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Turn the PPP model on its head

In restrospect, private sector participation in infrastructure was a case of too much too soon. Now, government should build assets, and then sell them to private operators

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A fundamental feature of our political economy is the demand for social protection. Any government in this country will struggle to create fiscal space for investment spending and make budgetary allocations for infrastructure. Private sector involvement in infrastructure development has therefore become a strategic imperative.

Although the scale of private participation in infrastructure has grown dramatically over the past 15 years, the experience has been mixed. Infrastructure services are a quasi-public good. It is not easy to balance the interests of the general public that expects to have access to affordable electricity and transport facilities with the profit motive of private developers.

The nature of these services is such that it requires the return to investors to be regulated in the broader public interest. This is not easy to do. Private-public partnerships, or PPPs, require sophistication in design and effective dispute resolution. In retrospect, India's experience in this area has been a case of too much too soon.

Over the past three years, confidence has taken a beating and private infrastructure development has been set back by a combination of regulatory uncertainty, bureaucratic delay, and allegations of corruption. Investment in infrastructure has fallen drastically. But India still needs an additional $1 trillion in infrastructure investment over the next five years. Unless remedial action is taken, this will remain elusive. Before the next wave of infrastructure asset creation can be launched, we must learn from the lessons of the past.

First, land acquisition for project development has been much harder than anticipated and exacerbated by the previous government's thoroughly over-engineered and complex legislation, the Land Acquisition Bill, 2013. Difficulties with land aggregation hit road development projects particularly hard. Under pressure from government to show progress, banks funded projects well before all the land was made available by the concessioning authority. As the land could not be delivered in the promised time, projects suffered delays, leading to cost overruns that in turn made half-completed projects unviable.

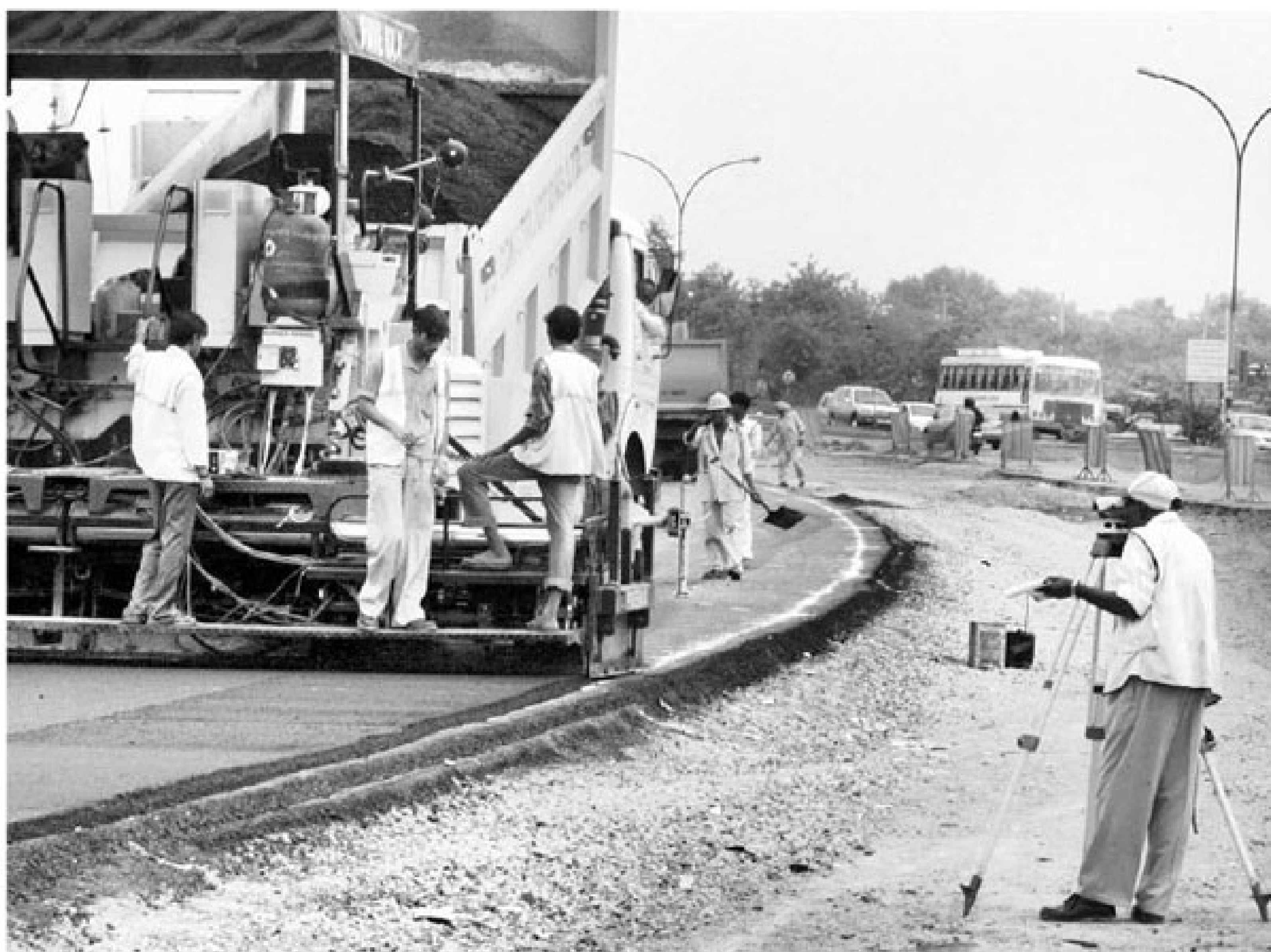
Second, the sluggish and unpredictable pace of regulatory approvals, especially environmental clearances, similarly contributed to project-cost escalation.

Third, in view of these execution risks, private developers took to gaming bids. Gold-plating of project costs was widely used by developers to take out their equity through means other than project cash flows.

Fourth, the government did not deliver on many promises. The most important example of this is the delivery of coal. About 40,000 Mw of generating capacity has already been built or is currently under construction on the promise that Coal India would deliver enough coal to have these plants operate at a Plant Load Factor (PLF) of 85 per cent. Coal India has fallen short of these targets, as a result of which many plants have either become unviable or are operating at capacity utilisation levels too low to service their long-term debt.

Fifth, the theory that competitive bidding is the best mechanism for allocating contracts because they lead to objective price discovery has been belied by the Indian experience. Bidding procedures have been poorly designed and subject to manipulation. Bidders have also bid irresponsibly. This has led to a backlog of dysfunctional bids particularly in the power sector where electricity generation contracts were bid on the basis of the lowest quoted tariff. These projects have become unviable and are stuck in litigation between state-level regulators who insist that the terms of the original contract be adhered to, and private developers who are invoking the force majeure clause to change the contract in view of circumstances beyond their control.

Sixth, the judiciary's efforts to intervene in this mess have been quite draconian. The cancellation of telecommunication licences and coal mines allocated to private parties with retrospective effect may have been technically justified in a legal sense, but have caused major dislocation and damage to investor sentiment in the infrastructure space.



In the road sector, contractors can be used to build new highways, which can later be sold to private investors

Seventh, a combination of skill gaps, lack of discipline and moral suasion from government has led to irresponsible funding by banks. This had added to the burden of non-performing assets that is weighing down the balance sheet of the banking system.

Finally, a disproportionate burden of funding infrastructure has fallen to the banking system that is not structurally equipped, from a risk management perspective, to provide long-term financing of the type needed by infrastructure projects.

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The reality is that although the private sector played a significant part in the recent boom in infrastructure spending, it is the government that will have to lead the next wave of asset creation in this sector. But the government's own fiscal resources remain scarce. So how might it be possible to get a resource-constrained government to lead the recovery in infrastructure investment?

Our recommendation is to turn the orthodox PPP model on its head. Instead of getting the private sector to build, own, operate, and then transfer the asset to government — in other words, to take the cost and high risk of greenfield construction on to itself and then transfer an operating asset to government — our recommendation is to reverse the process. The government or a public sector entity should take on the cost and risk of green field construction. It should then sell down the project to private investors once the asset is generating operating cash flows.

In so doing not only would the allocation of risk be more appropriate between public and private stakeholders, the public sector would also easily make a profit from its sale to the private sector. This is because the public sector is much better equipped and supported to tackle the challenges of land aggregation and obstacle course of regulatory approvals involved in green field construction, and the discount rate applied to post-construction risk is materially lower than that applied to construction risk. There are numerous foreign investors with deep pockets that would be willing to come into the Indian market to own, operate and manage infrastructure assets of scale provided they do not have to take the risk of constructing these projects. Pension funds looking for predictable, but not very high returns the world over have become important owners of operating assets such as power plants and toll roads. As the operational assets are transferred to such investors, the initial equity invested by government for construction would be returned at a profit, allowing the government to more than recover the fiscal cost of building the asset.

But who in government would be equipped to take on the responsibility for building new infrastructure assets in this manner? In the power sector the obvious candidate is NTPC, which is extremely well qualified to build new generating capacity. In fact, NTPC could easily create a world-class EPC (engineering and project construction) company that would be focussed on building new power generating plants with the goal of selling the same down to private investors once they are built.

In the road sector, NHAI may not have the skills to build its own EPC company, but it could use (and has done so in the past) private EPC contractors to build new highways and expressways, while carrying the equity on its own books, but with the goal of selling these down to private investors once they are operational. Using this reverse BOT approach we believe that it is eminently feasible to build about $60 billion worth of new power and road infrastructure projects every four to five years, selling them down to private investors once operational and redeploying the proceeds into the next wave of asset creation.

The writer is the executive chairman of IDFC