

# HOW WOULD A GOVERNMENT SET UP AN INFRASTRUCTURE PROJECT DEVELOPMENT FUND?

## Could this accelerate the development of infrastructure projects?

GIRIDHAR SRINIVASAN, AUGUST 21, 2013

There is a great need for bankable infrastructure projects. The Organization for Economic Cooperation and Development (OECD) estimates that through 2030, \$71 trillion of spending will be needed globally to finance the infrastructure gap. This is a staggering number. Given tight budgets, governments simply do not have the ability to finance such vast amounts of spending. There is an emerging consensus among government policy makers that they have to turn to the private sector to develop and finance infrastructure projects.

Policy makers have started to act. In response to demands from investors, many governments around the world have passed legislation to enable public-private partnerships (PPPs), instituted regulatory reforms around tariff regimes, and tried to streamline procurement processes. But governments constantly complain that they are not seeing enough investment, and that they are struggling to convert their ideas into projects. Is the problem that there is not enough financing available?

In fact, there appears to be plenty of capital available to invest in *well-developed* infrastructure projects. While project finance has been a well-established means to provide debt financing for infrastructure projects, the big change over the last 15 years has been the growth in the number of infrastructure funds looking to invest in the equity of infrastructure projects. According to Prequin, over \$200 billion of capital has been raised globally by infrastructure funds. The bulk of capital for such funds has come from pension funds and life insurance companies. They are attracted to several characteristics of infrastructure investments, including the asset-liability matching; stable, inflation-linked returns; and



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**Governments complain that investment is not forthcoming for their projects, and investors complain that they cannot find enough projects to invest in. How can this apparent paradox be resolved?**

lower risk profile compared to equities. CalPERS recently announced that it would invest up to 3% of its portfolio in real assets, while some Canadian pension funds have invested over 10% of their portfolio in infrastructure. Yet investors complain that there are not enough well-structured, bankable transactions in which to invest. In fact, much of the capital that has been raised remains uninvested.

Why is capital sitting on the sidelines? Is it focused on investing in the right areas? Could governments take a different approach?

### What Are the Stages of Infrastructure Project Development? What Are the Bottlenecks?

There are four stages in the development and financing of infrastructure projects:



Until recently, most institutional investors have focused on investing at financial close, to finance construction (Stage 3), and buying mature assets once they are stable and operating (Stage 4). But in fact, these are the last steps in a long chain of the development of a project. The real bottleneck is earlier—at idea generation (Stage 1) and project development (Stage 2).

Government ideas for infrastructure projects are derived from national strategic plans and economic needs. Unfortunately, many of these project ideas either are not feasible from a technical perspective or cannot be structured to be bankable infrastructure projects. So governments need to be able to rapidly screen projects and focus on developing those that appear to be viable.

A preliminary technical/feasibility study could cost anywhere from \$50,000 to over \$1 million, depending on the complexity and the amount of work that needs to be done. Funding for this comes from government budgets or donors (in developing countries). Private developers also come up with ideas and may try to investigate them.

If a project appears feasible and bankable, a developer will start to invest time and money to develop the project. Development activities include conducting feasibility studies, engineering studies, design studies, and environmental and social impact studies. Developers need to obtain licenses and permits, negotiate project agreements, and obtain debt and equity financing and any necessary guarantees.

This phase can be costly and time-consuming. A project development budget can consume 3–5% of the total cost of the project. (In emerging/frontier markets, this number often reaches 10% of the total project cost.) Developing a project and bringing it to financial close can take two to five years (or more). The process is typically funded by developers, and the risk of not reaching financial close is very high. It is extremely difficult for developers to raise capital at this stage.

In Silicon Valley, venture capitalists finance early-stage technology and healthcare companies. Unfortunately, a venture capital market does not yet exist to finance the development of infrastructure projects. A few institutional groups have invested in strong developers at the parent company level, e.g., Temasek in GMR of India, CITIC (China's sovereign wealth fund) in AES, and Reservoir Capital in Contour Global. But barring a few vehicles that have been sponsored by multilateral financial institutions (e.g., IFC InfraVentures) and donors (e.g., InfraCo and InfraCo Asia), there are barely any sources of early-stage, venture capital financing for projects.

Developers often feel that governments do not share their sense of urgency. Developers only make a return after a project reaches financial close. But governments are geared toward administrative tasks, not execution of specific projects. When a developer's proposal lands on a government official's desk, the official's focus is to make sure they do not make mistakes in their specific task area. No one within the government is driving the process *across* departments, agencies, and ministries, to make sure files move. While political leaders may be keen to get projects done, developers often are left to navigate government offices to seek approvals, inevitably causing delays and bottlenecks. Permitting, zoning, licensing, land acquisition, resettlement, and negotiating off-take agreements and guarantees are particularly time-consuming.

## **How Might a Government Accelerate and Help Fund Project Development?**

Governments can act to fix these bottlenecks. The keys are to get the incentives right, and change the mindset so that governments work actively alongside developers to catalyze the development of projects.

One solution is to *create an internal government-backed project development fund*. Such a fund would work through a joint project development agreement between a government and a developer. The two entities could share project development expenses, and work side by side to develop a project.

### **A. WHAT WOULD SUCH A FUND ACTUALLY FINANCE?**

The government project development fund would share some of the up-front costs associated with developing and bringing a project to financial close. The fund could be structured to invest *pari passu* alongside developers. Such financing is a critical bottleneck for developers, and such a fund could greatly help them.

The goal would *not* be to fund construction costs. If the project is well-developed, then, at financial close, financing for construction would come from project finance lenders and equity investors.

If we assume that a project development budget is around 5% of the total construction cost, the government might fund 20% of this project development budget. For example, if a 40 MW wind power project were to cost \$100 million and the up-front project development budget was \$5 million, the government fund would only need to invest \$1 million. This is less than 1% of the total cost of the project. If projects reach financial close, the return on such an investment could be quite high—both financially and in terms of seeing projects move forward.

## **B. HOW WOULD SUCH A FUND BE MANAGED AND GOVERNED? HOW COULD IT ACCELERATE PROJECT DEVELOPMENT?**

The project development fund would require a dedicated project team that, alongside the developer, works across different ministries and departments to secure permits, licenses, and approvals. While developers would always have to “own” the process, a single point of contact, or a designated official team of champions within the government, could greatly facilitate and accelerate the development of the project. *By having a government team incentivized to work alongside the developer to develop the project, the process of navigating government departments and securing permits and approvals would be expedited.*

Seasoned investors or project development professionals would be critical to running such a fund team, as their experience could help ensure that the project is structured to be bankable. Under such leadership, the fund staff could include experienced personnel seconded from other key ministries/agencies who understand the process of developing projects and securing approvals. To align incentives, the project team/government fund could be paid a bonus out of the development fee paid by lenders at financial close.

Governance arrangements must be worked out carefully. The more the government fund is involved in oversight and decision-making, the greater the alignment with the government’s strategic priorities. However, the fund will lose some independence, and other investors may not perceive the fund’s investments to be on commercial terms. In addition, unless the fund is independent, it could be misused to subsidize “white elephants.” The fund’s managers may lose interest in working at a government-controlled entity. It is possible to balance these competing priorities, but the issues must be addressed and worked through at the outset.

## **C. HOW COULD SUCH A FUND BE STRUCTURED?**

A fund could be capitalized by a central bank or national pension fund. Initially, such a fund might only need between \$50 and \$100 million. After funding overhead, this could easily lead to commitments for 40 to 80 projects over a five-year fund life. It is quite common for developers to abandon a project if there is no reasonable prospect of reaching financial close. As commitments are abandoned, the undisbursed capital would be returned to the fund

## **D. HOW WOULD THE FUND RECOVER ITS COSTS OR EARN A RETURN?**

As part of a memorandum of understanding or agreement signed between the developer and the government, the government fund might earn warrants or equity in the project. These warrants could be sold at financial close. Alternatively, the fund could be reimbursed its costs (and earn a return) from a development fee paid by lenders at financial close

## **Example: The National Infrastructure Fund (FONADIN) in Mexico**

The infrastructure project development fund approach may feel like an extension of the “single window of clearance” for foreign direct investment idea. But this is much more involved and specific to the infrastructure sector. The example below from Mexico illustrates numerous ways in which a government is supporting infrastructure projects. While it does not follow exclusively the

framework described above, the Mexican National Infrastructure Fund (FONADIN, *Fondo Nacional de Infraestructura*) does help finance and support early-stage infrastructure project development.

In the 1990s, a number of toll road projects in Mexico failed. Local commercial banks were saddled by non-performing loans of \$5.5 billion. Road projects failed due to poor concession designs, excessive guarantees, hasty due diligence, etc., and there was massive overinvestment. (For more, see Jeff Ruster, “A Retrospective on the Mexican Toll Road Program, 1989-1994” in *Public Policy for the Private Sector, Note 125*, published by The World Bank Group’s Finance, Private Sector, and Infrastructure Network, in September 1997. The article is available at <http://rru.worldbank.org/documents/publicpolicyjournal/125ruste.pdf>)

The government created a trust called the *Fideicomiso de Apoyo al Rescate de Autopistas Concesionadas* (FARAC, Support Trust for Rescue of Commissioned Highways) to take over the non-performing toll road loans and administer the projects. FARAC succeeded, and managed to recover the obligations through toll collection. The funds it collected were pooled with existing resources in the *Fondo de Inversión en Infraestructura* (FINFRA, Infrastructure Investment Fund) run by the *Banco Nacional de Obras* (BANOBRAS, National Bank of Works) to create a new organization called *Fondo Nacional de Infraestructura Inicio* (FONADIN, National Infrastructure Fund) in 2008.

FONADIN was created to serve as the federal government’s coordinating vehicle for infrastructure investment in communications, transportation, power, the environment, and tourism. FONADIN is intended to fund and/or contribute to funding infrastructure projects with social impact and/or profitability. In general, FONADIN provides recoverable support for profitable projects and grants for socially important but less profitable projects. Activities undertaken by FONADIN include:

- Coordinating the identification of infrastructure needs and project pipelines;
- Providing advisors to evaluate, structure, fund, and execute projects;
- Providing grants and recoverable support for studies;
- Providing grants and recoverable support to fund transaction advisors who help evaluate and structure projects;
- Promoting banking and non-banking financial intermediary participation in infrastructure funding; and
- Granting subordinated and/or convertible loans, guarantees, and capital contributions, to boost private and social sector participation in infrastructure.

In particular, FONADIN tries to help Mexican construction companies in project proposals with guarantees.

## **FONADIN’s Scope of Activities**

FONADIN supports both economically viable projects and projects that may be less economically viable, but that have desired social impact. FONADIN’s mandate allows it to support projects at the early (development) stage and at financial close.

TYPE OF SUPPORT	SPECIFIC ACTIONS	FEATURES	
Recoverable support, for projects with social value and financial profitability	Funding – studies	Up to 70% of study cost	
	Subordinated and/or convertible loans	Up to 15% of investment value, or 20% of debt	
	Guarantees	Credit	Up to 70% of credit value
		Stock market	Up to 50% of issuance value
		Task	Up to 15% of project investment and up to 40% of projected revenues
		Political risk	Case by case
	Venture capital	Direct	Up to 49% of concession company's capital
Indirect		Up to 20% of mutual fund's capital	
Non-recoverable support, for projects that only have social value	Contributions	Social profitability studies	Up to 100% of expenses
		Public work placements	Up to 50% of investment
	Subsidies		Up to 50% of investment value. However, excesses will be shared if flows offer an internal return rate greater than projected.

Source: FONADIN website (<http://www.fonadin.gob.mx>) and BBVA Economic Research Department Working Paper No. 10/03, “A Balance of Pension Fund Infrastructure Investment: The Experience in Latin America”.

## Conclusion

Early-stage project development is the most capital-starved and time-consuming segment of the infrastructure project development process. Developers find it very difficult to access capital, and governments are not organized to cooperate actively with developers.

This paper calls for an approach where governments tackle some of the toughest challenges, head on. The creation of an early-stage project development fund to invest alongside developers could give developers some breathing room and a financial cushion. Perhaps more importantly, by organizing government teams to execute projects and work alongside sponsors, the process of developing a project could be accelerated. Capital is already available to finance projects at financial close and to buy built assets. This approach could lead to more projects reaching a stage at which they can access such capital.

This is a fairly radical approach, and the governance arrangements need to be worked out carefully. But the infrastructure deficit is so vast—and the needs are so pressing—that we must act quickly. Previous approaches have only yielded incremental changes. It is time to try something new.

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