

## **The Lending Process in Infrastructure Transactions: the World Bank Approach to Risk Management**

### **Introduction**

1. Today, there is practically no such thing as purely public infrastructure projects in countries organized under liberal market economy principles. In most cases, so called "public projects" include a strong dose of private intervention. For instance, infrastructure is built by private contractors; operational equipment is furnished or sold by private firms. Symmetrically, purely private projects are still constrained, controlled, regulated by public organizations or entities, which retain the rights of approving lay-outs, prescribing norms, imposing levels of service, enforcing competition rules, or safety standards, setting or approving fares and rates, or tolls, and so on..

2. We can thus say that all of us all live, almost everywhere in the world nowadays, under the P.P.P. paradigm: the Public Private Partnership model. Now for all practical purposes, the effectiveness of the formula hinges on what the partnership concept means, and on what it suggests as implementation methods and principles.

3. Precisely, it is true, though, that, in the last ten or twenty years, the level of private intervention in traditionally public projects has increased widely, through a multiplicity of processes, from full privatization of former public entities, at one end, to the transfer of management from public to private, at the other end, passing through various forms of concession-type agreements, including all variants of BOT, BOOT, BOO etc.

4. It may seem trivial to state that the key to a successful outcome in all these different kinds of projects lies, for an important part, in an appropriate distribution of risks and responsibilities between public and private actors. But as it turned out, as for many other widely accepted principles, it might sometimes be easier said than done, and mistakes or uncertainties left unaddressed early in the process may well cost dearly during the implementation and operational stage, with sometimes both parties being affected. I will therefore propose first to quickly review the main public missions necessary to lay the grounds for a successful public/private partnership in infrastructure financing, then come to the risk-sharing principles it suggests at the project level, and describe here the principles and tools the Bank proposes today to help in reaching an efficient and rewarding agreement for all parties involved.

### **The Public Sector Mandate**

5. This new relationships pattern between public and private partners brings along a new set of questions when **it** comes to assessing the potential role of International Financing Institutions in helping these new arrangements to take root in a sustainable way, economically and financially, as well as environmentally and socially.

6. The issue of effectively delimitating public/private boundaries in port activities is likely to be the prominent question in any reform process, since the interaction of public and private players tends to be greater here than in other transport modes. It involves a clear definition of the public sector mandate and of

its relationships with its private partners, with a view to fostering private-sector led investment and development capacity. This requires a comprehensive understanding of the interests at stake, so that public and private partners can be in a position where they can provide each other with the services they are the best placed to deliver: an efficient and clear regulatory environment and a basic set of well interconnected infrastructure networks for the public sector, a cost-effective transport system for the private sector.

7. The prospective public sector's role in these areas can be described in a more comprehensive manner by defining, its mandate under three different natures of mission: the catalyst mission, the statutory mission, and the facilitation mission.

### ***7.1. The Catalyst Vision***

The public sector's role here would be twofold:

- (a) to finance transports assets which very unlikely would get access to private or alternative financing sources. and whose completion clearly appears on the critical path of transport development programs. Such investments would be primarily aimed at inducing the private sector in providing resources to cover operational investments, including infrastructure, once the public action has helped creating a physical enabling environment. For ports, specific intervention would regard in particular basic infrastructure and access connections with inland transport networks (road, rail, waterway).,
- (b) to create a regulatory enabling environment for private participation, by implementing an appropriate legal and regulatory framework to ensure fair competition, avoid monopolies and rent-seeking activities, and by assisting port authorities in dealing with labor redundancy issues, possibly in financing socially adequate redundancy schemes.

### ***7.2. The Statutory Mission***

The public sector's role here would be to take care of some of its statutory duties as a national authority: in the port sector this will deal mainly with transport safety, environmental protection, coastal management, and port/cities relationships. Specific intervention would regard in particular:

- (a) Navigation safety: navigation aids (lighthouses, beacons, positioning systems), vessel traffic services (enhanced traffic management systems), hazardous cargoes transit management (dedicated facilities, training);
- (b) Environmental protection: compliance with the MARPOL Convention (reception and treatment facilities for oil wastes on one hand, ship wastes on the other, anti-pollution prevention and mitigation equipment. national/regional emergency plans, training), compliance with the London Dumping, Convention on the treatment and disposal of contaminated dredged materials, implementation of Port State Control procedures (regional agreements, professional training);
- (c) Coastal management: shore and coastline stabilization, beach nourishment and coastal defense structures, shoreline defense policy (protection/relocation alternative);
- (d) Fostering common development policies between ports and cities: helping in setting up common planning boards or consultation committees on land development issues, assisting in port relocation operations and relating legal and financial arrangements for the disposal of redundant port facilities.

### **7.3 The Facilitation Mission**

The public sector's role here would be to implement measures aiming at improving the effective use of all modal transport networks, primarily by addressing the basic issues relating to the ports' nodal position in the international trade pattern. Within this background, the public sector's facilitation mission may therefore include the following tasks:

- (a) Strengthening public Governance improving institutional ability to monitor new public/private partnerships and oversee operations without interfering in the commercial sphere, helping devise and implement clear mechanisms to manage transactions between public and private bodies without hindering open competition;
- (b) Helping the trade facilitation process: improving customs regulations and practices, assisting in designing and implementing efficient enhanced communication systems, assisting in trade documentation harmonization efforts;
- (c) Spearheading, initiatives conducive to trade integration: assisting design and implementation of first development initiatives to induce value-adding activities to settle in port areas, helping finance facilities aiming at attracting distribution and logistics services within the port complexes, assisting in financing the first development phases of potential dry ports facilities and related intermodal connections.

8. Building up on the operational, institutional and financial landscape briefly described above, it seems consequently possible to identify some main areas for public sector intervention in this part of the transport sector, where the Bank can provide adequate financial or technical assistance. They may therefore be displayed as follows:

- (a) to provide financing for some basic infrastructure components, to pave the way for increased private Financing of operational facilities'.
- (b) to promote better physical and operational integration of sea and land transport networks-
- (c) to ensure appropriate safety conditions in port and navigation activities, and to monitor the environment protection policy;
- (d) to contribute to the trade facilitation process at the sea/land interface, thus helping ports to act as creative partners in international trade development.

9. In summary, the main thrust of Bank- activities would have to address the need to open up the sector to more private sector participation, while protecting the public interest. This would entail significant decrease of traditional infrastructure financing, which would be restricted to cases where specific public investment would still be needed to trigger private sector finance availability. On the other hand, prominent public statutory duties, referring mainly to transport safety and environmental management, would need renewed attention, all the more than the new distribution of responsibilities between private and public entities will likely put the latter in charge of monitoring these issues within a new multi-partners environments The Bank may be in a good position to bring adequate financing and advisory assistance in this respect. Finally, the widespread need to facilitate the international trade process in the context of an increased private sector participation in infrastructure management is giving rise to a complex set of issues, ranging from the need to strengthen public governance to the spearheading of the development of infrastructure and legal basis for integrated logistics activities, including, the necessity to foster more relevant common development policies for ports and cities. In all these aspects the Bank, building on its wide knowledge of the different fields involved, is actually able to provide appropriate assistance.

### **Risk Management Principles and Financing Tools**

10. The basic principle, which is expected to be widely shared, is that each partner should manage the risks it can best handle. Now let's take a look at the usual suspects when it comes to the main hurdles in the way of private investments in infrastructure assets:

- weak- institutional/regulatory framework
- long-term sovereign risk management
- assets economic depreciation period vs. short-term financial return object' Ives I
- weak domestic financial markets.

11. Most of these will result in an increased risk perception, which in turn will ask for appropriate risk coverage in term of interest premium on the cost of financing. The consequence in terms of cost recovery objectives may sometimes just make the project impossible to implement, at least 'n a marketable or socially acceptable fashion.

12. This situation translates into what is usually felt as a higher cost of capital for privately-financed projects than for publicly-financed ones, although this perception remains very questionable: the apparent lower cost of public capital mainly stems from the fact that the taxpayers provide a free repayment guarantee for any lender to a sovereign government. Should this guarantee be priced on a market basis, the difference would likely be significantly reduced. if not erased.

13. So, bearing in mind the motto of any reasonable banker facing a financing proposal-- everything which can go wrong, will go wrong--facilitating private sector investments in infrastructure projects will have to do mostly with *risk enhancement and credit enhancement* vehicles.

14. Typical risks in an infrastructure project can be categorized as follows:

*Project Risks:*

- (i) *Commercial Risks:* customer base and prospects, price sensitivity, demand instability, early obsolescence due to technological advances;
- (ii) *Construction Risks:* inadequate project design, insufficient technical experience of participants;
- (iii) *Operating Risks:* quality of project and operations management, adequacy of pricing policy, effectiveness of revenues collection.

*Political and Regulatory Risks:*

- (i) Potential conflicts among different governing bodies (central vs. regional or local);
- (ii) Adequacy of the legal framework and risk of change in the legal and regulatory environment,
- (iii) Price setting policy;

- (iv) Enforceability of contracts;
- (v) Risk of change in economic and political orientation;
- (vi) Redistribution/Public good management issues;
- (vii) Ex-post contracts renegotiation.

15. But it is also possible to consider an alternative risks classification, between *Objective* and *Subjective* risks, which will call for different mitigation tactics:

- Some risks will be defined as *objective* because they originate in a random event, such as those derived from shocks in demand or those affecting construction and operation costs.
- Some risks will be defined as *subjective* because they originate in the behavior of a participating agent. Typical examples are changes in regulations that may affect the income generating capacity of a project.

16. The distinction between objective and subjective risks is important because the former can only be insured, while the latter can be reduced or eliminated by correctly defining the incentives schemes each participating agent faces:

- Allocating the objective risks means finding the best devices for risk sharing among the participating agents while possibly insuring part of the risks through external parties.
- Allocating, the subjective risks means defining the best set of contracts to give the right , incentives to each partner, taking into account each partner's skills and know-how, his risk aversion and his reputation for sticking to its commitments.

17. Within this context, and keeping in mind the broad outline of the Bank's mandate as described in para.9 above, the Bank- Group approach to facilitating private sector investments in infrastructure projects can take the Following forms:

- when a minimum public investment in basic infrastructure is required to reach an acceptable balance between public and private financial commitments, thus making it possible for a privately-sponsored project to proceed on an economically viable fashion, the Bank may consider providing the financing of the public part using a conventional lending instrument;
- when a prerequisite for any private deal to succeed is the establishment of a new enabling institutional, legal, and regulatory framework, or the modernization of existing conditions, the Bank will be ready to help in providing the resources needed to make the required legal, institutional and regulatory assistance available, as well as in financing the corresponding training needs of administrative staff,
- when risk or credit enhancement is a critical aspect of a proposed operation, the Bank can propose to make use of its Guarantees Program, which will seek to alleviate part of the *Political and Regulatory* subjective risks associated with the project (see para. 1 8-22 below); and

- The private sector arm of the Bank Group, the International Finance Corporation, can take part in the financing package of a private investment project through lending, equity participation, or loans syndication.

### **The World Bank Guarantee**

18. The World Bank guarantees are provided to private lenders where the demand for funding is large, political and sovereign risks are significant, and long-maturity financing is often critical to a project's viability. By covering risks that the market is not able to bear or adequately evaluate, the Bank's guarantee can attract new sources of financing, reduce financing costs, and extend maturities. The guarantee can be especially valuable where activities traditionally undertaken by the government are being shifted to the private sector but where the government and its agencies remain involved, for example as regulator. The Bank's participation as guarantor can also facilitate the transparency of transactions.

19. The Bank's Guarantee is intended to act as a catalyst for private financing in developing countries. Toward this end, the Bank offers only partial guarantees, and risks are clearly shared between the Bank and private lenders. The Bank's objective is to cover risks that it is uniquely positioned to bear given its credit experience with developing countries and special relationships with governments. Private sector tenders and other partner institutions take other project risks.

### **Type of Guarantees**

20. The Bank's guarantee may be either for specified risks (the *partial risk* guarantee) or for all credit risks during a specified part of the financing term (the *partial credit* guarantee):
- a *partial risk* guarantee covers specified risks arising from non-performance of sovereign contractual obligations or certain political force majeure events; they are appropriate for private projects especially for 'limited-recourse financing', as in build-operate-transfer, build-own-operate and similar concession projects;
  - a *partial credit* guarantee typically extends maturities beyond what private creditors could otherwise provide, for example, by guaranteeing late-dated repayments or providing incentives for lenders to roll over short-term loans-, they are typically used for public projects involving sovereign borrowings.

### **Benefits of the Guarantee**

21. The guarantee can work to the advantage of borrowers and host governments in many ways. In some instances, the guarantee can make projects possible which would otherwise not materialize. By covering risks that the market would not bear, or would price prohibitively high, the guarantee lowers the cost of financing. More favorable regulatory treatment provided to lenders and investors--through reduced provisioning requirements. for instance--also decreases the cost of financing. Guarantees can also extend the term of lending, beyond the period for which the market would normally lend--an essential consideration for infrastructure projects that require long-term debt in order to match debt service with revenues.

22. The flexibility of the guarantee allows private sponsors to choose the financial structure that best serves the need of the project. For instance, this might involve the currencies and markets they borrow in and the interest rate (fixed or floating). For a government, a partial risk guarantee reduces its contingent liability to the minimum required to make a project feasible, the private sector takes on all or a substantial

part of the commercial risks. This contrasts with the traditional pattern where a government takes full responsibility for financing and thus bears the entire risk of a project. ( *For further detailed information, see the brochure The World Bank- Guarantee: Catalyst for Private Capital Flows.*)

23. To conclude, I would say that increased private sector involvement in infrastructure projects, possibly assisted by Institutions like the World Bank in the ways described above, can achieve a lot: it can improve projects, reduce running costs, introduce commercial behaviors, focus on the level of services, be customer oriented, better control commercial risks, maximize revenues, help alleviate budgetary burden, transfer charges from taxpayers to infrastructure users. But whatever the circumstances, it remains unlikely that it could transform an economically non viable project into a highly profitable one.

Finally, neither the private sector nor the Bank will ever produce miracles. But working together may help in getting close.

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