Infrastructure Financing

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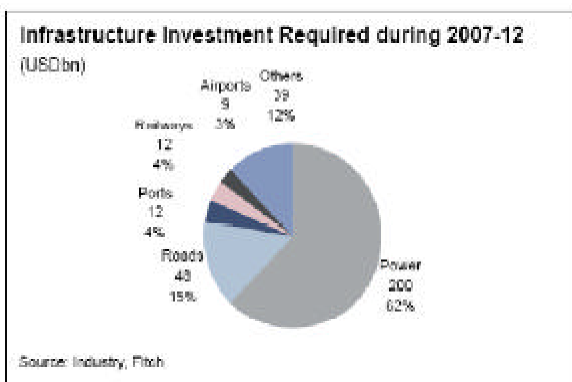
In my view, 2007 will be the year that marks significant change in the three critical levers driving the growth of the Indian infrastructure sector: regulatory framework, financial innovation and execution capability. It is heartening to note that all stakeholders seriously recognise the central role that infrastructure development will have to play in helping sustain the economic growth – at an annual eight per cent plus – momentum achieved during the last few years. Clearly, the USD320 billion (*Source: Committee on Infrastructure, Government of India*) investment in infrastructure – see chart below for a broad break-up – estimated to be required during the Seventh Plan period (2007-2012) is a mammoth task to accomplish.

Public investment, given governmental priorities to rein in the fiscal deficit and increase spending in the social sector, has to necessarily be supplemented by public-private partnerships (PPPs) and in many cases exclusive investment by the private sector.



Regulatory Issues

In order to reap the benefits of enhanced private capital investment and the anticipated efficiencies in project execution and operations, the regulatory regime must ensure both a fair economic return and transparency in the bidding process.

To this end, I am of the firm belief that the manner in which the telecom sector was liberalized needs to be appropriately replicated. The telecom liberalization resulted in an explosion in telephony penetration levels, improved service quality and lower tariffs, and it stands to reason that similar gains could be achieved across other sectors. Recent experiences with the PPP model in the road and airport sectors lend further credence to this argument. The resolution of “glitches” in the constitution of the PPP appraisal committee and certain clauses in the model concession agreement (MCA), should provide fresh impetus to the bidding for – and awarding of – projects under the National Highways Development Programme (NHDP).

Buoyed by the successful induction of private players for the modernisation of both Delhi airport and the Mumbai International Airport Private Limited (‘BBB (EXP)(ind)’), I think we will witness major progress in the modernisation of Chennai and Kolkatta airports and 35 non-metro airports. I am also reasonably sanguine that the much needed Aviation Economic Regulatory Authority will be constituted, giving a further boost to the sector. Likewise, in the ports sector, I hope that with the release of the MCA, the decks have been cleared for significant private sector participation in the development of some 276 projects as part of the National Maritime Development Programme.

Financing Issues

The year 2007 could mark the culmination of several innovations in financing models and the creation of alternative sources of capital required for financing infrastructure development.

Infrastructure projects continue to rely heavily on debt financing (mainly from banks) and to a lesser extent, on sponsor equity. I have come across several projects with a debt/equity mix as high as 4:1. Surprisingly, uptake of the Viability Gap Funding scheme (which offers a 20% capital grant for PPP projects during the construction phase) has been rather low, leading the government to contemplate a reduction in budgetary allocation on this account. Conversely, private participants have started offering negative grants to the National Highways Authority of India (‘AAA(ind)’) for securing concessions on some apparently profitable toll road projects.

Excessive leverage can be harmful, particularly when the economic cycle turns and revenue forecasts underachieve during the concession period in what are essentially long-term infrastructure assets. This can place a strain on debt servicing, and a few bad loans can discourage future lending to the sector. While banks have begun extending loans with tenors beyond 12-15 years, projects could be saddled with refinancing risks while exposing the banks to potential asset/liability mismatches. To overcome this risk, in the short term at least, some banks prefer tie-ups with large institutional investors to create a form of joint or ‘take-out’ financing.

However, in my view, the hitherto untapped potential of the bond markets presents the ideal solution to increasing

the available pool of capital, securing truly long-term financing and minimising the cost of debt. Speedy implementation of the Patil committee recommendations will pave the way for a vibrant bond market, facilitating the flow of large funds from investors with long-term liabilities, eg insurance companies and pension and provident funds. For pension funds and life insurance companies, trying to offset long-term liabilities, I see infrastructure as a "core asset in waiting." The long economic life and essential public service role of infrastructure assets creates an annuity value proposition for these investors that cannot be matched by any traditional corporate debt. Their default risk may vary on a case-by-case basis, but there is little risk of winding down a national airport, or a state highway, or a municipal water system. Until such a time as the Indian bond markets mature to a state where they can absorb primary issuances for funding infrastructure projects, I do believe that there is a case for existing lenders to 'sell down' their loan assets to the bond markets on the strength of independent credit ratings. I would expect the owners of operating assets with fairly stable revenue streams to be tempted to explore options of refinancing high-cost bank loans with bond issuances.

A number of other interesting developments are expected to gain rapid currency this year, and have the potential to supplement infrastructure financing. Firstly, the Government of India (GoI) has mooted a proposal to leverage India's huge foreign exchange reserves (currently estimated at over USD 200bn) to fund infrastructure projects through a subsidiary of India Infrastructure Finance Company (IIFC). This is likely to prove especially relevant to those projects with an imported component, eg imported assets required for a mass rapid transit system. The notion of funding infrastructure assets from income generated – by investing a portion of foreign exchange reserves in higher-yielding assets – is a welcome step and needs to be pursued to its logical conclusion.

Second, the constitution of the USD 5bn dedicated infrastructure fund floated by renowned international private equity investors, Blackstone and Citigroup in partnership with Indian financial institutions, could be a precursor to substantial equity fund flows into the sector. Lastly, the newly constituted IIFC, armed with market borrowings and a flood of project proposals, is poised to emerge as an important source of long duration funding for infrastructure projects, in partnership with commercial banks. With external assistance from independent agencies to augment its appraisal and credit assessment capacity, the IIFC can equip itself to ensure efficient deployment of scarce capital.

In terms of 'out-of-the-box' financial solutions, I think the time has come to explore leveraging of the fuel cess by both the federal and state government, to finance road development programmes. 50% of the special cess on high speed diesel (HSD) accruing to the Central Road Fund (CRF) is allocated to states for implementing the Pradhan Mantri Gram Sadak Yojana (PMGSY), while 30% of the sum of the balance, 50% of the HSD cess, and the entire cess on petrol is earmarked for state roads. I am convinced this would be an excellent addition to the financial toolbox available to issuers and investment banks. As a financing option, issuing bonds secured by future streams from the petrol and diesel cesses remains a vastly under-exploited tool in India.

(With Contributions from S.Nanda Kumar, Regional Head – South India, Fitch Ratings India Pvt. Ltd.)