Commercial Law Development Program
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Good afternoon everyone. Can I first start by saying how pleased I am to be invited here to talk to you about my observations on the use of Project Finance across the World and particularly the UK - my home country.

Some of you may have noticed from my biography, that I am first and foremost, a, private sector individual; one of my current activities is advising in the UK government on it's Private Finance Initiative, particularly on institutional arrangements and procurement best practice. I am fortunate to be one of a few people with experience of both sides of the negotiating table due to my time spent leading project finance bids for one of the UK's largest construction companies, I hope you will forgive me if some of my observations are borne of frustration.

A large amount of my time is now spent traveling to other countries to assist governments and sometimes even private companies with the same issues. My work with the "United Nations Commission on International Trade Law (UNCITRAL) in this area and also with some of the multilateral agencies active in this field, convince me that we are in the middle of a quiet revolution in the way governments provide their citizens with infrastructure and other public services.

Indeed we live in an increasingly changing world. Expanding populations and economies demand modem and efficient infrastructures to support them. The expectations and aspirations of more and more people are being elevated by increased awareness of neighboring countries' achievements. Awareness brought about by the massive advances in communications.

Most of the positive developments in human civilization over the past 150 years are related to our new found ability to communicate across great distances. These advancements will hopefully bring people together in a way that breeds tolerance, understanding and friendship. But all forms of communication require huge investments in infrastructure.

Additionally, populations demand improvements to their overall quality of life which may result for example from new or improved drinking water supplies and sanitation or access to reliable sources of power.

Of course, infrastructure development often brings with it economic progress and prosperity. Quite often, though, the financial resources necessary to bring forward such developments are only available later on as a result of the economic benefits of the projects.

This is where Project Finance can help by:

- bringing forward investment in infrastructure;
- by allowing the costs to be paid either directly in tolls by the user, or, indirectly

through taxation, both over an extended period of time; and

- importantly, the disciplines necessary to finance projects privately, demand (and achieve) great efficiencies in their preparation and management. And, these developments themselves, create favorable conditions for future domestic and foreign investment.

The increase in private financing and the management of public facilities and service provision in the 1990s has been dramatic. If you include participation from privatization, leases and concessions which have reached financial close, approximately 700 transactions have been concluded between 1990 and the present time, with project costs totaling $376 billion. The main drivers behind this expansion were the developing countries, with a peak of activity - between 1996 and 1997. There is no doubt however, that 1998 saw a huge reduction in this type of activity, caused by the threat of a global financial crisis at that time. During the first 10 months of that year, the transaction volume, dropped by half.

I will discuss the reasons behind this in a while, but first a look at the types of projects that lend themselves to project finance.

There are three basic models for private sector finance working in public sector sponsored projects:

first, stand alone projects - where the entire project development, financing and operating costs can be met by the charges or tolls imposed on the users as in a toll bridge, although you must understand that there are great variations in the scale and characteristics of individual projects. Even these projects often require different types of government support.

The second category of project type are basically joint ventures between the government, contractor and financial institutions - these are often used where a socially or commercially acceptable fee or toll is insufficient to pay for the whole costs involved, therefore a level of public subsidy is used to support the project. I will explain to you later some of the dangers of getting this particular balance wrong. A good example of a project in this category would be a public transport system.

The third model is one where the UK has provided much of the development effort. I will continue to call this the "third model" throughout the rest of my talk.

These are Service based projects - projects where the Government is the client and pays the developer directly for a range of services which are usually delivered through an asset. The developer is responsible for the initial investment in any capital assets that may be required and is paid for the availability and quality of the services provided. He also maintains the responsibility of ownership throughout the contract life. This has moved the philosophy of Project Finance into new areas - areas such as the provision of hospitals, prisons, schools and government buildings. So how does this third model of Project Finance work? This is considered as a possible method of procurement when the perceived need for a capital asset can be converted into the delivery of a service. Essentially, the private sector contractor agrees to supply the service to a level and quality specified by the government, for a number of years. This has been typically 25 years for many of the projects that have been completed. There is usually a link between the length of the agreement and the useful life of the associated asset. The private contractor is then contractually responsible for or the delivery of that service and, as such, must undertake to Design, Build, Finance and Operate any underlying assets.

So how did the UK arrive at the conclusion that Private Sector involvement in the country's infrastructure provision and the delivery of public services was necessary and desirable?

To explain this, I will need to take us back in time for a moment. Actually, the concept of privately funded infrastructure projects is not a new idea. Toll roads and bridges were being developed hundreds of years ago - (perhaps as long ago as the Romans) the design, building, financing and operating costs were paid for by the private sector and of course, ultimately the user.

The UK was one of the first countries to experience an Industrial Revolution. Contrary to popular belief it was entrepreneurial businessmen and not the government who created much of the infrastructure that supported the economic boom at the time. This remained more or less the case until the Second World War, when, for understandable reasons of rebuilding a war damaged country at the time, the UK, with many other countries, entered a period of massive state ownership and nationalizations.

Perhaps because the UK had been one of the earliest entrants to the industrial age, it meant that its infrastructure was generally older than that of many other countries and, during the late 1970s and early 1980s, it was becoming obvious that the costs of the replacement and maintenance of ageing systems was becoming a huge financial burden on the State. This, combined with the natural desirability to grow and improve the standards and quality of life, meant that something had to be done.

First of all, there were what might now be referred to as "the obvious privatization" such as British Steel, British Airways, British Petroleum and even Rolls Royce. Looking back, it seems strange to the average citizen today that such enterprises were ever State owned, even though more difficult privatizations followed.

Around the same time, various initiatives were launched, all with the same underlying purpose, namely to provide the best possible value in the delivery of public services and to reduce the overall burden of taxation. There were countless outsourcing exercises, and many service contracts were market tested. We were also realizing in this period that we were often getting poor value for our capital programs. There were high profile projects which were massively overspent on budget and sometimes years behind schedule. A study of public works identified average cost over runs of 24%.

So in 1992, against a background of increasing evidence of good value from short-term service contracts placed with the private sector, the UK Government decided to introduce a Private

Finance initiative of its own, in an attempt to instill the same private sector expertise and efficiencies into projects which would normally require large amounts of capital. By the end of 1998, some $18 billion have been invested in such projects.

So - not bad. This, however, was against a relatively poor start brought about: by the need to train both the public and domestic private sectors in understanding the requirements of the financial markets and the fact that there were several legal and institutional deficiencies in the system. Most of these were overcome over time and the UK experience is now considered an example of good practice. A better planned and more carefully prepared Initiative in the early days, would have prevented many mistakes, lost project costs and a loss of much goodwill. I urge any country considering its own initiative not to make the same mistakes - instead learn from the mistakes of others.

It is a significant feature of the UK's initiative that, from the earliest days it has enjoyed the support of all the major political parties. This support still exists today and is perhaps a testament to the quality of the purpose, despite the difficulties of implementation.

Good Government is not better Government simply because it owns more assets. The interests of the citizen are, in the services that are delivered from a particular asset. For example, they are interested in the availability and the quality of hospital places not in the ownership of the building.

Indeed they might be concerned if the valuable time of the medics is taken up with concerns about the efficiency of the boiler house or the waste disposal service. The resources can be made to run more efficiently if the private sector competes for the privilege of supplying the hospital building and the management of support services for long periods, perhaps for contract periods in excess of thirty years. This means that doctors and nurses can concentrate on the core business of primary healthcare. Much of the philosophy in this area is driven by the need to manage the correct balance between risk and reward. All the risks inherent in a project (any project) should be rigorously assessed and then accepted by the organization best placed to manage that risk. For example the risks of things going wrong during construction are best handled by the construction company not a government department and the risks of operating IT projects are best managed by those companies whose principle business activity is operating IT systems. Naturally, there are occasions when some risks will need to be retained by the government.

Perhaps I could partly describe our philosophy with the following old saying:

"The common law of business balance prohibits paying a little and getting a lot.... it can't be done. If you deal with the lowest bidder, it is well to add something for the risk you run. If you do that, you will have enough to pay for something better."

But the requirement to achieve the correct balance between the transfer of risk to private sector business and achieving value for money for the taxpayer, has made the road to success a difficult one. It has taken the UK seven years to refine the product and I won't pretend that there are not more difficulties ahead.

I have just mentioned that $18 billion worth of projects have been agreed. The diversity of these projects is of note. Most UK Government departments now have successful Project Finance schemes including defense where many support services are provided and financed by the private sector. Some $950 million of private money has been invested in Ministry of Defense projects. This initiative has delivered new prisons and hospitals, new IT systems and even Government office accommodation.

Since the government doesn't own the associated assets it doesn't attempt to be too prescriptive about the exact physical nature of any underlying asset nor does it specify exactly how particular services should be delivered.

We are now approached by many governments from all over the World, including some Arab countries to share our experiences, most are particularly interested in the third model.

Why should this approach be of interest? Interestingly, project finance can help deliver different objectives in different countries.

I have spoken to government representatives from many countries and it is the diversity of reasons for examining this project option that impresses me most. In developing nations, perhaps obviously, the prime motivation for using project finance is to encourage economic development or sometimes to provide essential services. In other specific examples though, one major far eastern government wants to use this type of procurement to reform what it considers a wasteful and corrupt public procurement system that fails to deliver value and efficiency (their words not mine!).

In another instance, a major European government is examining this option as a means of partial privatization. It would like to have privatization for many utilities and service, but has found this impossible to achieve for political reasons. The third model in particular allows the government full control over the service provider in its role of intelligent customer, while encouraging the best private sector skills to be employed in the process. The advantages of this approach can be summarized:

- Competition will produce the best value for the government, particularly when this competition is open and transparent.

- Naturally, when the private sector competes, it always has to produce now ideas and innovations to be competitive and to be able to win the business. Therefore, all parties to the project have to work together to provide the best possible efficiencies. In particular, the designer and the operator have to work together to produce good design and construction quality to serve the whole life of the concession period and not just to find the cheapest initial construction cost which may have consequences in only a few years.

- Similarly, its operating costs will need to be cost effective to be competitive. And importantly, the Government only pays for the services when they become available - in other words it does not have to accept the risk of problems with the construction or the commissioning of the assets.

- Payment by the Government to the successful company is linked with the availability of the facility and also the quality of the services that it delivers. This means two things: first the Government only pays for the services that it receives directly and, secondly, there is an incentive for the private sector contractor to perform to the quality standards that the Government expects - if it does not, then it will cost them money.

No longer should it be acceptable that taxpayers become the insurance of last resort for the poor management of public services.

Additionally, it transfers Government capital spending into revenue spending, and therefore, minimizes the impact of large scale capital programs. It creates a wider range of business opportunities, both for companies within the countries involved and for foreign investors.

I would now like to share my observations on the factors that make particular projects in particular countries more attractive than others. What are the factors that are most important ? It is essential that a country's legislative and constitutional powers are sufficient not only to achieve a country's infrastructure ambitions, but also to reassure the equity and. debt providers of the security of their money.

In order to attract private investment into infrastructure projects, the objectives arid requirements of the private sector need to be understood.

The most common mistake resulting in projects getting stuck, is the lack of a consistent overall government strategy. Often, statements by the most senior levels of government, announcing the country's openness to such ideas, do not translate into investments, since these policy declarations do not always get supported by an appropriate institutional framework. It is quite common to find a host of government entities, including line ministries, central government agencies, local and regional authorities and state owned enterprises all involved in the decision making process. All of these entities tend to have different motivations, frequently spiced up by political turf battles and a jealous guarding of their responsibilities.

In the vast majority of cases where projects have run into difficulties, these failures were the direct result of insufficient preparatory actions by the government to develop an appropriate institutional, legal and regulatory framework.

The legal framework needs to be accommodating. Uncertainties over the limits of private sector involvement or provisions that make legal challenges more likely will increase project risks, making them more expensive or even impossible to implement. Countries that have not established a legal framework that relates specifically to this type of project, tend to find their projects engulfed in legal challenges after the contract award, be it from consumer groups, labor unions or unsuccessful bidders. This is also a good reason to ensure that there is open competition, and that fair and transparent selection and award criteria are used, in order to minimize the government's risk of being accused of corruption.

In terms of the regulatory position, there seems to be a popular belief that private investors and operators don't want regulation, since it might limit their operational autonomy. In fact, the opposite is true. A politically independent regulatory mechanism can inject a degree of stability and certainty over the future operating environment. This fact will need to be recognized by host governments.

There is a need too, for new skills from government officials, who maybe familiar with turnkey projects but lack experience in developing the complex contractual structure of a project finance transactions. These skills are absolutely vital if good value is to be negotiated from these deals and sufficient protection for the interests of the citizens are to be maintained.

This lack of expertise often translates into private investment options being considered as a second best after more traditional procurement mechanisms through budgetary or donor sources have been explored.

Unfortunately, this leads to the sub optimal use of such scarce resources. It means that perfectly good commercially viable projects are allocated these public funds. With planning and an understanding of private finance possibilities, the commercially viable projects can be funded privately, leaving the rather more precious public resources to fund perhaps more socially targeted objectives.

And finally to the future, I mentioned earlier about the huge downturn in project finance activity in 1998. The main reason behind this decline was the reluctance of foreign equity investors and commercial lenders to provide financing to projects in some of the economies of South and East Asia and Latin America. Massive currency devaluations in these areas, brought a number of existing projects to the brink of bankruptcy. The increased volatility in exchange rates has led providers of finance to avoid committing large amounts of hard currency to projects which rely on cash flow from domestic currencies.

Also, a newly elected Asian government attempted to renegotiate some of the contractual agreements negotiated by the previous government on BOT schemes. This puts into question the reliability of government commitments to long term contracts and raises the perception of political risks in most projects.

For governments this means that private funds for public projects may be hard to source. The massive growth in this type of activity in the last few years led to increased competition amongst funds, sometimes at the expense of proper risk mitigation. Investor consortia were becoming satisfied with much weaker levels of government commitment and support - arrangements that would have been unacceptable only a few yew earlier - those days are over and in future projects will need to be structured more carefully than ever. The preparatory work that I have talked about, will be even more vital to encourage such investments.

The currency devaluation issue has highlighted the fact that really, no government guarantee can provide sufficient comfort to guard against it fully. The only real long term solution is to encourage a greater share of the lending from domestic capital markets to minimize foreign currency exposure. Overall, even though the current crisis has highlighted some important deficiencies, it does not mean an end to the revolution in this fascinating area of finance.

Thank you for your kind interest and attention.

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