Unfinished reforms in infrastructure: Impact on private investments

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Introduction

In 2012, 55 per cent of private participation in infrastructure (PPI) commitments in the developing world were concentrated in two countries: Brazil and India. India's success in attracting PPI can be attributed to three key factors: a) an enabling framework for sector reforms and public-private partnerships (PPPs) with a growing focus on transparent bid processes; b) the entrepreneurial Indian private sector; and c) strong political and bureaucratic support for PPI. India has outscored China and Japan to rank second on PPP project performance among the Asian nations and fourth in the Asia-Pacific nations.

Investing in infrastructure is essential for realising sustained economic growth and sustainable development in India and, in particular, Millennium Development Goal 1—poverty reduction. From the Eleventh Five Year Plan, a major impetus was given to infrastructure development. Spending on infrastructure has grown from about 4.5 per cent of GDP in 2004–05 to 8.41 per cent of GDP in 2011. While the primary driver for PPI has been inadequate public (and human) resources, evidence of private sector efficiency has helped to mainstream PPI in the procurement strategies of public agencies. The Twelfth Plan target of Rs 56.3 trillion for private sector; and c) strong political and bureaucratic support for PPI key elements need to be put in place, preferably sequentially.

This paper provides a narrative of the private investment story unfolding in key sectors and argues that for sustained large-scale PPI interest must be secured and sustained through appropriate and sustained political support for such reforms will include the establishment of independent regulators early on in the process: until the industry transitions from a monopoly to a competitive structure, regulation must ensure minimum service standards and fair determination of tariffs. Private sector interest must then be secured and sustained through good governance over the project lifecycle.

The challenges

Despite successes, private investments are concentrated in few sectors and states. Electricity, telecoms and roads together accounted for about 88 per cent of the total PPI investments during the Tenth and Eleventh Plans (their shares were 41 per cent, 37 per cent and nine per cent, respectively). Social sectors remain largely funded by public agencies, though private capital is flowing into education (US$70 billion by 2013). At the state level, a review of all the PPP projects (completed, under implementation and under pipeline) shows that, as of March 2012, eight of the total 28 states account for about two-thirds of the total number of PPP projects, totalling up to more than 80 per cent of the total PPP investments.

Only limited municipalities are awarding PPP projects, mainly in water and sanitation, roads and urban transport, due to their poor fiscal condition, inadequate accounting reforms and limitations on levying user charges. Public funds available for projects in states and municipalities under the Jawaharal Nehru National Urban Renewal Mission may have crowded out private investments.

PPI in South Asia fell by 20 per cent to $35.1 billion in 2012 (India accounted for $31.2 billion) – back to 2008 levels after seeing the sharpest increase in 2010 and contrary to trends in Latin American countries. PPI in the telecoms sector has dropped 15 per cent in developing countries and has been at its lowest since 1999. After a sharp rise in PPI since 2006, a sharp reduction in the telecoms, road and energy sectors in the last year signals unresolved systemic issues.

Telecoms

The New Telecom Policy 1999 set the foundation for reforms by promoting competition and choice to consumers in terms of services and technology. It also opened national and international long-distance services to the private sector. The outcome included remarkable improvements in telephone density (from 4.3 per cent in March 2002 to 73.1 per cent in March 2012) and a huge reduction in tariffs (from Rs 16/min to 0.7 paisa/min). Average revenue per user in the sector is the lowest while competition intensity is the highest, globally.

The Telecom Regulatory Authority of India (TRAI), constituted in 1997 to regulate tariffs and licenses, has both a recommendatory and regulatory role. It regulates tariffs, service standards and interconnections. TRAI played a credible role in the reform process and made several recommendations to promote competition and service quality in the sector. It also recommended allocation of spectrum for 3G licenses through e-auction. These recommendations are based on extensive stakeholder consultations. Telecom Disputes Settlement and Appellate Tribunal was constituted in 2000 to resolve disputes.

In 2011, the public audit agency Comptroller and Auditor General of India reported an astronomical loss in the allocation of spectrum for 2G licenses. The Supreme Court recorded a finding that the recommendations made by TRAI on a first come first served basis were flawed and implementation thereof by the Department of Telecommunications (DoT) resulted in violation of the objective of the telecoms policy (the reform blueprint). It also recorded that changes made by the latter in the bid process were done to favour a few real estate companies with no previous experience of the business.
The Supreme Court order to cancel the 122 licenses awarded in 2008, despite large sunk investments, show that projects can be challenged for ad hoc bids or arbitrary decisions during the bid process; even after award and construction. This sent a strong message to the private sector and politicians against trying to manage the system. But this also resulted in shaking investor confidence as it introduced unpredictability into the investment environment. The result of the rebidding was not encouraging and it is largely felt that the reserve price set is high.

DoT has made several policy changes in critical areas such as the delinking of licence from spectrum, allocation of spectrum via auctions and spectrum liberalisation. Clarity is still awaited in key areas such as levy of one-time spectrum charge, re-farming of spectrum, spectrum trading, merger and acquisition guidelines and legality of 3G roaming agreements. The sector is mature and poised for consolidation. The National Telecom Policy 2012 sets out a broad vision for the sector, but it needs to be supported by specific implementable policies soon.

**Power**

The power sector reform blueprint enshrined in the visionary Electricity Act 2003 envisaged the unbundling of state electricity boards; corporatisation of generation, transmission and distribution, followed by privatisation (though not mandatory); and the setting up of independent state regulators. The provision regarding availability of non-discriminatory open access in transmission and distribution is an important enabling provision of the act for facilitating competition.

The unfolding reforms saw the freeing up of generation and the induction of independent power producers (IPPs), leading to remarkable growth in generation capacity. Renewable energy in particular, supported by incentives, saw spectacular private investment. Sporadic privatisation of distribution companies (discoms) saw the franchise and licensee models evolve but not scale up. Low private participation in transmission is leading to congested transmission corridors. Open access is not fully operationalised.

Where tariffs are regulated, the regulator must ensure that the industry remains viable for financing on commercial terms. However, they yield to political pressure and keep tariffs low. This has set the sector up for failure as distribution sits atop the revenue cycle. Inadequate tariff reforms cause revenue cycle distortions as the loss-making discoms – financial year 2012 net loss is Rs 190,000 crore – cannot pay the generators, who in turn cannot pay the fuel suppliers or service debt to lenders. The discoms prefer load shedding to buying costly power, impacting user services.

Timely and fair determination of tariff, separation of agriculture feeders, transparent regulation, accounting and payment of subsidies by states are all required if we are to prevent this story from repeating itself every few years and secure greater PPP in distribution.

Another issue plaguing the industry is fuel supply constraints due to slow reforms and governance failures in upstream sectors (coal and gas). The reliance on imported coal has altered the profitability of generation companies and they face a huge financial risk due to volatility in fuel prices. In addition there are challenges in using imported coal in existing plants. Ultimately the solution to easing fuel constraints lies in ensuring reforms in the coal mining sector and streamlining processes for environment and forest clearances.

The stranded generation capacity of the private sector due to fuel supply constraints and the inability of discoms to pay them have caused a lock-in of equity capital and debt overhang. Given the large quantity of loans disbursed and poor debt servicing ability of the projects, a crisis could develop for the sector if not addressed soon. Investments in power generation have come to a standstill and this reflects systemic issues. The lesson is that half-hearted reforms do not serve the sector in the long term and regulators have to be accountable for their performance. Interdependencies between sectors deserve serious attention in the design of the reform blueprint.

**Roads**

The Ministry of Road Transport and Highways launched the National Highway Development Program (NHDP), a large-scale private sector driven programme, in 1999. Elements that underscored its success were: i) a specialised nodal agency, National Highway Authority of India, duly empowered through legislation; ii) a dedicated revenue source like the Central Road Fund ensuring cash flows for the programme; and iii) a programme approach.

Given the availability of funds, the incumbent functionaries (NHAI) preferred to award construction contracts in the initial phases and NHDP relied on huge borrowings to build roads but ‘privatised toll roads could have expanded faster without much burden on the exchequer. A great opportunity to build self-sustaining highways was thus missed’. From a 74 per cent share of total kilometres awarded in Phase I and II of the NHDP, the share of EPC contracts has fallen to just seven per cent of the total kilometres awarded since 2006–07, while the remainder have been awarded to private developers on build-operate-transfer mode. Over a period of time 9,000 km of projects were awarded on PPP mode during the five-year period of 2005 to 2010, compared to 890 km during the ten-year period from 1995 to 2005.

The NHAI road project award grew at 114 per cent compound annual growth rate between financial years 2009 and 2012, but was 1,116 km in the financial year 2013, down 83 per cent from 2012. The award for construction contracts is closer to targets than for PPPs. NHAI has been unable to hand over land for awarded projects on schedule due to delays in land acquisition and stricter requirements for forest and environmental clearances than before. The time and cost over-runs for projects due to construction delays and low traffic adversely impacted project profitability. In the face of aggressive bids developers served termination notices and/or re-negotiation proposals to NHAI. After an initial period of aggressive lending to road projects, banks set stringent condition to disburse loans (such as 100 per cent ‘right of
way for road projects and higher upfront equity infusion from cash strapped and debt-ridden promoters). Many companies are using corporate debt restructuring mechanisms to restructure debts. Projects have been stalled as they cannot achieve financial closure.

The key lessons emerging from this PPP programme is that a mature rationale for any PPI programme must exist or it could be open for scrutiny/renegotiation later. For instance, value for money and affordability must be the basis for opting for PPP. Strong action to reject aggressive or low bids can then be taken, based on a diligent study. As the performance of public agencies improves this will become increasingly important. Further, as traffic risks are controllable by neither the private sector nor the government (growth in traffic is correlated with the growth rate of GDP), it may be time to further refine the PPP model and, since unforeseeable contingencies may occur during the project life, give suitable renegotiation provisions in contracts. The Planning Commission is preparing a discussion paper on provisioning for renegotiation in PPP contracts, including existing projects, to deal with unforeseen developments.

The road sector has no regulator and tolls are fixed by the government. Contract management, dispute resolution and renegotiation frameworks need urgent attention. States must support national highway projects by meeting their obligations as set out in the state support agreements. A greater focus on the end user is called for, particularly in managing queues at tollbooths and safety.

Railways

Indian Railways (IR) is a huge public monopoly. A high degree of vertical and horizontal integration has led to crippling inefficiencies. The prioritisation of social objectives over commercial imperatives has resulted in underinvestment in revenue generating capacity enhancement, the highest freight rates in the world and the resultant sub-optimal modal shift towards roads. The resistance to corporatise Indian Railways coupled with the low productivity of a large work force employed by the government is reflected in the alarmingly high operating ratio (88.8 per cent). Policy debate on railway reforms is focused on organisational and tariff reforms rather than on creating a competitive industry structure. Railways have attracted only four per cent of private sector investments. Recent policy measures on the anvil include setting up a Rail Tariff Authority and increasing rail fares to increase the profitability of IR. A PPP policy with six models for participation by private sector and other players has been cleared by the cabinet and permits foreign investments in first mile and last mile connectivity projects. IR is building a pipeline of PPP projects for award in the Twelfth Plan.

The role of central and state institutions

The Ministry of Finance (MOF) and the Planning Commission supported PPPs through several initiatives. Viability Grant Funding helped leverage private investments, while adherence to the governance framework prescribed by the MOF was ensured from central and state agencies as it became a precondition to availing grants. Inherent guarantees in the model concession agreements (MCAs), substitution rights and ring-fencing revenues (escrow accounts) provided comfort to lenders triggering aggressive lending. The effort of these two is laudable as transparency in bid-process management is sine qua non in PPP projects.

The Committee on Infrastructure, set up in 2004, was replaced by the Cabinet Committee on Infrastructure in 2009, which, chaired by the Prime Minister, expedited the financial, institutional and legal measures required to enhance investment in infrastructure sectors. Now the Cabinet Committee on Investments, set up in January 2013, will assist in fast-tracking large projects facing regulatory delays. The emphasis is shifting from reforms to governance.

States set up specialised institutions to support PPPs and infrastructure development: PDCOR in Rajasthan; Gujarat Infrastructure Development Board in Gujarat; and the Infrastructure Development Corporation, Karnataka (modelled on Partnerships UK) in Karnataka were early initiatives. With support from the MOF, states institutionalised PPP cells thereby increasing the pipeline of bankable projects.

Sector regulators in most sectors were established early in the reform process and their impact has varied from sector to sector. India has done a credible job in attracting PPI into the telecoms, power and transport sectors in the last decade. Sector reform blueprints are not only well designed, but largely in place. When reforms were not carried out in their true spirit or remain unfinished, it has resulted in some of the current challenges. Land acquisition, forest and environmental related reforms can be fast tracked and processes streamlined further. Transport capacity constraints could derail growth in other sectors so railways must urgently develop a long-term reform blueprint.

Central and state governments both have a major role to play. Where dependence on government is high scale up is slower. The telecoms success story is on account of telecoms being a union subject and dependent mainly on technology for scale up, once the reform blueprint is established. Where states are depended upon to implement reforms, the central government has to devise creative strategies to ensure success (such as the reform linked assistance in the power sector) as aligning 28 states to a common reform agenda can sometimes result in intra and inter-governmental gridlocks. Political leadership and support can make the reforms happen.

The MCAs, guidelines for procurement and other efforts towards creating a sound governance framework have facilitated a rapid scale up of PPI. Lately, standardisation has received more attention than reforms and serves the risk-averse government officials well. Dispute resolution remains weak and sometimes the fall back is on courts. The government is now finalising the Public Contracts (Settlement of Disputes) Bill 2013 in order to give respite to the private sector as investments over Rs 135,000 crore are held up in contractual disputes and the average period of resolution is 15 years. It is a major reason for the time and cost over runs of projects. This becomes significant as the private sector has been awarded projects even while public agencies are not geared to fulfil their obligations. Non-alignment of incentives between the government, bureaucracy and the private sector causes a ‘mismatch’.
Conclusion

As value unlocking takes place in infrastructure sectors, regulatory oversight and capacity is critical in preventing speculation by both the government (setting very high reserve prices) and bidders (bidding at unrealistic prices). The governance failures in telecoms and coal suggest that ‘incumbent players acting in tandem with entrenched interests can not only subvert reforms but also hijack governance’. 11 Cronyism and oligarchic capitalism12 must be preempted by regulators. Increasingly, lessons from across the sectors suggest that development of regulatory capacity, independence and accountability of regulators is the need of the hour. The judicial intervention seen of late could well be reflective of inadequate stakeholder and public consultations.

An overarching institutional mechanism (such as a national infrastructure commission) to plan and monitor major projects, regulate contracts, concessions and licenses, and to ensure that reforms remain at the forefront of the consciousness of the Indian polity may be a solution. This becomes important given the interdependencies between the sectors.

Only a limited number of companies in India have the capacity to develop large infrastructure projects and they have overstretched balance sheets. There is thus an opportunity for foreign developers to invest in new projects as well as in some of the operational projects. Seventy-five per cent of the banking system is running on stretched balance sheets. It is facing a concentration risk and asset liability mismatch on account of its exposure to the infrastructure sector. The government is facilitating long-term funds through innovations such as the Infrastructure Debt Funds. FDI and external commercial borrowing norms are continuously reviewed and relaxed. There is a need for greater participation in projects by foreign investors and developers now. Structurally, these investments could lower the cost of projects as well as of financing. Given the current drop in investment levels in infrastructure and the beneficial impact of infrastructure on economic growth, continued attention to the four elements – reforms, governance, regulation and political support (including in states) – is needed to create a conducive and predictable investment climate, now more than ever.

ENDNOTES

1 UNESCAP. Crore is a unit equal to ten million.
2 Private sector share was 21.75 per cent in the Tenth Plan and is anticipated to be 37 per cent in the Eleventh Plan. For the Twelfth Plan, 92 per cent of investments in the telecoms, 54 per cent in the electricity (including renewable energy) and 34 per cent in the road sectors are expected from the private sector.
3 Foreign companies like Etisalat, Loop Telecom and S-Tel closed Indian Operations. GSM auctions in November 2012 and then in March 2013 did not get any bids. The CDMA auction in March 2013 got only one bid.
4 The V. K. Shunglu committee attributed the losses to the poor management and operational practices of the discoms, irresponsible actions of the state governments and regulatory lapses in determining tariffs.
5 BHEL’s equipment order inflow is as an effective proxy for investments in greenfield projects and in 2011–12 this was Rs 22,000 crore, down 64 per cent compared to Rs 60,000 crore in 2010–11 and then slightly improved to Rs 31,000 crore in 2012–13.
7 Edelweiss sector update: Construction, 10 June 2013.
8 Up to 50–100 per cent instead of earlier 25–35 per cent.
9 ‘Stalled PPP infrastructure projects likely to get a renegotiation clause’, Economic Times, 14 October 2013.
12 Oligarchic capitalism where market and political power of major corporations drag down long-term growth and cause policy distortions: ADB.

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