Market Based Financing of Municipal Infrastructure

India Experience
(Chongqing, China.)

L.Krishnan
Infrastructure Leasing and Financial Services Limited
Mumbai-India
Lay out of the presentation

- Municipal Institution – an Introduction
- New Governance Paradigm
- Market Access for civic Projects (Requirements)
- Examination of Revenues and Costs
- Role of Higher Level Governments
- Changing Modes of Municipal Service Delivery
- Credit Delivery and Risk Analysis for Municipal Projects
- Some examples of market based Institutions
Municipal Institutions—an Introduction

- Municipal or City Level governments are local self-governing institutions constituted by the Provincial or central governments through a specific Act of Legislation.
- They are territorial and are characterized by fairly dense concentration of population per square Kilometer.
- Majority of the citizens receive their incomes from non-agricultural or non-farm operations.
- They constitute the sub-national governance systems in cities and metropolitan areas all countries and attend to the day to day needs of a community such as roads, street lighting, water supply and sanitation, schools and colleges, parks and recreation avenues, burial for the dead, public health, internal security and so on.
- India, China and other nations have accounts of independent towns with religious and cultural history such as Kasi, Agra, Kochi, Beijing, Shangai etc., vying with each other for prosperity.
Introduction – New Governance Paradigm

• Modern age living has brought in specific infrastructure issues such as underground sewerage services, tunneled communication services, high speed motor ways and dedicated metro rail systems for fast commuter movement and so on.

• This has brought in need for different management systems at city level putting a premium on professionalisation and competence in service delivery consistent with stakeholder expectations.

• It has also raised issues of financing and sustainable delivery of services.

• Market Capital is slowly emerging as a possible source of financing city infrastructure.
What Markets Are

Markets in India are uncompromising entities looking for:

- Safety in deployment of funds
- Predictability of revenues/costs
- Sound management structure and Processes
- Financial viability of the project/entity
- Legal and Taxation Status
- Simple and straightforward market instruments to invest.
- Availability of market with adequate width and depth for transactions
- An efficient dispute resolution mechanism comparable to international standards
Rating Parameters: Financing of Municipal Projects (IL&FS)

– Economic Base & Demographics
  • Demographic
  • Economic Base

– Financial Parameters
  • Revenue Income Assessment
  • Revenue Expenditure Assessment
  • Capital Expenditure
  • Debt Management
  • Collection Efficiency

– Service Delivery & Managerial Assessment
  • Infrastructure Assessment
  • Past Capital Investments and Future Plans
  • Track Record in Reform Implementation

– Legal & Administrative Framework
  • Functional Domain, Taxing Powers, Decision-making Powers, Borrowing Powers
Rating Parameters: SPV Projects

- Technical Feasibility
  - Status of Land
  - Location Aspects

- Commercial Viability
  - Policy Incentives & Industry Outlook

- Financial Viability
  - Level of Sponsor Support
  - Capital Structure & Means of Funding
  - Debt Servicing Capability

- Project Management & Implementation Risks
  - Contractual & Management Risks

- Physical & Financial Progress

45% 45% 10%
Market financing in India – key institutions

- Direct Lending to ULBs (HUDCO, Banks and Fis)
- Lease Financing (IL&FS, ORYX, TDFC in states such as TN)
- Take out Financing, equity participation (IDFC, IIFCL, IL&FS)
- Financing of Business entities engaged in civic services (Banks, Funds)
  - IL&FS Waste Management and Urban Services Limited
  - Tamilnadu Waste Management and Urban Services Private Limited
- BOTs/Special Purpose Vehicles (Banks, Funds such as TNUDF, PMDOF)
  - East Hyderabad Expressway Limited
- Clusters/New Townships (PMDOF)
  - Gujarat International Finance Tech (GIFT) City
State level Urban Funds/Pooled Funds

They are important market intermediaries.

- Facilitates small and medium sized municipalities, with average credit quality and infrequent borrowing needs, to access capital.
- Lowers default risk since investors exposed to portfolio of cash-flows rather than cash-flows of individual municipality.
- Accelerates credit absorption by municipalities to design and implement urban service projects.
- Several States in India are at advanced stages of setting up state funds – with a natural progression to state level pooled finance entities, which would be an opportunity for:
  - Co-finance with FIs
  - Lend to Fund corpus with stipulated security terms and conditions for each project sanction, which when blended with Government Funds, would provide an attractive source of funding for urban projects
In order to address the gap in urban infrastructure investments, 15 banks/institutions committed lines of credit to a dedicated urban facility: ‘Pooled Municipal Debt Obligation Facility’

- The Memorandum of Agreement was signed on October 13, 2006 at Bangalore for the facility with an initial corpus of Rs 27.5 Billion. US $ 500 Mn
- Has sanctioned term loans for US $150 Mn
- Finances Municipal institutions directly as well as Public Private enterprises rendering municipal services
- It is a serious attempt to look at sub-sovereign lending using the market mechanism and services of a professional Asset Manager (ILFS)
Tamil Nadu Urban Development Fund (TNUDF)
A state Sponsored Fund (India)

- A Trust established under the Indian Trusts Act, 1882, by GoTN, ICICI, HDFC and IL&FS with a line of credit from the World Bank
- Managed by a professional Asset Management company with share capital from GoTN, HDFC, ICICI and ILFS
  - TNUDF is a trust fund engaged in the development of Urban Infrastructure in the state of Tamilnadu.
  - The Fund has been in existence for 8 years
  - The fund has disbursed Rs.8 Billions (US $ 160 Mn) of Loans so far
Housing and Urban Development Corporation Ltd
HUDCO

- A premiere public sector urban infra financing body
- Established in 1970
- Has outstanding loan assets of US $20 Billion
- Number of Schemes Sanctioned-16108
- No. of Schemes Completed-15754
- Project Cost (Rs. in Crores)-342225-US $ 70 Billion
- Raises funds through bonds in local currency, External commercial borrowings, insurance companies and commercial banks
- Provides term loans for urban sector projects to governments and municipal institutions and authorities(Special Purpose Vehicles)
Market Borrowings by ULBs directly

Some of ULBs have mobilised funds through bonds in the capital market - Started with Bangalore for water supply and other municipal corporations followed such as Ahmedabad, Nashik, Ludhiana, Madurai and TNUDF - Mobilization has been limited at US $ 200 Mn - Mostly tax exempt bonds and contributions by public provident funds and commercial and co-operative banks - Involves higher risk premiums and collaterals such as Debt Service Reserve Funds, Grant interception mechanisms, guarantees by provincial and multilateral institutions such as US AID etc - Government of India has launched a Debt Service Reserve Fund Assistance for US $ 100 Mn - Response from the bond market is lukewarm -- mainly due to perceived political risks, structural weakness of the municipal finance and accounting systems as well as the governance and service delivery mechanisms
What do Markets look for

Markets typically look at the following factors while funding city level projects:

- Legal structure of the entity
- Level of autonomy for raising resources and incurring expenditure
- Local management and governance structure and processes
- Managerial and technical capacity of the executives
- Book keeping standards
- History of Project implementation and debt servicing
- Efficiency of asset usage and cost recovery
Factors Affecting Market Access

Market Financing of typical Municipal projects in emerging economies such as India is affected by:

- Evolving market arrangements
- Bonds/Debentures with limited liquidity
- Illiquid Project Loans
- Inadequate Legal and regulatory regimes especially on raising capital and revenues through taxes and user charges
- Structural issues in city government setup
- Rating agency issues – their understanding of sub-soverign governance and infrastructure formation
- Perception of Credit risk and efficiency of risk mitigation measures at city level (it affects rating).
Revenues and costs in ULB context

- Principally revenues for a local body come from assets and transactions within the revenue jurisdiction of the ULB.
- While some of them are taxes and duties, others arise out of provision of specific services by the ULB.
- Moreover specific powers vest with provincial and central governments in many countries to levy and collect taxes and duties on transactions howsoever happening within the territorial jurisdiction of the municipalities.
- Such taxes and duties are usually shared with the municipalities based on specific understanding arrived through bilateral or institutional negotiations between the municipalities and the higher-level governments.
- In India, the State Finance Commissions look into this transfer mechanism and come up with awards periodically say once in five years.

Broadly therefore municipalities revenues can be classified into, Own revenues, Transfers and assignments, Grants for specific purposes allocated by the next level governments.
Revenues and costs in ULB context-Model mix of Revenues

• Typically, Municipalities would be reporting different mix of transfers, assignments, grants and own revenues based on their

  ▪ Location,
  ▪ Economic activities,
  ▪ Level and efficiency of local level administration and
  ▪ Demand for public services and paying capacity of its citizens
Challenges in Revenue Mobilisation

– Sources and size of revenues would largely depend upon the general economic factors and per capita income of its citizens.

– It would also depend upon the billing and collection system in place

– Efficiency of municipal staff in the collection and accounting of such revenues.

– Revenue sources should be buoyant and should respond positively to change in income levels and economic prosperity of the municipal area.

– There should be enabling legislation for capturing appreciation in value of land and building assets due to efficient infrastructure provision, general economic development and inter city connectivity

– New and innovative revenue sources—IT and consultancy, knowledge based services, entertainment and modern communications etc.,
Expenditure and income management

A popular indicator is the Operating ratio
• Operating ratio is calculated by dividing the total expenditure on running the civic services by the revenues realized from various sources.
• A ratio below one is a good indicator of revenue management
• Ratio above one indicates need for urgent review of both the resource mobilization measures as well as quality and efficiency of expenditures.
• A matrix of such ratios and what needs to be attended to is an interesting field of discussion and action for serious professionals.
• These studies and plans for revenue optimization as well as expenditure management take into account local factors in revenue and expenditure composition.
• A serious evaluation has started recently through the JNNURM which is an initiative started by GoI

While some of the municipal entities are solvent institutions in their own right, many of them have serious issues of financial and technical capability to organise and run their services to the local community
Cost Recovery

- The four important co-ordinates of a sustainable cost recovery regime for a municipal service delivery project are:
  - Project design in terms of service delivery and coverage,
  - Tariff and taxes,
  - Project finance and funding
  - Institutional mechanism for service delivery and tariff collection
Cost Recovery- Optimal Cost recovery regime

- In general, cost recovery regimes become stable in Indian Urban Local Bodies
  - If the project design is optimized for consumer expectations of service delivery
  - Capacity to pay for services.
  - Assigning active role to the stakeholders in planning and scheduling operation and maintenance of the facility (especially where the basic resources are limited like an external water source for a ULB or land for parks and gardens in a metropolis or right of way in a classic old town with high concentration of population per km.)
  - Constant consumer education on what the project facility can serve, limitations of the facility and the approach by the policy makers to overcome these limitations
  - This will serve to sustain consumer interest in paying for services and aspiring for better standards in the next phase.
  - Adoption of IT based accounting and billing system, preferably outsourced to remove internal pressure for discretionary treatment of consumers for service delivery and billing. This will ensure that demand notices are sent in time and all payments are properly accounted for and receipts given to the consumers without disputes.

A significant improvement in solid waste collection in some of the wards in Indian Municipal Corporations through a private sector company increases the expectations of citizens in other wards. It also provides the required moral and legal support to the Corporation to extend the arrangement progressively in other wards against opposition from some of the key stakeholders.
Role of higher levels of governments such as provincial and federal governments

- The federal and provincial governments can play a vital role in revenue generation and cost recovery in Municipalities
- They can provide enabling legislation for cost recovery and private sector participation in civic projects
- Come up with good and sound regulatory regimes easily enforceable in local context—urgently required are the disclosure requirements and standardised information
- Undertake time bound review of existing enactments
  - On urban land ceilings,
  - Rules for development control and zoning of municipal areas under various statuetts (Town and Country Planning Acts, )
  - E-Governance and municipal accounting and audit formats,
  - Exemption from staff hiring and contract labour legislations etc.
  - Design Fiscal incentives which are simple to understand and administer.
Role of higher levels of governments such as provincial and federal governments (Indian Example)

• They need to recognize that municipalities constitute the first and basic level of governance in a city and accordingly provide for higher levels of budgetary allocations.

• They need to encourage formation of urban management and financing intermediaries (such as TNUDF, PMDOF Managed by the Infrastructure Leasing and Financial Services, a company promoted at all India level by Financial Institutions such as the State Bank of India, the Central Bank of India, UTI etc.)

• Through such intermediation, they need to channel their budgetary allocations both for project development and financing as well as for leveraging scarce public funds for implementing large civic projects.

• They should encourage active collaboration between civic bodies, urban sector intermediaries and the government directorates to enhance managerial and technical capabilities at all levels of city governance.

• Above all, the government should put in place appropriate policy framework for associating private sector in Public – Private partnerships with city governments for creating and maintaining large civic infrastructure facilities.
Paradigm Shift in ULB service Delivery

- ULBs are moving away from financing and physical delivery of services to becoming procurers and/or regulators of civic services for the citizens.
- This paradigm shift in thinking is throwing up new modes of organizing urban services.
- Many schemes such as water supply, sanitation, solid waste management, transportation etc., are getting delivered through special project vehicles, public private partnerships etc.,
- Cities which have housed traditional clusters such as textiles, leather, handicrafts, metal work, carpets etc., are relocating these clusters outside the city limits ---to ensure better quality of life for citizens and at the same contributing to overall growth of infrastructure.
- This calls for different methods of financing projects in urban sector.
Projects under PPP Framework

• Increasing realization among municipal entities to undertake effective implementation of urban infrastructure projects under PPP framework

• Cities such as Bangalore, Hyderabad, Pune & Ahmedabad creating legal frameworks for segregating project cash-flows and inviting private sector to implement the urban infrastructure projects

• Need to seek proposals from private sector SPVs entrusted with responsibility of creating and managing infrastructure assets for groups of economic activities--- manufacturing, software, hosiery etc.,
  – Proposals appraised and sanctioned by Credit Committee (PMDO) so-far under SITP Scheme (MOT) CETPs etc., would be one sub-set of such private sector SPVs
In Short

Market Financing of Municipal infrastructure would be facilitated by

- Governance Reforms in revenue mobilization and service delivery
- Transparent and commercially acceptable accounting
- Project based revenue and cost modeling, escrow of cash flows and asset based security offering
- Public disclosure of activities, assets and liabilities including contingent liabilities
- Stable policies and a well announced political commitment to reforms both in expenditure management and cost recovery
- Entry of financial intermediaries both in public sector and in partnership with private sector
- Market making institutions such as primary and secondary participants