

PROJECT FINANCING A SOLUTION TO PRIVATE INFRASTRUCTURES

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1. Need for private infrastructures

Investment in development of infrastructures and public utilities is an important and urgent issue for developing countries. However, this area requires huge investment capital which is of shortcomings of most of low GDP nations. When the starting point for economic development is low, the economy will find hard to grow. In the past 10 years, the developing countries have began exploiting private investments in infrastructures and public utilities including electricity and water supply, roads, bridges, ports, etc. Nevertheless, this is an area needing large investment capital but facing slow recovery and many risks, so it is less attractive.

In Vietnam, after the Government issued Decree 87/CP dated Nov 23, 1993 on BOT contracts, Decrees 42/CP, 43/CP on management of investment in capital construction and bidding, Decree 62/1998/NĐ-CP dated Aug 15, 1998 concerning regulations on foreign BOT, BTO and BT investments in Vietnam and Decree 02/1999/NĐ-CP dated Jan 27, 1999; some investment projects on electricity and water supply have been implemented in BOT form. From 1993 until now, Vietnam has granted two investment licenses to Malaysian Emac & Sadec and French Lyonnais des Eaux in water supply industry. The Finish Wartsila NSP Power Development, Quảng Ninh Power Plant (300 MW), Phú Mỹ 2-2 Power Plant (700 MW) have also been permitted for construction in BOT form.

There is only one local BOT project approved. It is the project building the interprovincial route 15, from Km 5 to Bình Khánh ferry, 8.5 km long. Its investor is the Vũng Tàu Petroleum Construction Company. In the directory of projects calling for foreign investment published by HCMC People's Committee in 1998, a series of projects in various industries are introduced to foreign investors including BOT infrastructure projects such as projects upgrading Nhà Bè - Cần Giờ road capitalized at

US\$7 million, building the water supply network for Cần Giờ District estimated at US\$10 million...The BOT investment is on the whole in the stage of preparation, those projects which have been completely designed for approval remain modest.

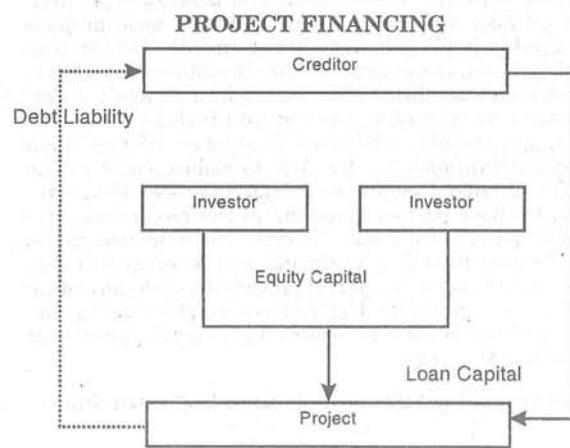
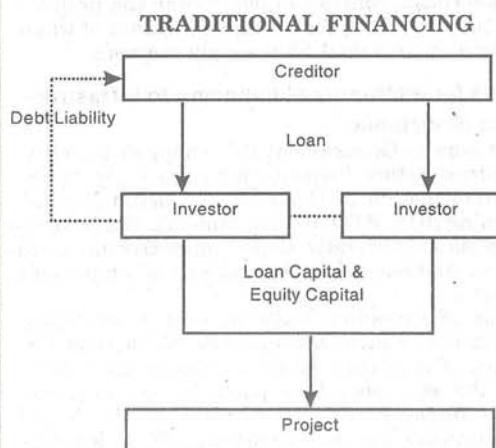
Those investors who are capable of engaging in infrastructures and public utilities are technically construction contractors. Although they have technical competence, their capital is limited. Most of them depend on their equity and loan capital for investment. However, with their own capital, the borrowing of money to build infrastructures is mostly impossible to individual investors, both local and foreign ones if applying traditional financing. This indicates the current offering of credit to projects should be reviewed.

2. Traditional financing - why not attractive?

From the beginning, the funding by credit was regarded as a process of establishing debt relations between individuals in goods exchange. The credit has been needed afterwards not only in goods exchange, but also in production and investment activities. At present, when taking loans for projects enterprises are asked for collateral worth 145-155% of the loan value whether the loan is used for projects with high or low feasibility. This method is called traditional financing. It has many deficiencies. For example, it allows giving no additional loan to those enterprises having low financial competence (by determining a particular percentage of debt); in addition, the credit history of enterprises is a factor which is seriously examined by the creditors. These features of traditional financing have disabled individual investors' involvement in construction of infrastructures and public utilities.

3. Project financing - a solution to private infrastructures

THE DIFFERENCE BETWEEN PROJECT FINANCING AND TRADITIONAL FINANCING



Form of project financing is like a revolution to credit activities when it overcomes existing shortcomings of traditional financing. The project's financial competence including assets and revenues, but not the project investor's financial competence, is just a determinant for receiving credit. In case of bankruptcy, the loan is taken back from the project assets. The investor has limited liabilities. That is he/she has no responsibility for the asset value exceeding his stake in the project. It is not wrong that the basic principle of project financing is to transfer the debt burden from the project investor to the project itself (See previous page).

In Vietnam, the project financing has not yet been applied widely. The Bank for Investment and Development of Vietnam, one of four major state-run commercial banks, has financed most of projects requiring huge capital, however, the investment form is mainly financing

Table 1 indicates main possible risks and the creditor's common methods to spread risks in highly risky countries in the Middle East, South America, Southeastern Asia following the experience from the International Finance Company (IFC) (1996, *Financing Private Infrastructure*) and Robert L. K. Tiong (1990, *BOT Projects: Risks and Securities*). The pace of project construction depends on the main contractor's experience. The losses caused by slowdown in construction should be compensated by the contractors' commitments. The performance bonds should be issued when the project is completed and transferred to the project owner. Risks from political instability require the host Government's commitments on reducing losses. The project's assets need be ensured by competent insurance companies. Moreover, there are couple of different methods to mitigate particular risks by spreading risks to the best risk manager.

Table 1: RISKS AND RISK SPREADING INSTRUMENTS

Risks	Risk spreading method
<i>In the project construction</i>	
Delayed schedule	Hiring experienced contractors - Provisions on fines and loss compensation applicable to contractors - Requiring tested technologies - Performance bond
Exceeding the budget	Commitment to reserve credit line of other financing resource - The investor pledges to increase his stock
Political instability	Buying insurance of assets - The host Government's commitments
Infrastructure condition	The Government's assistance commitments
In the project operation	
Input supply	The commitments to supply materials
Market change	Market research reports in the feasibility study process - Wholesale contract -Joint venture with wholesale purchaser
Project technology	Requiring tested technologies
Operation/maintenance	Participation of contractors/guarantors - Employing experienced project managers
Foreign exchange rate	Using the formula of adjusting prices automatically in the contract. - Offshore bank account - Securing the central bank's exchange rate - Using swaps

Source: IFC, 1996, *Financing Private Infrastructure* and Robert L.K. Tiong, 1990, *BOT Projects: Risks and Securities*.

based on the investor's financial position. Nevertheless, the revenue of feasible projects is increasingly appreciated. Those projects of high feasibility will be given priority instead of those enterprises with good financial position but realizing unfeasible projects. The common financing form is a mix of traditional and project financing when the investor's ratio of debt to capital is permitted to rise. However, in case of failure, the investor's responsibility is still investigated. Loans will be retrieved from the investor's business activities (in other projects).

As such, the investor will find benefits from project financing. It is the possibility to borrow more money as compared with his financial ability. It is also the possibility to get access to credit when he obtains good projects although his lending history is not smooth. He can also sell his stock in the project to other investors. But what is the necessary conditions for the creditor to avoid risks? They are risk spreading instruments including commitments, agreements, conditions from project formulation to implementation with the aim to reduce risks to the project's financial competence and revenue. Risks are spread to those parties involving in the project who are the best manager of a specific risk. The evidence shows most of commitments, agreements, and terms concerning the project in case of project financing are risk spreading tools set up by creditors. Unlike traditional financing, the creditor's level of control is much higher in the process of supervising the project.

4. Risk spreading forms widely used in project financing

Derived from many commitments, provisions, obligations of parties involving in the project, the project financing is featured by many parties involving in the project. This is also a necessary condition for the success of project financing when risks are spread to the best risk manager.

In fact, the BOT projects in developing countries which face a wave of private infrastructure have general characteristics: They are directly or indirectly implemented by consortiums, often in the private sector, built by consortiums, operated and maintained by consortiums; there are many pledges to secure the project revenue by agreed price formula, contract of purchasing the project's products in the long term, for example, contract of water wholesale, tolling, and electricity supply contract.

5. Conditions for international financing to infrastructure projects in Vietnam

The Vietnamese Government has changed its viewpoints on infrastructure investment in the early 1990s. Since the promulgation of Decree 87/CP dated Nov 23, 1993 concerning BOT, BTO, BT investments, the Government has encouraged privatization of infrastructures and public utilities and opened opportunities and challenges to the creditors.

By means of spreading risks in project financing, private-invested infrastructure projects still attract foreign financing. The project's pace and feasibility will increase with the assistance from potential investors and international financial institutions such as the World Bank, International Finance Company (IFC), Interna-

tional Development Association, Asian Development Bank, and Multilateral Investment Guarantee Agency. According to the IFC's statistics, some 60% of IFC's loans are offered to those countries having low or average GDP. IFC has financed US\$6 billion to 35 projects in Côte d'Ivoire, Tanzania, Uganda, Zaire, Zimbabwe, Bangladesh, India, Nepal, Pakistan, Sri Lanka, Vietnam and Honduras (statistics until 1997).

To receive funding, the projects in those countries which have high riskiness and low GDP must meet the following conditions:

Attainable revenue of the project: When the project revenue is ensured, the creditors' capital will be likely recovered. The two projects implemented in Vietnam and financed by IFC will illustrate this condition. The US\$10-million project upgrading the Saigon Port was financed in 1988 with a view to reducing traffic congestion at the Saigon Port. The high economic growth rate signaled a rise of 60% in the container volume handled in the 1989-1994 period. Furthermore, the efforts of investors in negotiating long-term contracts of landing strengthened the project's revenue. The other project, building the Bình An Waterworks in Bình Dương Province, has a feature that its whole products are purchased by the HCMC Water Supply Company. As a result, the project revenue is surely secured.

Securing foreign exchange for debt payment: Regarding the above mentioned port project, most of earnings are US dollars following international practice, therefore, forex risks are trivial to foreign creditors. Nevertheless, in case of the Bình An Waterworks, the project revenue is in Vietnamese đồng (gained by the water supply company), the exchange from local to foreign currency for interest and debt payment is not simple, especially the local currency is not stable. As a result, IFC has to spread risks by requesting a water wholesale contract between Bình An and the water supplying company, in which the payment is made in đồng but at US dollar-based price. When receiving payment, Bình An is allowed to exchange the amount for foreign currency and send it to an offshore bank to pay interest and principal to the creditor when due.

The investor has the competence of finance and project management: In the project upgrading Saigon Port, the foreign investors include an international goods supplier and an influential shipper. The local creditors

are an importer and a commercial bank. The Bình An project's investors are Malaysian companies specialized in water works and real estate business. These investors had 40% stake in the project. The remaining capital came from international creditors led by IFC.

The host government makes commitments to guarantee and assistance: The Bình An Waterworks project has been given many supports by the Government in securing revenue and paying its debt. The HCMC Water Supply Company pledges to purchase products, the investors are permitted to exchange profits from local to foreign currency and send this amount to a foreign bank. In case the project has to terminate operation before the expiry date due to Vietnam's Government, the investors' investment capital and reasonable profits will be compensated. These Government's supports become increasingly important. They are an important factor affecting investor's determination of pouring their money in highly risky countries.

Thanks to these characteristics, the projects in low-income countries still attract international financing regardless of their scale. It is recognized that there is no relation between a nation's income with the size of projects calling for international financing. The low-income nations' projects have an average investment capital of US\$171 million each, as compared with US\$184 of the world's average project.

Because there are a few projects implemented from the beginning to the end by only one enterprise, the

out-sourcing through networks is a comparative advantage of investors. The investors pour their money in the project, the competent contractors build infrastructures, the suppliers provide competitive machinery and equipment. The capital insufficiency will be overcome by project financing. Hidden risks will be spread to the party who is the best risk manager. As a result, the question of private infrastructures has had a satisfactory answer. ■

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Table 2: FOREIGN FINANCING TO DEVELOPING COUNTRIES BY INCOME AND RISKINESS

	Number of nations	Number of projects	Investment capital (US\$ mil.)	Average investment capital per project (US\$ mil.)
<i>Income</i>				
Low income	13	35	6,000	171
Low average income	18	47	7,986	170
High average income	9	60	12,099	202
Total	40	142	26,085	184
<i>Riskiness</i>				
High riskiness	18	36	3,529	98
Medium riskiness	20	70	16,310	233
Low riskiness	11	35	7,976	228
Total		141	27,815	197

Source: IFC, 1996, *Financing Private Infrastructure*
na: not available

These figures do not include multinational projects.