# The Privatisation Paradigm

## Jumping onto the infrastructure bandwagon

***Ryan Orr***

### The Infrastructure Privatization Paradigm

The fixed physical wealth of nations, infrastructure assets – roads, railways, bridges, ports, airports, dams and tunnels – are increasingly being transferred to private sector owners and operators.

Cash-strapped governments in the developed world – Australia, Canada, the UK, Japan and the US – are trumpeting private finance as a solution to decades of neglect of their antiquated infrastructure assets.

At the same time, banks, pension funds, and other private investors are looking to infrastructure as a new, long-term, inflation-linked asset class, that sits alongside private equity and real estate, and that offers a combination of hard assets and visible long-term earning streams.

What's more, multilateral development agencies are ever-optimistic that private investment and financing have an important role to play in resolving the economic ills in Africa, Asia, and other lesser-developed world regions by enabling the private provision of basic power, water and transportation services.

Consequently, each of the major players in the system – projects sponsors, institutional investors, governments, multilateral development agencies and bankers – acting in its own self-interest appears to be reinforcing the trend towards greater privatization of infrastructure. We refer to this marriage of convenience as the 'Infrastructure privatization paradigm'.

### The Rise of Infrastructure Funds

The latest chapter in the infrastructure privatization story is the rise of a new set of private infrastructure funds. In the past six months alone, there has been a flurry of activity as many institutional investors have come to embrace the idea of infrastructure as a viable asset class. The next wave is upon us, for example:

- Macquarie Bank closed a US$964 million infrastructure fund in a South Korean IPO;
- Alinda Capital Partners LLC, New York, a private equity firm specializing in infrastructure assets in North America and Europe, headed up by Christopher Beale (who was formerly the head of project finance at Citigroup), is reported to be raising a new US$1 billion infrastructure fund.
- The Infrastructure Development Finance Corporation (IDFC) in India announced its intent to raise a second US$350-450 million infrastructure fund;
- Carlyle Group established an eight-person team to raise a US$1 billion fund to focus on U.S. infrastructure, such as rail, airports, water assets, schools, hospitals;
- Dubai International and HSBC announced a US$500 million infrastructure fund;
- Emerging Markets Partnership is raising a US$730 million fund for investment in Islamic Development Bank member countries;
- Goldman Sachs International is reported to be preparing a US$3 billion global fund for infrastructure investment;
- KB Asset Management, a joint venture between ING Group NV and Korea's Kookmin Bank, formed a US$1.2 billion infrastructure fund of funds with a consortium of 17 domestic pension funds and insurance company investors;
- Carlyle Group and Riverstone Holdings closed a US$685 million Renewable Energy Infrastructure Fund;
- GE and Credit Suisse announced that they will each invest US$500 million in a new global fund to invest in power plants, pipelines, airports, railroads and toll roads;
- JPMorgan Asset Management has announced establishment of an infrastructure group to complement its real estate group;
- Morgan Stanley announced plans for a multi-million English Pounds Sterling infrastructure fund;

A number of factors explain the institutional investors' strong interest in infrastructure assets. First is the financial appeal: these investments typically yield returns in the range of 10 to 35 per cent. One of the early institutions to invest in infrastructure – Macquarie Bank – has achieved a rate of return of 19.4 per cent over 11 years on a growing pool of capital that now includes many billions of dollars of infrastructure investments under Macquarie's management. Macquarie's early successes may be one reason why other funds are jumping onto the infrastructure bandwagon.

Second, particularly for long-term investors such as pension funds, infrastructure investments represent an attractive source of very long-term returns which, to date, have demonstrated stability over time not related to the more volatile swings of the share markets and other investment classes.

Third, for many institutional investors the categories of investments which they are permitted to make or which these choose to make has been expanding. In the developing markets, Korean banks and Indian insurance companies, for example, are being permitted by their regulators to make modest infrastructure investments which, in the aggregate, are proving a substantial new sources of infrastructure finance. For other institutional investors, a restrictive definition of what actually constitutes permissible 'real estate' investments has slowly been widening. As the definition of 'real estate' as an investment category has broadened to also include 'other real estate-related assets', it has become possible for pension fund trustees to allocate part of the portion of their asset base that they have traditionally reserved for real estate investments (typically 7 to 15 per cent of assets) into infrastructure assets.

As project finance continues to mature as a distinctive branch of finance, it will offer increasingly adapted models and procedures for mobilizing debt and equity for major infrastrucutre initiatives

Fourth, there is a glut of capital looking for returns in real estate and real estate related activities and yet there are limited investment opportunities at valuations which are considered attractive.

In addition to these four factors, the rise of infrastructure funds comes at the convergence of several other key reinforcing trends that further buttress the infrastructure privatization paradigm:

- Demographers project more than one billion new inhabitants of our planet over the next decade; the infrastructure needed to meet their basic needs has been estimated to cost in the range of US$8 to US$30 trillion;
- Developed countries face a similar, multi-trillion dollar backlog of deferred maintenance and upgrading for their public infrastructure;
- Infrastructure assets are inversely correlated to the historical returns of most other investment categories and thus they are increasingly being recognized as an ideal vehicle for the diversification of risk;
- The long-term lifecycle of infrastructure assets closely matches the long-term investment periods that some investors, such as pension fund managers, seek for their portfolios;
- With the counsel of the multilateral development agencies, many countries have passed laws allowing international ownership of public infrastructure, which, just 20 years ago was uncommon throughout most of the world;
- As project finance continues to mature as a distinctive branch of finance, it will offer increasingly adapted models and procedures for mobilizing debt and equity for major infrastructure initiatives;

## Lest we forget: the lessons of the 1990s

As seductive as infrastructure privatization and investment may be, problems remain. We have only to go back as far as the 1990s to remember the catastrophic crash of the first boom of private infrastructure projects in the developing world – with many projects being renegotiated at a loss for investors or even abandoned.

Some of this was due to 'macroeconomic shocks' that hit certain regions of the world, such as the Asian financial crisis of 1997, the Russian financial crisis of 1998, and the Argentine peso crisis of 2002 – which caused the 1990s push for private infrastructure projects to come crashing down. But many failures have been unrelated to these macroeconomic shocks, occurring in countries not experiencing similar economic calamities. Indeed, by one recent estimate, more than 40 per cent of the contracts for private infrastructure projects, excluding those in the telecommunications sector, have been or are being renegotiated.

More than 40 per cent of the contracts for private infrastructure projects have been or are being renegotiated

The General Counsels' Roundtable at Stanford University – co-chaired by Professor Thomas C. Heller of the Stanford Law School and Barry Metzger, a senior partner at Baker & McKenzie – has been focused on analyzing and drawing lessons from the significant pattern of legal or contractual failure relating to private infrastructure projects, primarily in the developing world.

The Roundtable has grappled with the fact that despite carefully-negotiated and varied contractual guarantees and protections, approximately half of all long term infrastructure investment contracts ended up being renegotiated, with significant changes to the economics of the original contractual arrangements. Examples of renegotiations where initial equity investors have taken major 'haircuts' include a string of power plants in Indonesia, the Dhabol power plant in India, and the Dulles Greenway in the U.S.

Clearly, despite all the enthusiasm relating to private sector investment in important infrastructure projects throughout the world, there is a troubling pattern of failure and renegotiation that could chill such investment in the future.

Evidence from the Roundtable suggests that the carefully crafted contractual terms for such projects were not adequate deterrents to failure, subsequent renegotiation, or default. As one participant in the Roundtable noted, "the legal paradigm has not fared well in terms of providing the underlying basis of predictability that has come to be the central element of insuring the project economics."

## Problems Leading to Legal-Contractual Breakdown

What are the problems that have led to such pervasive legal-contractual breakdowns?

First, long-term infrastructure investment agreements are incomplete contracts that do not deal particularly well with the problems of uncertainty and changed circumstances; thus, they tend to be inherently brittle. It is almost inevitable that, over the 20 to 30 year period of a major infrastructure project, there will be unanticipated changes in the broader socio-economic-political environment that may destabilize the project.

Second, allocating risks on the principle of "having them handled by the party most able to bear them" has not always proven a formula for success. For many projects initiated during the 1990s, the bargained-for allocation of such risks proved unsustainable commercially, politically and legally, notwithstanding sophisticated risk analysis and risk allocation. When the risk crystallized into liability, the party to whom the risk was allocated (often the host government) proved financially incapable of meeting its obligations.

In many cases, there has been inadequate appreciation by project sponsors and lenders of the strength of the opposition to projects among civil society and interest groups; particularly when privatization means that prices for services will rise beyond traditional government-subsidized levels and maintenance staff will face lay offs in order to increase operational efficiency.

Legal-contractual arrangements have proven ineffectual in the face of multi-country political-turmoil and macro-economic shock

Finally, while projects are designed on a one-on-one basis, failures often tend to be much more structural and to occur in bunched clusters. Legal-contractual arrangements have proven ineffectual in the face of multi-country political-turmoil and macro-economic shock, such as the Asian and Argentine financial crises.

## Re-engineering the legal-contractual model for International Infrastructure Investment

While many factors point to acceleration in private sector infrastructure investment, the failures of the 1990s provide a stark reminder that many problems remain unresolved and that legal tools – including elaborate contracts, offshore arbitration requirements, and insurance provisions – are not always adequate to protect investors' property rights.

Investors need to be wary not to get caught up in yet another wave of over-exuberance like the one that played out in the 1990s. The General Counsels' Roundtable – and other groups like it – need to continue to do work to resolve these problems.

For private investors to achieve above average returns in this sector, fund managers will need to get beyond the current paradigm that risks are to be identified ex-ante and managed entirely through contracts. Instead they will need to engage in more active strategic management to monitor technical risks and shape social and political expectations that continuously fluctuate over the lifecycle of a long-lived infrastructure asset.

In addition, private investors will likely fare better if they engage in joint-venture style relationships with host governments, with real profit-sharing and co-alignment of financial interests, and with governance by a board of directors composed both of government and private sector participants, to promote greater information sharing, trust and co-adaptation.

Finally, host governments will also need to make improvements if they ever hope to achieve the promises of privatization. In particular, they need to develop new educational programs and incentive systems to foster sound public management practices in order to achieve accountability and transparency in the way that contracts are awarded, and in the way that private owners and operators are monitored. This should help to minimize ever-destabilizing possibilities for allegations of corruption.

***Ryan Orr, Executive Director of the Collaboratory for Research on Global Projects, Stanford University***