



# Thomson Reuters Project Finance

The changing landscape of project financing and the growing importance of public-private partnerships

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In April 2017, Thomson Reuters hosted the first of a series of round table discussions with a panel of construction industry experts. Our aim was to gain insight, examine the challenges faced by the sector and explore potential solutions that could accelerate project completion in the Gulf Cooperation Council (GCC) area.

## Public-Private Partnerships: in times of budget deficits, are these key to kick-starting projects?

### Introduction

The potential use of Public-Private Partnerships (PPPs) in the GCC provokes much debate and many questions, such as what are PPPs? What do they entail? How should they be financed? Are there any examples of successful PPPs in the GCC? Is there a market for them? And how should they be run? But perhaps the biggest question of all is how can PPPs be used to optimise public spending and accelerate completion of large scale projects?

There is a perception that PPPs are relatively new to the Gulf. In fact, they have been in the region for decades, mostly in the form of independent power projects (IPPs) and independent water projects (IWPs). These were developed prior to the financial crisis as governments used public-private partnerships to attract international expertise and investment capital and provide efficiency gains.

However, while PPPs have been relatively successful in the Middle East’s utility, refining and petrochemical sectors, PPPs have been little used by governments in other infrastructure-heavy sectors such as education, healthcare and transport. This paper will discuss some of drivers behind PPPs, the challenges in implementing these partnerships; and the steps governments are taking to overcome them.

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## Why are PPPs in focus now?

The sharp fall in oil prices from mid-2014 and corresponding drop in crude revenues, led some GCC countries to face major budget deficits for the first time. This is a situation that 20 years ago would not have been as much of a problem because GCC states had large surpluses of cash and, in general, were not investing heavily in social and economic infrastructure.

Since the Arab Spring, ruling families and governments in much of the Middle East and North Africa (MENA) entered into “social contracts” with their citizens to improve general living standards and modernise state infrastructure. This included providing better transport, healthcare and education facilities.

These social programmes were launched to varying degrees across the region, requiring significant budget allocations for capital expenditure investments and operating expenses.

There is now immense financial pressure to run infrastructure efficiently and find funding to complete partially delivered projects. Questions are being raised on how future spending plans will be financed.

Countries such as Saudi Arabia have made it clear that the bulk of projects must be delivered and that to do so major projects will likely rely on PPPs.

Most OECD countries have developed highly efficient PPP models across the social infrastructure spectrum. Gulf ministries and advisers will have to consider how to transfer and learn from these successful contractual models, while the challenge for investors will be to determine the certainty of equity returns. Lending banks will have to be reassured that revenue risk for these projects is appropriately allocated between the public and private sector. Without this, the long-term debt required to finance projects will simply be unavailable and international banks will deploy their capital to less risky and better structured deals elsewhere.

## How have PPPs in the energy and petrochemical sector succeeded in the GCC?

There are many reasons why PPPs have been successful in the utility, refining and petrochemical sectors, but struggled to get off the ground in other areas. To understand why, it is important to recognise how these sectors were able to develop a contractual structure that benefitted all participating parties.

About 15-20 years ago, governments realised that to attract the technology and expertise to build the required infrastructure, they needed to develop models which were attractive to foreign investors and international commercial lending banks. That meant assigning legal ownership of assets to the private sector part of the partnership, even though foreign ownership of such assets was not allowed at that time.

To overcome this, governments developed legislative frameworks that would regulate partnerships and permit the foreign ownership of these assets. Qatar enacted an electricity sector law. Oman did likewise, also creating the Regulator AER.

Other regional governments followed suit, establishing the regulatory and then contractual framework to enable to procurement of projects on a streamlined basis.

Similar regulations have not been introduced to allow foreign ownership of key assets in other sectors, leaving projects in these industries to be fully government funded or indefinitely delayed.

“ *There is now immense financial pressure to run infrastructure efficiently and find funding to complete partially delivered projects.* ”

## Is there a one size fits all PPP?

Perhaps the biggest hurdle to overcome in making PPPs work in the region is to educate various stakeholders about the potential benefits of a PPP funding structure. Different sectors require different contractual rules governing revenue. For instance, school PPPs are largely procured on a long term “availability/capacity payment” basis. This is similar to a power IPP where the basis of the tariff is a “fixed capacity charge” irrespective of whether the plant is commissioned. Roads have the flexibility of being structured as live tolls or “shadow” tolls – or indeed a mixture of both.

The reality is that these partnerships vary on a project-by-project basis. For example, in some the private sector may only oversee project management, finance, or a certain portion of the build.

In a true and equal PPP, for a project to be attractive to the private sector the asset must provide long-term profitability. This means once an asset is completed the private sector component of the partnership requires a share of the long-term revenues. The feedback from our panel of experts is that this is often where a PPP will fail to get off the ground. It seems that many public entities are just looking for a contractor to “build an asset at no cost if they get the land for free”, rather than a true long term PPP partnership with the private sector.

## Increased accountability for public sector spending

One positive aspect of the fall in oil prices is that finance ministries are raising standards and now require individual ministries to plan and budget in better ways. They are looking for more accountability from state-owned enterprises and municipalities.

In the past, there was little consideration of the total life cycle cost of a project and funds were allocated out of the petro-dollar cash surplus, but now there is a substantial push to understand how much is being spent, where it is being spent and the likely ultimate return on investment for the project. And most importantly, what government objective would that spending meet?

Governments are reluctant to fund entire projects and PPPs are seen as a means to plug a budget deficit, but governments are also wary of working with parties that have yet to complete a PPP in that specific sector in the region.

## Development of a legal framework

Governments are starting to recognise they lack the skills and processes to drive projects suitable for PPP through to completion. Most lawmakers in the GCC have begun writing their own PPP laws. Dubai completed its PPP law in 2015, while Oman, Qatar and Saudi Arabia are in the process of formulating their own legislation. It is important to recognise that this is only a first step - Kuwait has had a PPP law in place for over a decade and has yet to complete a single PPP transaction outside of the power sector. For PPPs to succeed you need more than a law or framework, you need a high-level government commitment that will drive reform.

## Risk appetite and funding availability

According to our panel of experts, there is a perception issue surrounding private sector funding of a project. The perception is that funding is scarce and that it is difficult to fund large scale projects. Yet our experts say that for each project in which they have been involved there was an abundance of funding - often 3-5 times the liquidity needed.

Moreover, banks do not look at projects from a risk perspective any differently than they did pre-2008. They are simply looking at the project life cycle and whether the business case adds up. If a project has a well thought out commercial rationale it is likely to gain funding. From a global perspective, it is true to say we operate in a more capital-constrained funding market, but very often this creates a “flight to quality”. Well-structured, high quality, bankable projects will always attract investors and lenders.

Funding providers seem to possess the necessary risk appetite and the private sector has always been adept in understanding the ROI behind a capital investment project. From a PPP perspective, a project can run into trouble when the public sector is unable to adequately assess and allocate operational and financial risks.

If too much risk is passed to the private investor, the risk premium factored into the ROI and project pricing can distort the “availability or capacity” payment paid by the government.

If this is too high, value for money to the government will be eroded and the PPP model should either be replaced or a more sensible risk allocation be considered. In developed countries, the economic case for utility PPPs is more transparent because such projects generate a physical product for re-sale (e.g. electricity or water).

These commodities are ultimately consumed and paid for by end users, who pay cost-reflective tariffs that fully cover the cost of generation and distribution along with providing private PPP investors with a fair profit margin.

However, in many emerging markets such as the GCC, massive government subsidies to end users completely distort this value chain. While the IPP investor is charging a cost reflective tariff to the government agency off-taker (through the PPA) – the generation, distribution and retail cost elements of the commodity are rarely fully paid by the end customer. If end user tariffs are fully cost reflective, it is easy to calculate the profitability and value for money along the value chain.

In the case of social infrastructure projects, the mechanism is different in that the long-term availability fees paid by government to the investor are funded out of general government receipts and there is often no tangible product being purchased by a government agency for re-sale. The government is purchasing “availability” of assets and services at a defined quality and quantity. For social infrastructure projects, a certain level of sophistication and financial literacy is needed in the public sector to calculate risk allocation and value for money.

“ *If a project has a well thought out commercial rationale it is likely to gain funding* ”

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## Cost of funding and potential market innovations

Banks are often criticised for charging higher interest rates than the benchmark sovereign cost of borrowing to finance PPP projects. Why not simply dip into government cash reserves or issue new sovereign debt to finance projects? However, this argument fails to consider that banks will calculate the cost of risk and lend accordingly.

One of the fundamental reasons for doing a PPP is to transfer risk to the private sector. Naturally, this risk will have to be priced into the cost of debt to which lenders are exposed. If a project is deemed to be very high risk - perhaps the commercial plan has gaps, or it is likely to have supply chain risks or overruns - the bank will lend accordingly at an appropriate rate. In public sector funding, these risks are not factored into the equation. Furthermore, a steady supply of central funding very often leads to higher construction costs and operating cost overruns. PPP practitioners would say "nothing comes for free" and this includes public sector money.

A project will on average re-finance roughly every 5-7 years to take advantage of cost efficiencies and a reduction in the project's risk profile. The cost of interbank lending is substantially higher than 10 years ago, with banks unwilling to take risks and lend at low rates over a much longer period, prompting the need to refinance a few years into the project's life cycle.

Ideally a major infrastructure project would prefer a 20-year loan/lending period, but this simply isn't a realistic way to get the best rates.

The panel feels that 20-30 year bonds could be a better way to raise funds for long-term projects. It seems that governments also recognise the benefits of using bonds in this way and are matching the bond period to a specific project.

In April 2017, Saudi Arabia released its first dollar-denominated sukuk, which raised 9 billion dollars (with orders of \$33 Billion). In October 2016, Saudi raised \$17.5 billion in what became the largest bond issued by an emerging-market country. There is clearly a market for these investments and we would expect other bonds to be issued to help finance large scale projects.

### Future Projects in key markets:

- The First PPP project in Qatar outside of power is for 10 schools for nationals, procured by the government.
- Qatar is also pushing for PPPs in the transport sector and seeking wider private sector participation. This will be hard to achieve because of the sheer size of capital expenditure and relatively uneconomical nature of the returns, but there is a growing appreciation of contribution transport can make to GDP.
- The rail market (predominantly Doha and Riyadh) is restructuring due to private financing.
- Last year, Dubai's Road and Transport Authority (RTA) launched an RFP for red and green line productions; whilst currently quasi-private financing funds this it is slowly moving towards full PPP.
- Infrastructure, particularly within ECA, for construction and finance is growing rapidly.

## Conclusions

While there are myriad hurdles to overcome, the panel is confident there are solutions to these challenges in creating and maintaining successful Public-Private Partnerships – particularly in sectors which historically have been procured and funded by governments.

The panel believes the following recommendations could help in the creation of PPP in the GCC and allow more projects to move forward.

### **Improve education about PPPs:**

There is currently a lack of skills and expertise to execute on partnerships. This can include understanding the basics of a PPP, the correct risk assessment of a project, commercial planning and long-term financial planning. Added to this, a PPP typically includes a 20-year contractual agreement and in the public sector there is a lack of necessary expertise to run such partnerships successfully. If governments are serious about PPP, then there must be an upskill of people able to manage these long-term relationships.

### **Structural reforms:**

There is a need to create and complete legislation and regulatory frameworks for PPPs.

### **Creation of ministerial PPP units:**

This could help advance PPPs in other major projects. Saudi Arabia could benefit from this approach to help kick-start some of its delayed projects.

### **Start small and specific:**

It sometimes seems that each project in the GCC needs to be bigger and better than any other and unique in its scope. The challenge such an approach immediately runs into is that there is no PPP precedent and so in all likelihood a PPP will fail to be agreed. The panel believes that successful PPP projects will be those that have a defined and specific scope. The first of its kind PPP project in a country does not have to be the largest in the world. Better to close one transaction successfully and then create a pipeline of transactions having built up a banked precedent.

The GCC is becoming known for many innovative practices. Over the past 10 years, the bloc has expanded and diversified its economies. In Europe, PPPs are extensively used for Social infrastructure and there is no reason why GCC governments should not be similarly successful. All that is required is the political will and the motivation to implement a successful PPP programme.

“ *The panel believes that successful PPP projects will be those that have a defined and specific scope* ”

## List of participants:

	Name	Title	Company
1	David Charlier	Partner	Ashurst
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3	Frank Beckers	Global Head of Project Finance Advisory	NBAD
4	Rohit Gokhale	Executive Director - Acquisitions & Project Finance, Investments	ACWA Power
5	Andrew Ward	Director of Infrastructure Advisory	Hill International
6	Colin McDaid	Senior Director Finance and Administration	Turner (TIME)
7	Ali Tabbal	Former CFO at Kerzner, CFO at Kingdom Holding and CFO at Dubai Holding	Personal Capacity
8	Kathleen Swalling	Strategic Legal and Sustainability Expert	GAICD
9	Aaditya Sarna	Managing Director	United World Infrastructure
10	Daniel Xu	Senior Legal Consultant	DLA Piper
11	Prof. Ammar Kaka	Provost & Vice Principal	Heriot Watt University Dubai
12	Maarten Wolfs	Partner, Middle East Project & Infrastructure Finance Leader PwC	PwC

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