Plenary Session III

Private-Public Partnership for Infrastructure Development

Private-Public Partnerships for Infrastructure Development

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Introduction

Nearly two years ago, the Asian Development Bank, the Japan Bank for International Cooperation, and the World Bank embarked on a joint study to map out the infrastructure challenge for East Asia and the Pacific. Many topical challenges were well known: large infrastructure demand caused by rapid economic democratization and growth; understanding the impacts of decentralization, enhancing regional cooperation, and a host of other sector and country-specific topics. The goal of this report was not to tackle each problem individually, but rather to provide senior policymakers, infrastructure practitioners, the private sector, NGOs, and the development community at-large with a new approach to understanding the larger framework under which infrastructure decisions are made and the wide-ranging effects that infrastructure plays in the region, and to suggest a course of action for medium-term and long-term outcomes.

The resulting report, *Connecting East Asia: A New Framework for Infrastructure*, [1] details the current challenges within a structure that focuses on three thematic focal points which eschew the mantle of sector specific discussion in the absence of a strategic vision on a larger scale. This framework is comprised of: Inclusive Development, Coordination, and Accountability and Risk Management. Each element, as detailed below, delineates a conceptual approach focusing on East Asia's infrastructure challenge:

Inclusive Development: The role of infrastructure in improving the income and lives of all members of society, especially the poor.
Coordination: Generating strategic vision and turning that vision into reality, given the long-term impacts of infrastructure.
Accountability and Risk Management: Rewarding organizations that perform for their stakeholders (and penalizing those that perform badly); and making risks and rewards commensurate with each other in order to drive good performance.

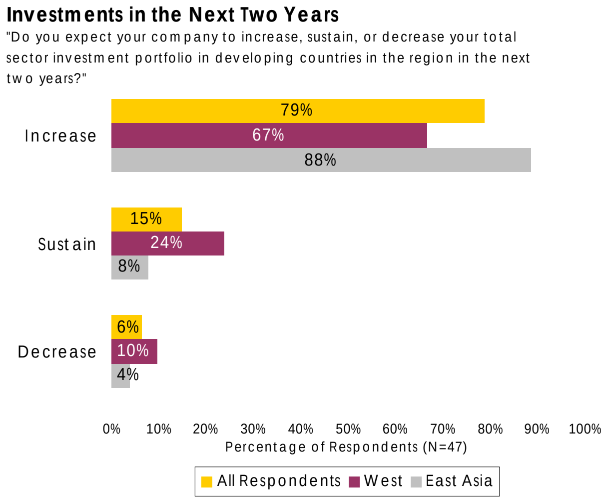
[1] Please see http://www.worldbank.org/eapinfrastructure for the full report and associated project materials, including background papers and conference findings.

This framework is the vehicle by which the report's policy messages are derived. The topic of this panel, private-public partnerships (PPPs) for infrastructure development, is a crucial component of the region's infrastructure puzzle. As such, the report's conclusions, point towards the necessary steps needed to invigorate PPPs within the new framework, and importantly, outline the steps that multilateral development agencies can take to promote these partnerships in the region.

The PPP Challenge

Infrastructure needs to sustain current growth rates in East Asia are large: about $200 billion annually. Private investors have played a key role in the 1990s; they have invested approximately $190 billion in East Asian infrastructure since 1990. Even at its mid-1990s peak, however, this represented only a minor share of total infrastructure investment in the developing world in general (20-25 percent). Moreover, levels of private investment in infrastructure have sharply declined throughout the developing world in the aftermath of the Asian crisis.

However, annual private infrastructure investment levels in developing countries as a whole were still about 50 percent higher in 2001-03 than in 1990-95, while in the region they were roughly the same over those two periods. Essentially, the current levels of actual new direct investment in East Asia appear to have stabilized at the levels of about ten years ago, lagging behind the global average, with private investment financing less than 10 percent of the region's total investment needs today. While these trends are partly dictated by global capital market considerations, they are also heavily influenced by the specifics of the investment climate in the region, and the reduced risk appetite of private investors following the East Asia crisis.



A survey undertaken for this study shows a renewed positive sentiment overall among potential investors in East Asian infrastructure. But this sentiment varies by country and sector, and is contingent on policy improvements to reduce risk.

In both the survey and discussions with regional investors during the preparation of the study, a number of stated desires emerged as pre-conditions for greater investment:

- importance of predictability in assessing specific investment opportunities
- better understanding of attitudes and motivations of local governments in order to assess viability of investment

- consistent enforcement of contracts, which enhance regulatory stability and predictability
- partners must be financially and technically credible and have reasonable experience, particularly for complex cross-border projects

In order to ensure that PPPs will have positive impact, the main conditions that need to be met revolve around ensuring greater certainty: stable macro-economic environment; legal frameworks for contract enforcement and remedies, regulatory stability; effective checks against corruption; and a developed (or developing) domestic debt market. The more arrangements that exist to promote competition, the better the potential for effeciency. There is evidence that private firms in competitive markets outperform public firms across a host of measures including social welfare (however, the evidence in non-competitive markets is much weaker and depends crucially on the quality of regulation).

Clearly, much needs to be done on the policy and institutional front to mitigate risks for the private sector and also to maximize the potential benefits of PPP for society as a whole. In essence, the core issues are not public versus private, but about how public and private parties can share the risk and rewards in a way that works for both sides, and how the public sector can harness the efficiency gains that the private sector can bring. The sources of funding and ownership are in many respects secondary.

Operational Implications

We have briefly presented above the main building blocks of the new framework presented in the report by ADB, JBIC and the WB on Connecting East Asia, namely the concepts of (i) inclusive development (ii) coordination (iii) accountability and (iv) risk management. We have also briefly reviewed PPP experience in East Asia. Let's now put the two together and discuss how the new framework presented in the report can inform the way in which PPP projects should be prepared and implemented.

The *economic analysis* of infrastructure projects traditionally focuses on the economic rate of return of the projects. While such analysis attempts to estimate the positive and negative externalities associated with the projects, there is a growing consensus that, in practice, it is often inadequate. In many cases, the benefits of infrastructure to *inclusive* development are underestimated. In others, it is the negative impacts on environments or local communities that are over-looked. To account for the full impact of a given infrastructure project, one has to estimate this impact not only on incomes but also on other dimensions of well being (such as access to basic services, engagement in collective activities, ability to be heard and more generally to exercise control over one's life) and one has to compute such impact not only on the direct users of infrastructure services but also on the population at large. Government decisions on which PPP projects (or in fact any infrastructure projects) to promote need therefore to rely on impact analysis that go beyond economic rate of return evaluation as commonly practiced.

Institutional analysis has played an increasingly important role in the evaluation of infrastructure projects. From the end of the second world war until the late 1980's, a vast majority of large infrastructure projects were carried out by public entities and institutional analysis focused on the ability of the relevant entities to adequately prepare and implement the projects. Once private investors and operators stepped in, the analysis became more complex: public entities were evaluated, not for their ability to implement a given project, but for their capacity to provide a suitable environment for privately managed projects; the terms of the agreement between public and private parties became an essential driver of the parties' incentives; and the performance of new regulatory institutions came under scrutiny. Today, in many East Asian countries, new *coordination* issues are again coming to the fore, and in particular how to reconcile strategic vision with demand driven investment and decentralization, and how to design effective public-private partnerships in a context of rapid decentralization.

This raises a number of new questions. For example, how does one foster the re-emergence of an adequate planning capacity at the central level without hampering the workings of newly liberalized markets? How does one ensure that national priorities are taken into account at the local level without jeopardizing the responsiveness of decentralized authorities and private operators to local needs? And how does one reconcile decentralization with the need to take advantage of economies of scales and of network integration beyond the limits of individual local jurisdictions? These are some of the new institutional issues with which today's practitioners are still trying to come to grip.

Financial analysis is another key dimension of project preparation. Cost recovery and finance mobilization tend to be challenging in infrastructure. Private-public practitioners will often advocate cost-covering tariffs, wherever possible, to achieve cost recovery - and justifiably so given the addictive and potentially fiscally dangerous nature of public subsidies. But in some cases, social considerations will require that public subsidies be used to enable the poor to gain access to infrastructure services. With regard to finance mobilization, efforts have tended to focus on using funds from government and from development agencies to catalyze private resources for large projects. In both areas, project designers are being asked to come up with new and innovative *risk management* solutions.

The key issue is how to design optimal forms of public support to private infrastructure projects. Some of the difficult questions include the following: (i) when the overall situation is precarious (think of the Philippines today for example) what constitutes a fiscally prudent level of public subsidies? (ii) how does one design public subsidies that do not breed inefficiency and that are effectively phased out when they are not needed anymore? (iii) what are the forms of public support best tailored to catalyze private resources? and (iv) how does the government keep track and manage the public liabilities that accrue from the provision of such public support ?

Infrastructure is costly and thus a central focus of central financial authorities. In addition to the issue of subsidies, new areas of analysis focus on the issue of fiscal space;

sustainability of infrastructure investments; and risk-management frameworks and contingent liabilities management.

Finally, the *technical analysis* of infrastructure projects has been impacted by new considerations as well. There was a time when engineers single-handedly took care of the technical work. But not any more. With fast economic growth and rapidly deepening inter-dependence between economies, the objectives of infrastructure policies, and of individual projects, have become more complex. With increased participation of private investors and operators, and the emergence of more pluralistic societies, a variety of new actors have a say in the design of projects. And with a better appreciation of the negative impact of corruption on the investment climate, more and more governments are making serious effort to try and improve standards of governance in infrastructure. This all means that a whole new body of "technical" work is now geared toward securing adequate levels of *accountability* in the provision of infrastructure; it is being pursued, for example, through environmental and social impact assessments, participatory mechanisms for project preparation, more stringent procurement processes, and the intervention of (more or less) autonomous regulatory entities among others.

Official Lenders and Donors: The Way Forward

Let's now focus on the development community, and in particular on bilateral and multilateral development agencies, and ask how these institutions can best support public and private parties as they grapple with the new operational agenda. What changes should development partners themselves make in the way they conduct their operations in order to be more attuned to the new needs of their clients?

In purely monetary terms, official development assistance (ODA) has never been more than a small portion of infrastructure financing needs. ODA and official aid accounts for approximately 1 percent of gross investment in low-and middle-income countries of East Asia.

These flows are however more important in some countries than others. For example, aid as a percentage of gross fixed investment is 54.1 percent for Cambodia, 69.2 percent for Lao PDR, and 51 percent for Mongolia, versus 4.9 percent for the Philippines, 5.2 percent for Indonesia, and 12.9 percent for Vietnam.

Also, official financing of infrastructure in the region is on the rise again. The contribution of infrastructure to poverty reduction—indeed of growth to poverty reduction—has been reappraised. The depth of the policy and institutional challenge is now better appreciated. A relationship of mutual support and partnership between private and public actors is re-emerging. Official lenders and donors are repositioning themselves, and infrastructure now has a higher profile in the development community at large.

Official lenders and donors must be ready to support broad and coordinated reform efforts. This means moving away from a project-by-project basis, towards a sector-wide approach. As some countries have strengthened their macroeconomic situation and have started to tackle the main impediments to PPP, policy-based operations providing overall budget support to governments – through direct lending or through guarantee instruments that help governments tap international financial markets – can be the right vehicle to promote a broad set of desirable interventions across government departments. The so-called SWAPs (or sector-wide approaches) - whereby official lenders and donors finance sector programs - constitute for their part promising tools that can be used to support the range of public investments or subsidy mechanisms needed to promote and complement public-private partnerships.

With the greater complexity associated with fast-growing and inter-related economies, comes also the need for more flexibility. Support to broad government programs – through policy-based operations or SWAPs as mentioned above – tends to provide such flexibility as these instruments do not need to prescribe specific project details and can easily be tranched to support different phases of a reform program..

The drive toward decentralization of responsibilities in infrastructure also adds new dimensions of complexity and inter-linkages, and development agencies need to tailor their interventions to operate effectively in support of PPP in a decentralized environment. Development institutions need to re-tool to directly engage provinces or municipalities more effectively. Policy-based operations can be designed for sub-national entities. When it comes to providing financial support to specific projects at the local level, development institutions need to intervene more efficiently than on a project by project basis. Partnerships are needed with intermediary financing institutions that support private projects under sound risk management principles and that have the knowledge base and the staff required to identify promising on-lending opportunities at the local level.

More traditional, project-specific, investment lending will remain essential in infrastructure. But in the vast majority of countries, the magnitude of infrastructure needs is such that development agencies can only contribute a small fraction of the monetary resources required overall. In addition, the financing is only part of the equation; the nature of the incentive structure is the key determinant of project impact. Therefore, ensuring that the available financing has a catalytic impact needs to be a key objective of the development agencies and of their clients. And this catalytic impact can take different forms. Development agencies' interventions can give other financiers the comfort they need to step in – think of Nam Theun 2, a $1.2 billion project, to which ADB and The World Bank jointly contribute only up to $90 million in loans (and up to 200 million in guarantees). Also, development agencies' participation in a given project can provide an opportunity for engagement and support on sector or cross-sector reforms that are key to facilitate or maximize the benefits of PPP.

Finally, the complexity of the agenda warrants serious research efforts with relevance to PPP on the part of the development community. We have already mentioned above a number of issues with which development practitioners are struggling at present. Let's just highlight here a few that appear particularly challenging:

- Designing planning institutions at the national and at the regional level suited to the needs of economies in the process of decentralization and liberalization;
- Estimating the magnitude of the fiscal space available for public support to PPP projects;
- Designing credible sunset clauses for public subsidy schemes;
- Developing financial intermediation schemes specifically suited to the promotion of public-private partnerships for infrastructure service provision;
- Designing mechanisms that provide for gradually adapting levels of regulatory discretion to levels of regulatory competence and autonomy;
- Developing effective ways of combating corruption at the various stages of project identification, construction and operation.

In summary, East Asia is a dynamic region making important strides in poverty reduction. But its institutional structures also need to adapt to a fast changing environment. This requires a new framework on how we do business. East Asia's infrastructure needs are huge, requiring new forms of private-public partnerships. But to tap this potential, much effort will be needed to review and adapt the policy environment and risk framework under which private (and public) operators commit funding to large investments. The World Bank Group, and other public institutions, is ready to help, especially as a catalyst.