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Across the Pacific: Financing of PPP projects

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ACROSS THE PACIFIC
- Financing of PPP projects

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CONTEXT

Colombia is South America´s only country with access to both Atlantic and Pacific coasts. This advantageous position gives it easy access to North American, Caribbean, Asian and European markets. A positive investment cycle, coupled with favourable international commodity prices and a consolidation of the country´s macroeconomic framework have underpinned Colombia's growth over the last decade, leading to it being awarded investment grade in 2011. In June 2012 credit rating agency Fitch affirmed Colombia's foreign currency long-term issuer default rating (IDR) at *BBB* - with its local currency long-term IDR at *BBB*[1].

Despite the significant improvement in Colombia´s economic fundamentals, serious issues remain in the country´s transport infrastructure. This article looks at the Colombian Government´s response to these shortcomings, the launch of a fourth generation of public-private partnership (PPP) infrastructure projects ("4G Infrastructure Projects") and the ways in which institutional investors can be used to meet the financing demands of Colombia´s fast expanding infrastructure market.

4G INFRASTRUCTURE PROJECTS

A lack of road planning over recent decades has left Colombia with a deeply fragmented transport infrastructure. In 2011-2012 Colombia came 95th in terms of infrastructure quality out of 143 countries surveyed in the World Economic Forum´s Global Competitiveness Report.[2]

The absence of an integrated multimodal transport system means that the cost of transporting a barrel of oil in Colombia is now at around three times its cost of production.[3] For Colombia to sustain its economic growth, the Government has prioritised spending on transport infrastructure through a PPP framework regulated primarily by Law 1508 and Decree 1467. This law was introduced in January 2012 in order to attract qualified players to develop Colombia´s 4G Infrastructure Projects. In 2011, Colombia invested approximately US$3.6bn (1% of GDP) in infrastructure with investment set to triple in road network transportation to 3% of GDP by 2014. Two thirds of new investment is to be obtained through private sector concessions, whilst the remaining third will come from public sector funding. The primary focus of this investment is on road network transportation, airports, port dredging and railroad networks.

Under the contracts for 4G Infrastructure Projects, prequalification for the first tranche of road concession contracts (*Victoria Tempranas*) has already begun, with the total value for 8170km of 4G road concession contracts estimated at US$24.4bn[4]. The proposed scale of investment in Colombia, along with investment in other Latin American countries, is generating unprecedented demand on local sources of finance. A look at the historical sources of financing infrastructure in Colombia illustrates the need for adopting new approaches to financing projects with the advent of Colombia´s 4G Infrastructure Projects.

THE FINANCING OF INFRASTRUCTURE PROJECTS

Traditionally, PPP projects in Colombia have been financed through the local banking sector as well as public finance. Bank lending will remain a key source of financing 4G Infrastructure Projects, an example of which is *Banco de Bogotá´s*[5] latest pledge to maintain its infrastructure loans.[6] In 2012, *Banco de Bogotá* issued loans of US$1.5bn for the financing of petrol and gas transportation projects along with the development of port and road infrastructure.

However, the scale and volume of forthcoming infrastructure projects in Colombia, the near saturation of the local banking system and the shrinking appetite of banks for traditional project finance, make new capital market financing, through multilaterals, international banks and institutional investors, an essential element of the new financing landscape.

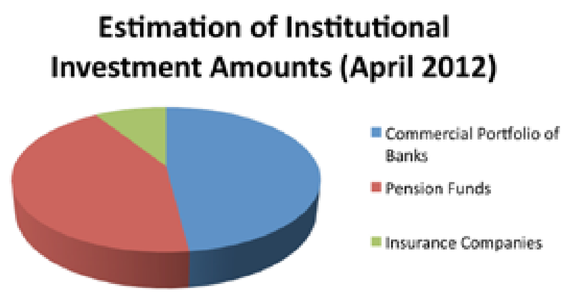
Colombian infrastructure projects have previously tapped international markets with considerable success during the 1980´s and 1990's as seen in the financing of Eldorado Airport´s second runway or the Medellin Metro.

Today, however, the global financial crisis has caused many banks, particularly European ones, to tighten credit lending. This has severely constrained the availability of long term debt needed to finance new infrastructure. Other sources of finance need to be tapped; and the growth of institutional investors, fed by a rapidly expanding pensions market in Latin America, provides promising new funding opportunities for 4G Infrastructure Projects.

The expansion of the pensions market in recent years was illustrated recently by the President of the Colombian Association of Pension Funds (ASOFONDOS), Santiago Montenegro, who confirmed that current pension funds could finance up to US$25bn of infrastructure projects[7], over half the total value of infrastructure investment presently proposed by Colombia´s national infrastructure agency (ANI). Institutional investors can therefore play a critical role in Colombia´s 4G Infrastructure Projects.

INSTITUTIONAL INVESTORS

As illustrated in the pie chart below, the ANI estimated in 2012 that the investment portfolio of institutional investors in Colombia stood at circa US$150bn, with 43% held



by pension funds (US$64bn), 48% by the commercial portfolio of banks (US$72bn) and 9% by insurance companies (US$14bn).[8]

It is only in the last two decades that investors have started to recognize infrastructure as a distinct asset class with the realisation that long term, inflation linked revenues, can be used to match the long term index linked liabilities of pension funds. Traditionally, institutional investors have invested in this sector through listed companies and / or funds. An example is the recent listing of Greencoat UK

Wind (www.greencoat-ukwind.com) on the main market of the London Stock Exchange. Greencoat provides institutions with a tradable instrument for investment in operating onshore and offshore wind assets. If institutions can play a bigger role in financing operating assets, this will enable project developers to recycle their invested capital into new projects.

The challenge however in current market conditions is to link short-term construction finance (usually in the form of hard or soft mini-perms) to long term institutional take-out, whilst not imposing an unacceptable refinancing risk on project developers. One way forward may be for the public sector, working with a private sector contractor, to finance construction and initial operation with a view to creating a fund(s) seeded with assets that have operating track records.

Only a very limited number of pension funds have the ability to originate, evaluate and underwrite primary project finance transactions and in so doing accept construction and development risk. This was the traditional preserve of commercial banks and building teams to undertake these capabilities is expensive and time consuming. In Colombia, pension funds are in fact prohibited from investing in primary project finance as will be discussed in more detail below. For these reasons, the more promising approach remains, for the time being at least, for institutional investors to invest in funds comprising of a portfolio of operating assets. Larger projects may be targets for direct investment once financial and operating track records have been established.

PROJECT BONDS & SECURITIES

Alternative methods of attracting institutional investment are through the sale of project bonds or securities, approaches which have met with mixed results. An example of securitisation for project financing is the setting up of a special purpose entity (SPE) which issues debt and equity securities, after a project has been constructed and is performing satisfactorily. The SPE then uses the proceeds from the issuing of its securities to purchase project loans from the original lender.

Project bonds on the other hand are debt instruments issued by PPP project concessionaires and typically bought by institutional investors such as pension funds and insurance companies. It has been widely recognised that given current financial market conditions and a drying up of credit in the banking sector, bond financing can play a role in bridging the financing gap for infrastructure investments.[9]

In Peru, the capital markets have been used for financing large-scale projects backed by *CRPAOs* (a right to collect

an annual construction payment, in the form of a physical certificate governed by New York Law) and more recently by *RPICAOs* (a right to receive a payment on a certain date in the future that vests under the concession agreement). Key examples of projects financed through these initiatives are the IIRSA Norte and IIRSA Sur toll roads.[10]

Such financing structures have yet to be used in Colombia, but their arrival is now surely overdue given the scale of ANI´s infrastructure ambitions and the appetite of Colombian pension funds to invest in local infrastructure markets. Project bond financing does, however, raise particular issues for institutional investors which need to be taken into consideration:

(i) Credit Quality

Institutional investors typically invest in high quality assets with a low likelihood of loss. To meet the expectation of investors, the "arrangers" of bond issues (usually banks) involve rating agencies and seek to structure their transactions so as to achieve high credit ratings (usually A- or above.)[11] As typical PPP projects are structured to achieve a BB+ or BBB- rating, bond financings are likely to involve "credit enhancing" instruments – usually involving some form of public sector support – in order to achieve the rating required by investors.

(ii) Size / Costs and Deliverability

Bond financing is only suited to PPP transactions of a significant size given investor appetite and the cost, complexity and due diligence requirements of individual projects. Preparatory costs will include obtaining a credit rating for the bonds as well as marketing and preparing the bond placement documentation. The deliverability and pricing of bonds are normally only confirmed upon actual issuance which for PPPs means that some uncertainties inevitably remain throughout the procurement phase.

With these issues in mind, it is important to look at Colombia´s current regulatory regime applicable to institutional investors.

REGULATORY REGIME

According to the EIU´s latest evaluation of PPP environments in Latin America and the Caribbean[12], Colombia leads the emerging cluster of previously "nascent " LATAM countries on the basis of its new PPP regulatory framework[13] which has increased accountability for government and private partners whilst improving bidding mechanisms and limiting contract renegotiations.

(i) Law 1508 of 2012

Under Colombia's new PPP legal framework, Law 1508 of 2012 aims to provide incentives for the private sector to propose, structure and finance PPP projects. The first private entity to put forward a PPP proposal under the new regime is therefore granted exclusive rights to work with the contracting authority in question on the pre-feasibility and feasibility phases of that project. Should a private initiative be proposed without public finance input[14], the private sector initiator will also have the chance to better any rival bid which is submitted to the contracting authority at the project´s tendering stage. Compensation mechanisms are also put in place under Law 1508 of 2012 to ensure that should the initiator of a project lose out on the eventual award of contract, it is nevertheless reimbursed for those costs which it has incurred in structuring the project prior to tender. As recently noted by the CEO of a large multinational operating in the Colombian market, Law 1508 of 2012 provides clear incentives for private sector investors to be the first in putting forward infrastructure proposals to the Government.

(ii) Law 1328 of 2009

From an investor´s perspective, Law 1328 of 2009 and its regulatory decrees allow for greater flexibility in the participation of institutional investors in Colombian project finance, with a raise from 30% to 60% in the maximum participation of bond finance in project portfolios. Nevertheless, there are still certain challenges in Colombia regarding the way in which institutional funds can invest in PPPs. The following are some of them:

(a) Institutional funds should not be defined as public debt;

(b) Payments will only become available on completion of the works and contingent on proper performance; and

(c) Institutional funds are not willing to assume construction risk.

Concerning (b), concessionaries will only have access to funds raised from project revenues, such as those arising from tolls or fiscal payments, once a project´s construction phase is completed by the contractor. This is a relatively new regulatory change introduced by Law 1508 of 2012. Likewise, under (c), multilaterals or international banks will still be required to take on the initial financing and construction risk of a project. This position was recently reaffirmed by the President of ASOFONDOS who stressed that pension funds would not be used to finance the construction phase of 4G Infrastructure Projects. Instead, concessionaires could exchange short term banking loans issued for project construction with long-term loans financed by institutional investors once the construction phase of the project is complete and an operating track record has been established.[15]

WHAT NEXT?

It should be remembered that investment in infrastructure is different from other asset classes as scale and high up-front costs mean that the nature and risk of these investments require dedicated resources which many smaller pension funds do not have. Furthermore, such resources can take years to develop as seen with Canadian public pension funds which have become some of the most experienced infrastructure investors in the world.[16]

An additional issue for pension funds has historically been the lack of objective, top quality data on infrastructure investments. Investment risk along with a comparison of the investment returns of other assets have therefore been difficult to assess. Without such information, pension funds will remain reluctant to enter into infrastructure markets.

Latin American experiences in Mexico and Chile suggest that institutional investors, in particular pension funds, can be instrumental to the growth of the corporate bond market and in turn the provision of development finance.

In order for Colombia to attract institutional investors into its infrastructure sector, policy makers need to approach the issues investors are facing from an asset allocation perspective and make the asset class financially attractive. Issues regarding foreign exchange risk also need to be considered so that income streams raised for projects avoid a foreign exchange mismatch.

For Colombia, the rules of the game will be established in the details of the 4G Infrastructure Projects to be tendered by the ANI over the next two years. The issuing of infrastructure bonds or securities may be a determining factor in the successful execution and financing of these projects. However, to ensure investor participation, this article proposes the following four steps:

I. Fiscal payments and toll revenues must be recognised as a single source of revenue for payment of bonds and / or securities in order to ensure that such instruments are not classified as public debt. Unless there is a single treatment of both revenue streams, pension funds will be at risk of exceeding their cap on public debt and will in turn be reluctant to purchase bonds or securities in this sector.

II. Reductions to availability payments made to the concessionaire for failure to comply with quality standards or levels of service must be capped so as to provide the requisite level of risk mitigation for pension funds.

III. A refinancing mechanism must be put in place so as to ensure that banks will be repaid once a project has achieved an operational and financial track record. Without the assurance of ´take out´ on bridge financing when the project becomes operational, pension fund investment will not be forthcoming.

IV. In taking on the risk of revenue shortfall during the project´s operating phase, the ANI needs to provide intermediary compensation to the concessionaire during the lifecycle of the project in addition to any final settlement of payment made at the end of project´s term.

These measures should help attract institutional investors to the financing of Colombia´s 4G Infrastructure Projects. Until such time, regional pension funds will be accumulating cash faster than they know what to do with it.

ENDNOTES

1. Fitch Ratings – Global Infrastructure and Project Finance. Colombia´s Infrastructure: Connecting the Dots. 17th September 2012.

2. The Global Competitiveness Report 2011-2012, World Economic Forum and the Colombian Chamber of Infrastructure, Publication No. 51. January-February 2013, page 26.

3. Idem.

4. http://ani.gov.co/proyecto/general/cuarta-generacion-de-concesiones-1068

5. Banco de Bogotá is Colombia´s oldest commercial banking institution.

6. La Republica - "En 2015 Los fondos de pensiones invertirán en infraestructura"- Finanzas, 3 Abril 2013.

7. La Republica. "En 2015 los fondos de pensiones invertirán en infraestructura". Finanzas, 3 Abril 2013

8. Fitch Ratings – Global Infrastructure and Project Finance. Colombia´s Infrastructure: Connecting the Dots. 17th September 2012.

9. European PPP Expertise Centre – Financing PPPs with project bonds. October 2012.

10. Lexology - "Boosting the Peruvian Infrastructure Market" - 18th April 2012.

11. European PPP Expertise Centre – Financing PPPs with project bonds. October 2012.

12. The 2012 Infrascope: http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=37447865

13. Law 1508 of 2012.

14. A maximum limit for which is 20% of the total project cost

15. La Republica. "En 2015 Los fondos de pensiones invertirán en infraestructura". Finanzas, 3 Abril 2013.

16. OECD Working Papers on Finance, Insurance and Private Pensions, No. 29. "Trends in Large Pension Fund Investment in Infrastructure", November 2012.

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William was called to the bar of England & Wales and on completing his pupillage at Keating Chambers has specialised as en employed barrister in construction, public procurement and competition law. William recently completed a 9 month placement in Colombia´s largest law firm, Brigard & Urrutia, working in the infrastructure & public utilities team and continues to act as an external consultant for the firm in helping foreign clients invest in LATAM markets.