

Talking Points

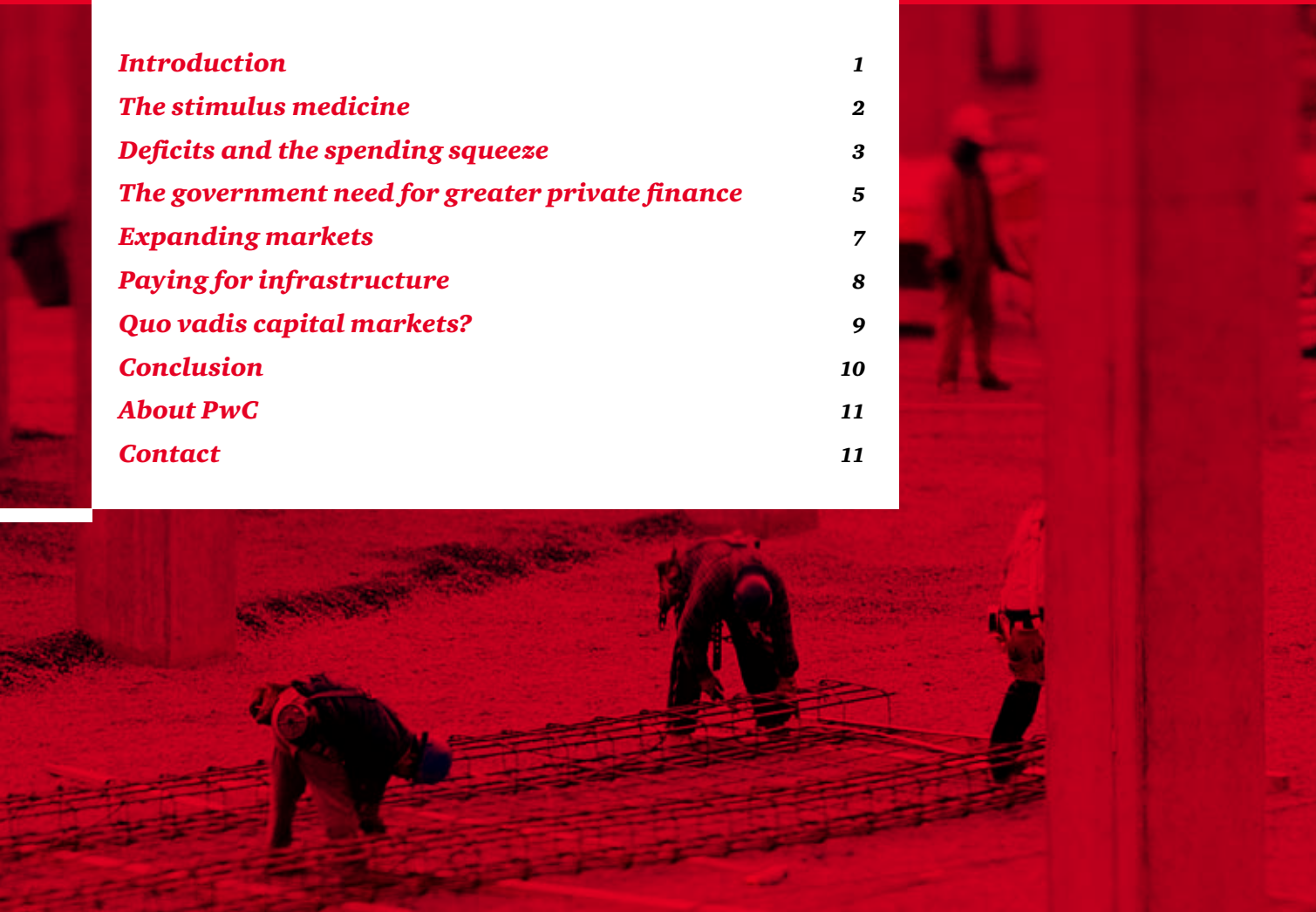
Infrastructure investment in the wake of crisis

Impact of the global
economy on PPPs in
OECD countries

This Talking Points publication was first published as an article by Richard Abarde and Peter Brown, titled "OECD governments are facing a perfect storm following the global finance crisis" in PFI magazine's PFI Yearbook 2011

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Introduction

OECD governments have now spent several years supporting their economies through fiscal stimuli and bank bailouts. While these measures have reduced the decline in their Gross Domestic Products (GDPs), they have inevitably led to burgeoning deficits and borrowings. Their legacy is therefore a new economic challenge: the need for deficit and debt reductions.

Deficit reduction programmes around the globe have so far incorporated both direct and indirect tax increases, as well as severe spending cuts. These cuts have generally focused most heavily on social programmes, such as medical care, welfare benefits and pension commitments, but capital budgets have also been targeted.

Those who have lived through previous recessions are all too aware that cutbacks in capital new build and maintenance budgets are soft targets for budget setters.

However, the need for continuing investment in infrastructure is irrefutable. The OECD report “Infrastructure to 2030” argues for infrastructure investment of more than 3% of global GDP¹. As infrastructure investment has declined due to the worldwide financial crisis, to achieve such an investment means that even more has to be spent over a shorter timespan.

Some countries, such as Spain and France, are attempting to keep their infrastructure investment, partly by using more private finance to support their programmes. Meanwhile, those countries that are cutting deeper into infrastructure budgets are only storing up significant future challenges for which project finance will be needed. Either way, governments that have maxed out their own borrowings will find there is a need for more private investment.

¹ OECD (2006), Infrastructure to 2030: Telecom, Land Transport, Water and Electricity

The stimulus medicine

GDP per capita is commonly taken as an indication of the overall economic strength of a country. When compared with the recent rankings by the World Economic Forum (WEF) Competitiveness Report on the quality of overall infrastructure, the relationship between GDP and competitiveness can be clearly seen, particularly for countries with less developed infrastructure (Figure 1).

Even as constraints on spending and borrowing have grown, governments have been emphasising the importance

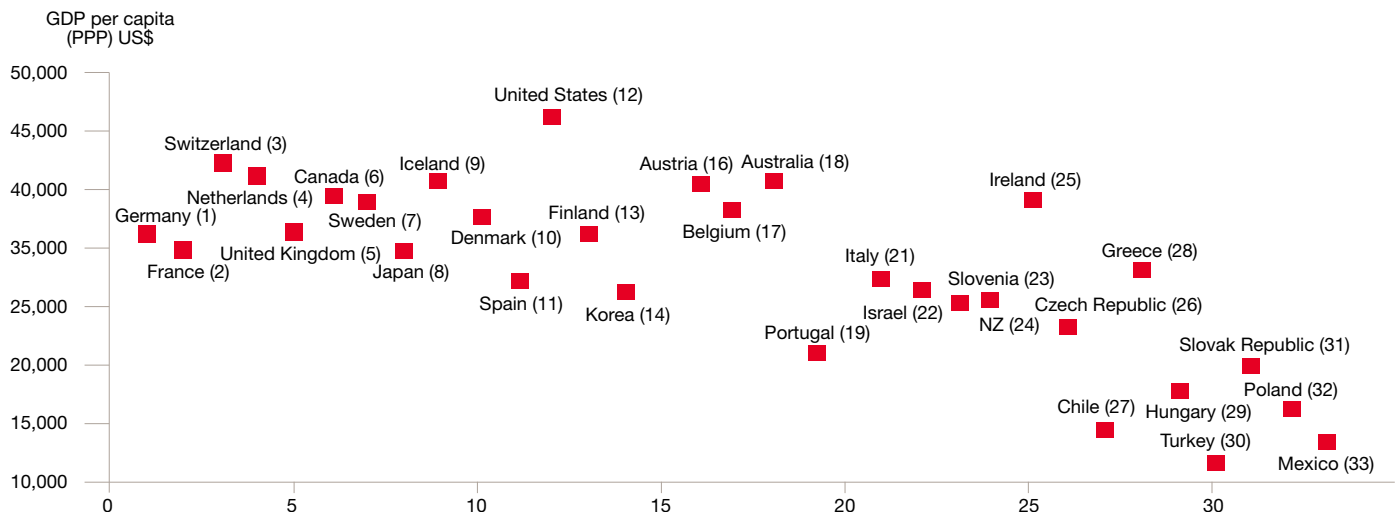
of infrastructure in assisting economic growth. A number of countries have explicitly recognised this as part of their stimulus packages. According to the OECD², the average fiscal package across its member countries over the period 2008–2010 is forecast to be 1.4% of GDP, with around 25%–30% of this package being spent on investment.

Australia has taken the lead in this regard, investing about 2.6% of GDP. It has put aside A\$5bn towards social housing and A\$2.3bn on road and rail alone.

Infrastructure projects are useful economic stimuli, but the time taken to approve, procure, design and raise finance for them can mean that the stimulus effect is delayed. To overcome this, some governments have emphasised the need for projects to be “shovel ready”.

2 OECD Interim Economic Outlook (March 2009), Chapter 3: The Effectiveness and Scope of Fiscal Stimulus
Related images

Figure 1: OECD countries in-group infrastructure ranking, and GDP per capita based on purchasing power parity exchange rates. Luxembourg and Norway have been excluded as being outliers on GDP per capita. WEF infrastructure ranking is based on in-group comparison.



Source: World Economic Forum Global Competitiveness Report 2010–2011; CIA World Fact book

Deficits and the spending squeeze

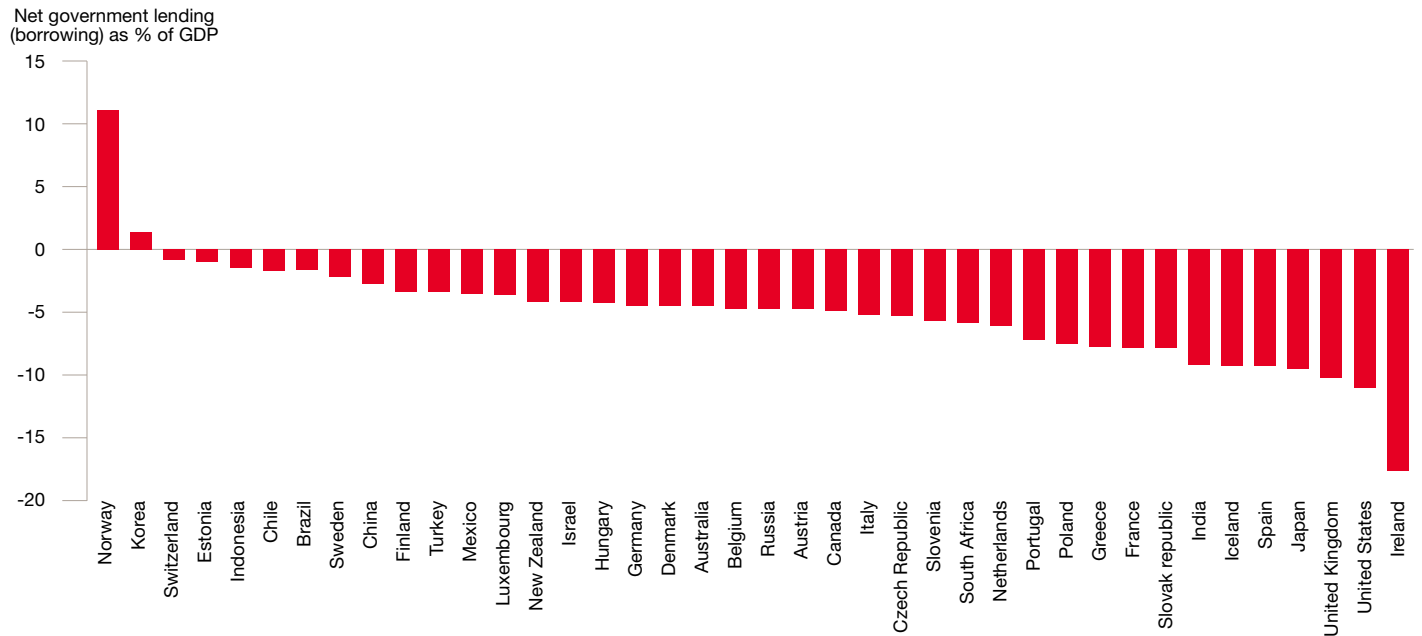
Moving beyond the stimuli, the real question for PPPs is how they will be impacted by the longer-term squeeze in governments' spending. As the legacy of government stimulus packages lingers, a dark cloud of sovereign debt looms over future publicly funded infrastructure.

Figure 2 paints the stark picture of in-year government deficits. Ireland, Spain, the USA and the UK provide particularly daunting figures. However, other large economies such as Japan, France and Spain are not that far behind. Governments are facing pressure to

reduce these deficits and significant spending cuts are inevitably part of the solution.

The long-term effect of these spending cuts on the future PPP market is uncertain. High budget deficits and

Figure 2: Forecast 2010 in year government surplus/deficit levels as % of GDP (accession and BRIC countries also included)



Source: World Economic Outlook Database, October 2010 edition: IMF

borrowing levels should encourage the use of private finance to deliver infrastructure, particularly economic infrastructure that is paid for by users. However, social infrastructure that relies on government as a payer is more likely to see reduced investment.

The example of Portugal may provide a cautionary tale for policy-makers as they consider taking on new PPP projects in this climate. Over the last decade Portugal has committed heavily to PPP schemes, including 13 road schemes. But the contractual obligations of PPP payments risk plunging government finances into greater difficulties in the future. With public debt at around 80% of GDP, the government cannot afford to run long-term deficits. Faced with this dilemma, Portugal has recently put on hold a range of future projects, including a number of PPP rail lines and hospital projects.

There has also been a reduction in the PPP pipeline in the UK. The government's spending review cut back heavily on social infrastructure investment, including the large-scale cancellation, de-scoping or delay of school, social housing and solid waste projects.

However, the news is not all doom and gloom. Governments throughout the OECD have been reiterating the importance of spending on infrastructure at the same time as making cuts, particularly recognising the contribution such investment can make to economic growth.

Spain, for example, has put in place a €22bn Special Infrastructure Plan. The UK has also published a National Infrastructure Plan that emphasises the benefit of investment in economic infrastructure.

Australia and Canada, two countries with traditionally strong PPP markets, have not cut back on capital investment, partly because their economies were not impacted as severely by the global economic climate. As a result, deal-flow has not been adversely impacted in these markets.

The government need for greater private finance

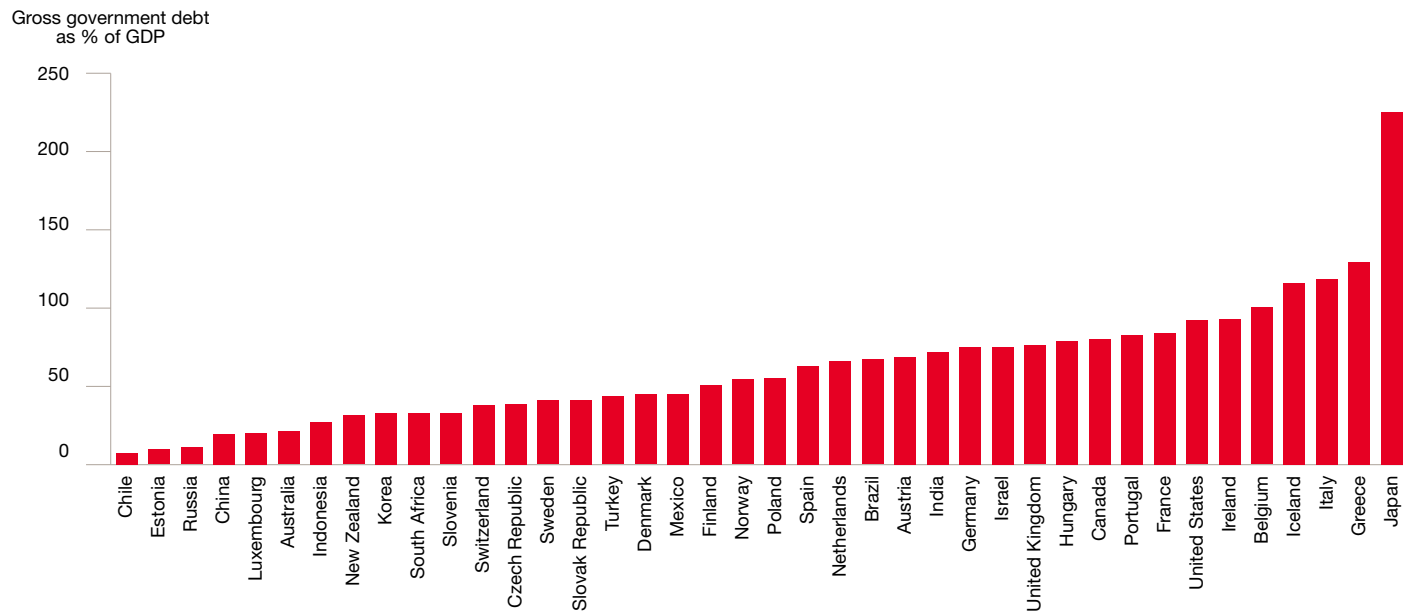
Governments face two key constraints when trying to deliver infrastructure:

- **Cashflow constraint** – The need to save cash to cut deficits means governments have to reduce direct infrastructure investment, for both development and maintenance in the short term.

- **Balance sheet constraint** – The vastly increased burden of cumulative sovereign debt, as a result of bank bail-outs as well as spending deficits, means that governments will avoid borrowing significant sums to fund infrastructure investment.

Figure 3 shows that overall debt burdens as a percentage of GDP for many OECD countries are reaching the high double figures. The perception of sovereign risk has significantly changed; from being treated as almost risk-free, we have seen markets suddenly wake up to the

Figure 3: Cumulative forecast public sector debt levels as % of GDP (OECD accession and BRIC countries also provided for comparison)



Source: World Economic Outlook Database, October 2000 edition: IMF

realisation that sovereign debt will need to be “restructured” (with investors taking a hit) if countries are not able to get their debt burdens under control.

Some countries, such as Greece and Ireland, have already had to call for international help to fund their ongoing commitments in the face of the flight of capital from their countries. Financial markets in Europe are now concerned about other economies, such as Portugal and Spain.

The flight of capital from these countries has impacted the infrastructure finance markets, as lenders and investors with significant country exposures limit new investments and loans. Until these countries’ finances stabilise, they could struggle with limited liquidity and higher than average pricing for infrastructure assets.

The CEE countries have placed heavy reliance on structural funding from EU institutions to renew their infrastructure. For example, Poland is forecast to receive €67bn of funding between 2007 and 2013, with 41% going to infrastructure and the environment.

These countries have focused on absorbing the “free” accession money rather than driving the use of private finance to deliver infrastructure. Consequently, PPP deal flow across the CEE has been sporadic and is likely to continue to be so as long as significant structural funds are available.

One interesting side-effect of structural funding is the need for public authorities to provide a certain percentage of co-funding, which they have often funded through borrowings, thereby limiting their ability to invest in non-structurally funded projects.

Nevertheless, for most countries, project finance provides a logical means to deliver key infrastructure projects as it limits pressure on both short-term cashflows and reduces the need to borrow heavily. PPPs suddenly seem very attractive once the cost benefits are taken into account in terms of whole-life costing and private sector efficiencies. In many countries this situation is providing the impetus for recognising the role that project finance can play in bridging the infrastructure gap through the use of PPPs.

Expanding markets

Spain is a prime example of a country that is focusing on greater private investment. It has launched an €11bn programme for high speed rail and road with circa 70% of the funding going to rail. There are a total of 20 projects scheduled for tender in 2011 alone. In addition, there are suggestions that Spain will alter its approach from driving aggressive tendering by mainly Spanish contractors to something that is more bank and investor-friendly, and that will encourage overseas participants.

France has also strengthened its PPP pipeline, including several planned waves of prison PPPs, and is encouraging more private investment. State support for its PPP programme includes a €10bn State Guarantee Scheme for priority projects delivered using PPP and co-funding a further €8bn through Caisse des Depots. These moves show that France has recognised the importance of attracting private investment and lending to supplement public investment in its infrastructure.

In North America, Mexico (ranked a lowly 65th out of 125 nations by WEF on its infrastructure) has strengthened its PPP structures in recent times as part of its National Infrastructure Plan. It has set up

a US\$20bn National Infrastructure Fund to facilitate private sector investment and is seeking to strengthen the legal and institutional capacity of state and central governments, so they can apply harmonised PPP models across the country. Mexico's pipeline now includes a total of 12 prisons, two hospitals, two light train projects, and a number of roads all due to be built through PPPs.

Chile has also sought to improve its institutional framework for PPPs, for example through the use of variable-term contracts that depend on demand realisation, and Turkey is continuing with its PPP pipeline, with the Bosphorus Tunnel and Bridge, Ismir Road and hospital projects all going ahead.

The US has used privately financed PPP intermittently to deliver key infrastructure. However, PPP deal-flow has been dwarfed by the tax-exempt municipal finance market, which has been a dominant source of infrastructure financing for local authorities.

The demise of the monoline industry, coupled with the credit pressures on many municipal borrowers, means that PPPs may become more frequently used in future. However, at some point the US will need to tackle its budget deficit and borrowings and, unlike many other OECD countries, it is unclear when this will happen. As a result, the future impact of deficit reduction measures on infrastructure investment is not as clear.

As well as those specifically mentioned here, many other countries deliver infrastructure using PPPs and project finance and will continue to do so in future, despite or because of the perilous state of the public finance markets.

Paying for infrastructure

There are strong views on both sides of the debate around whether user charging is the best way of paying for infrastructure. The key argument used by supporters is that it allows users to make a discretionary choice about whether or not to use the infrastructure and to pay for it, which is not afforded to taxpayers.

Given the constraints on governments' budgets and their reluctance to further increase taxes (as many have done already to contribute to balancing the books), it is likely that user charging will become a more common policy.

In the UK, for example, the central government has eventually opened up the opportunity for local governments to borrow through non-tax exempt municipal bonds (known as "tax incremental finance", whereby additional tax revenues are hypothecated). In Portugal, the government is intending to start tolling many of the road PPP routes that were previously free to the user with the government paying the concessionaire a fee not linked to demand.

Regrettably, this move to user charging will come at a time when the project finance markets are increasingly reluctant to take demand risk. The recent experience in Australia, where four toll roads have failed due to overoptimistic traffic assumptions, emphasises this point. Banks have re-evaluated demand risk and are generally attaching a higher price to it.

Australia, Belgium, Spain and Ireland are several countries moving towards availability-based payment mechanisms rather than user charges. This does not stop governments tolling assets, but it does mean that, at least in the near future, PPPs are more likely to attract funding on competitive terms if the demand-revenue risk remains with the public sector.

Quo vadis capital markets?

At the very time project finance is needed, banks are under liquidity and credit pressure. Regulatory changes from Basel III will increase the pressure on banks to limit long-term lending to infrastructure projects or match the duration of assets and liabilities on their balance sheets. The consequences are inevitable shorter-term debt with more expensive ratchets and refinancing requirements.

The capital debt markets are ultimately the logical long-term holders of project finance debt, and the whole market is focused on attracting institutional investors. Infrastructure policy-setters in governments have talked about it in mystical terms, but have done little to intermediate the market. Development banks, including some multilateral ones, have discussed intermediating through various financial structures, but until now they have not delivered anything that can be banked.

Selected boutique and niche investment banks have sought to create institutional project finance debt funds, as yet without success. Interestingly, and unsurprisingly, the project finance lenders themselves will likely be most effective at making institutional project finance a reality; probably by the syndication or sale of project finance projects and portfolios to institutions. There is little evidence of the more ambitious initiatives coming to market anytime soon, though we can all hope someone succeeds in doing so.



Conclusion

The financial constraints many OECD governments will face for the foreseeable future provide the perfect opportunity for project finance and PPPs to deliver much needed infrastructure investment. Taking this opportunity will require governments to be courageous in continuing to invest in key infrastructure to meet the needs graphically highlighted by the OECD.

In the long run, those countries that don't invest in infrastructure will find investment going into their OECD neighbours or into countries such as India, Brazil and China, whose allure is already significant. However, those governments that do will reap the benefits of higher GDP growth, improved standards of living for their citizens and higher levels of inward bound investment.

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