency to overkill in order to be absolutely sure of everything and to reinvent the wheel, starting from the limited examples available. This is a factor that is significantly delaying deals. The private sector must be willing to compromise and take some risks with the deal, governments must provide clear rules of the game and make the commitments in the forms of investment codes or protocols

and multilaterals must act as clearinghouses of best practices, provide technical advice, act as honest brokers between the private and public sectors and in general, promote understanding and simplification of the regulations and procedures.

*Antonio Vives,
Division Chief
Infrastructure and Financial
Markets Division
Inter-American Development Bank*

Roles for the private sector, governments and multilateral creditors in Latin American private infrastructure

The nations of Latin America and the Caribbean are demanding new physical infrastructure in roads, power plants and distribution, telecommunications, ports, airports, water and sanitation systems, in order to make up for past neglect and keep up with future needs. Conservative estimates, based on maintaining and upgrading the current stock, put investments needs at \$50 bn a year. With other pressing needs and the significant amount of resources required, the public sector can no longer finance all the work that needs to be done. By Antonio Vives, division chief, and Martin Chrisney, economist, infrastructure and financial markets division at the Inter-American Development Bank.

As policy makers have opened up their economies to greater competition through the liberalization of prices and privatization, so have infrastructure services been turned over to market forces. Various modes from BOT to concessions to privatization have introduced the private sector as designers, contractors, operators and financiers of infrastructure projects. Since the late 1980s, in Latin America and the Caribbean, more than \$22 bn in infrastructure assets have been sold, leased or contracted out in some fashion to the private sector.

Currently, the private sector is promoted as an important source of this new investment with a potential of up to 25% of the region's investment in infrastructure. Nonetheless, there seem to be few projects completed. In spite of a regional economy of more than \$1.2 tr, a highly urbanized population that is poorly served by many basic infrastructure services, the rate at which deals have been closed falls short of the estimated needs -- many projects never get off the ground, while others are delayed. Part of the apparent failure is a result of the long lag between the preparation and the completion of projects, so the recent boom still has many more projects on the drawing board

than completed in the field. The recent sharp rise in project financing for infrastructure in the region, and worldwide, supports this view. However, even with the recent increase in project finance and on-balance sheet financing from international capital markets, the amount of debt raised for private infrastructure appears to fall short of estimated needs.

The shortfall in financing for private infrastructure projects can substantially be explained by the large number of impediments that exist to closing deals. At the risk of oversimplifying the case, the impediments can be divided into three categories: financing, public-private partnerships, and putting the deals together. A review each of these areas and an examination the role of the major stakeholders in project financing clarifies why private sector infrastructure investment has not lived up to its billing. Or, put another way, we can answer the question: Why are there are so few projects when the needs are so large?

Key barriers to private sector projects

Financing

Infrastructure projects require significant

amounts of long-term funds that are capable of accepting the commercial, operational and political risks inherent in these projects. Structuring the equity and debt financing is therefore critical to the viability of any project. If a project were exclusively equity financed, it could readily withstand the long payback periods, large fixed costs, as well as the risks implicit in projects in developing countries. The higher expected returns for equity holders, however, would require that high rates be charged for the services provided to the public, which in practice is self-defeating for political, social and economic reasons. Long-term debt, with its lower expected return, is needed both to leverage the returns to equity and lower the overall cost of capital. Lenders, however, avoid the perceived risks of these projects by providing shorter term debt than is required, while avoiding the riskier construction phase of projects. In the marketplace for financing projects, these factors result in equity being parsed out in small amounts (in order to have the greatest leverage) and debt being provided for short terms (in order to lessen risks).

Additional factors also complicate financing infrastructure projects. On the debt side, there are the concerns about the currency of borrowings and project foreign exchange exposure. Where infrastructure projects generate revenues in local currency there should be a larger share of financing in local currency, particularly interest expenses. Where local financial markets are underdeveloped, however, debt is largely unavailable in the amount and tenor Government's, however, cannot make long-term commitments or adapt to changing conditions if the rules of the game cannot withstand close political scrutiny. Although private infrastructure is most effective when managed as a business, it cannot be forgotten that it has a social character as well. In particular, opposition from the public must be confronted since infrastructure services are often viewed as a right of citizenship as well as a means of redistributing income. To be effective, a

required. On the equity side, there must be an exit strategy before a prudent equity investors will think of putting their money into a project. At some stage, investors need to realize capital gains from the project through a public offering or private placement of shares. In developing economies, where clear exit options are the exception and not the rule, the desire to maximize returns leads equity holders to bring relatively little cash to the table. Instead, the investor prefers to finance equity through the project's own cash flow or out of profits from the construction contracts or equipment they supply. In these instances, the lower commitment of owner equity and shorter payback period can jeopardize the financial viability of the project.

The public-private partnership

To raise private finance for the large fixed investments needed in infrastructure requires an implicit or explicit understanding between the private and public sector. Since the investor has a limited ability to respond to changes in the market through strategic choices,

such as changing the product line or shifting to a new market, there must be clear rules regarding the non-commercial risks that adversely affect a project's profitability. Since all future 'states of the world' cannot be accounted for, even by the best advisors, rules must be established for adapting to these changes. Policy makers and sponsors should focus on stable rules for dealing with change.

public-private partnership must resolve the potentially conflicting goals of profitability and social needs, which can be done only if there is an acceptable allocation of the project's benefits as well as risks.

To achieve a fair distribution of the benefits requires collaboration among all the parties. It cannot be assumed that private provision will necessarily be more efficient and that all parties will benefit. First, the conditions for efficiency must be created. Competition is

the surest means of ensuring efficient outcomes and to avoid merely transforming the inefficiencies of a public monopoly to a private one. Second, where open, competitive markets cannot be created, as is often the case in infrastructure, alternatives must be used such as competitive bidding for concession rights to operate a local monopoly. In this case, the public sector obtains some of the efficiency gains from the private sector by competitive bidding. However, unforeseen states of the world can lead to underestimates (or overestimates) of the efficiency gains of private sector participation, yielding what some will call "excessive" profits (or losses) for the private sector operator.

In a fair distribution of benefits, the private sector sponsors should not absorb all windfall profits derived from these unexpected changes or underestimated benefits. The long-run sustainability of the project requires that some additional benefits are shared with the government and the public, either through lower rates or additional services provided. Of course, the opposite can also occur and profits may be lower than anticipated owing to unforeseen regulatory changes, such as changes in the agreed pricing mechanism or expanded safety and environmental regulations. In these circumstances, there should be a mechanism to compensate the private sector, monetarily, either through increased rates or through the extension of a concession, or other compensating measure.

To adapt to either unexpected gains or losses in a project, the regulatory framework and concession agreement must have built-in flexibility. Only under these conditions can the private sector expect, or the public sector provide, the long term commitment needed to raise financing for private participation. Especially in developing countries just beginning to transfer infrastructure services to the private sector, the failure to account for windfall gains can create political opposition that will stifle

future efforts.

On putting together the deal

Infrastructure projects involve a multitude of actors: the public, governments, sponsors, commercial and investment bankers, multilateral institutions, non-governmental organizations, etc. These groups bring a multiplicity of interests to the bargaining table that raise the cost of transacting business. One of the major challenges in private infrastructure finance is to coalesce these interests into binding arrangement.

Adding to the degree of difficulty in this process, some actors, particularly the public sector, have limited experience of dealing with project finance. The trend towards greater decentralization to local governments, often only magnifies this problem since state and municipal officials are less experienced, have shorter planning horizons (shorter terms in office), and may be more vulnerable to political pressures. For their part, sponsors may have extensive technical knowledge, operators may be capable, and the construction firm may have years of experience, all of which is less relevant when transplanted to a developing country. Furthermore, if multilateral lenders are involved, they also have their own constituency and objectives. Trying to achieve a developmental impact from a project by compliance with environmental and social requirements will probably raise project costs and increase the time required to close a deal. These interventions, however, have to be viewed as a means to achieve a fair distribution of benefits, and not only as additional costs to the project.

Timing is also a critical factor in the deal-making process. Often the political and economic conditions that favor a deal exist for a limited time period -- the beginning of a new administration, a period of economic stability. To take advantage of this window of opportunity, all parties must act in concert to complete the deal adding problems of coordination as it is rushed to completion. When national regulations are not adequate

and must be revised through the legislative process, it may not be feasible to wait for all the appropriate changes. Instead, project design and regulation must incorporate the necessary flexibility. On the other hand, if a project is hurried through by award the contract without competitive bidding, the deal can become subject to unwanted criticism by outside parties that could jeopardize the project in the longer term. Not only could the deal have been completed at a lower cost, but it would have withstood political pressures if there was a competitive, transparent award.

The role of the actors

From the above it seems clear that the odds of failure in private infrastructure financing are much higher than those of success. The investment needs of the region and the potential efficiency gains from private participation, however, are evidence of the need to raise the chances of success. By examining the role of the key stakeholders (the private sector, government and multilateral creditors) in each of the areas discussed, we can identify a set of rules that reduce barriers to private sector finance and recognize that each party has a significant and interdependent role to play.

Private sector

Financing

The private sector must demonstrate its long-term commitment with an equity contribution that supports the level of debt even under adverse economic conditions. The larger the cash equity, the stronger the investors commitment. Moreover, it is beneficial to have local sponsors who will take a longer-term view of the project since their local reputation and investment will depend on its success. Finally, the private sector should absorb a share of risks commensurate with the expected rate on return on equity. It is precisely because there are risks left to equity that the expected rate of return exceeds the rate obtainable on low-risk government obligations.

The public-private partnership

A partnership will be effective if the private investor avoids the temptation to “cash in” quickly the project’s returns. Only by a willingness to share the returns with the public they serve can project succeed in the longer-term. If the sponsor enters the deal under competitive and transparent bidding and works within a regulatory framework that allocates those benefits properly, projects will be sustainable and returns will be fair and longer term.

Putting together the deal

The best owners will be those that are fully prepared to understand all the complexities of the local markets and institutions, while taking a long-term view to work with the interested parties productively, rather than try to find short cuts. Furthermore, they must avail themselves of good advisors willing to make the necessary compromises.

Governments

Financing

In the first instance, governments should maintain sound macroeconomic management which in turn will maximize the role the private sector can play in the development of markets and new instruments. Governments must also promote the proper financial regulation and legislation that enhances the development of local financial and capital markets.

Governments must realize that some projects may not be profitable without public sector support, either for the capital cost of the project or in the form of subsidies based on services rendered. In either case, these interventions must be determined based on a competition among project sponsors for the lowest subsidy, as is done in many road, water, and sanitation projects. In terms of capturing the efficiency gains, it is still more effective for the government to share construction costs or to pay limited subsidies, than to continue to own and operate the facilities in the public sector.

The public-private partnership

Here the government can contribute the most. A well-managed, independent, and stable regulatory environment, which admits flexibility in determining outcomes is central. Governments must also provide the proper procedures for assigning projects between public/private actors and among private sector actors, as well as a long term commitment to the success of private infrastructure. If the rules are fair and the public sector's commitment is strong, the private sector will participate in the partnership.

Governments must resist the temptation to squeeze the profits from a deal, but rather should ensure that the benefits are equitably distributed. Moreover, they must be prepared to recognize that some public sector policies may adversely effect a project's financial viability, and be willing to make proper compensation.

Putting together the deal

When dealing with private infrastructure, the government must understand the complexity of the issues and give them the utmost attention and devote skilled personnel to the task. There is no room for improvisation and the best advice must be sought. Also, governments should seek to eliminate many of perceived risks arising from uncertain government policies. The government can set the norms of behaviour by establishing the general laws that recognize the rights of all parties in a transaction and/or through individual contracts and/or general investment protocols.

Multilaterals

Financing

Because of their funding, multilaterals are well suited to provide long-term debt financing and, in some cases, even equity to support the long term nature of the investments. In addition, their lower financing costs can aid the profitability of projects and lower rates charged to the public. They can provide a variety of instruments, from straight debt

financing to enhancements on private debt to credit guarantees and contingent loans that extend the maturities of market debt issues.

Multilateral creditors can also support sound macroeconomic management through their lending programmes and overall relationship with governments. In the longer-term, multilateral creditors can promote the development of local capital markets that will channel domestic resources into infrastructure and other productive investments. Multilaterals can have a decisive role in the development of domestic sources of capital through grants and loans to create institutional investors (pension reforms, insurance companies), for institutional strengthening and prudential regulation, and for the development of new instruments and markets.

The public-private partnership

Multilaterals by their very nature are particularly suited to act as honest broker in the deals involving both the private and public sectors. In the capacity of adviser to governments, the multilateral creditor can ensure that the efficiency gains are equitably distributed and the interests of all parties are preserved. From the point of view of the public interest, multilaterals can assure compliance with international safety and environmental standards, and that projects have a positive, or at least neutral, impact on other developmental objects, thereby enhancing their long-term sustainability. In the capacity of guarantor of specified policy risks, the multilateral can create the conditions for a long-term commitment by the public and private sector through the selective use of guarantees and political risk insurance.

Putting together the deal

Multilaterals are able to collect vast amounts of information and experience across countries that enable them to identify the best practices that make good and sustainable projects and legal frameworks. Acting as a clearinghouse of both

successful and unsuccessful projects, the multilateral can disseminate information that enables project partners to build on successes and avoid failures. Through the accumulation of technical know-how they can also act as advisors to governments or the private sector on the conditions for a successful deal.

Finally, multilaterals can promote the standardization of procedures, such as bidding, dispute resolution, protection of property rights and in other matters where international experience helps to set the norms of behaviour. In many cases, the risks present in projects result from a deficient legal framework, that can be eliminated or mitigated through bilateral or multilateral investment codes or protocols, that multilaterals are in a condition to promote.

Conclusion

In their quest for development, the countries of Latin America and the Caribbean need large-scale and efficient infrastructure investment, which in most cases are beyond the financial and management capacities of their governments. Private participation in infrastructure has become an urgent priority. These investments, however, are extremely complicated, partly by their very nature, but partly because the conditions do not yet exist for their development. Countries do not yet have the legal and regulatory frameworks in place and/or the players do not yet have the necessary experience to effortlessly put the deals together in a sustainable manner. There are many steps that need to be taken to resolve these issues, but they all start with the key stakeholders in the private sector, government (as representatives of the public), and multilaterals working together. All need to work together to make private infrastructure both viable and sustainable.