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P3s and the $90 Trillion Infrastructure Need.

As global populations migrate towards cities, the need for new infrastructure has become more urgent. Oil and commodity producing countries, such as Brazil, Colombia and Peru, as well as Gulf Cooperation Council countries like Dubai, Qatar and Saudi Arabia are looking to build new roads, railways, ports, water, and power facilities as part of broader strategies for driving economic growth in non-oil sectors. At the same time, US President Donald Trump swept to power promising to spend $1 trillion on new bridges, roads, tunnels, sewers, water systems and dams to stimulate economic growth and employment — and rejuvenate creaking infrastructure.

According to the McKinsey Global Institute, from 2015 to 2030, global demand for new infrastructure could amount to more than $90 trillion. But who is going to fund these new projects? Low oil prices have left the aforementioned Latin American and GCC countries with depleted government coffers. And the US Congress is unlikely to support the hefty increases in federal spending required to fully fund President Trump's ambitious infrastructure plans. This can already be seen with talk of federal funding cuts for mass transit projects in Silicon Valley and the new Hudson River tunnel.

The Trump administration also proposes scrapping the federal Department of Housing and Urban Development's Community Development Block Grant program, which many cities and towns across America rely on to fund housing, education and other public infrastructure. This creates a funding gap that must be addressed.

McKinsey estimates that $7.7 trillion will need to be found annually for the next 15 years to pay for additional global infrastructure needs. With the public sector unable or unwilling to shoulder total financial responsibility for all of this much-needed infrastructure investment, due to budgetary constraints and other considerations, some of the financial risk and burden is likely to shift to the private sector.

A recent study by the Brookings Institution in the U.S. found that Public-Private Partnerships (P3s) are "integral to the overall capital investment and infrastructure strategy of the nation." However, P3s are still a relatively small component of overall infrastructure investment, and are not as well established as other forms of infrastructure development.

Most public infrastructure in the US is financed either in the form of government appropriation — which does not include a mark-up for risk in the case of a default or cost overrun — or municipal bonds, which offer low rates of interest and are subsidized through tax exemptions. According to the Brookings Institution, from 1985 to 2011, there were just 377 P3s in the US, which constituted a mere 9% of total infrastructure P3 nominal costs around the world.

P3s, wherein private investors finance and build public infrastructure in exchange for a relatively decent inflation-linked return on their investment, are gaining in popularity. Greater private-sector investment in public roads, bridges and railways — among other projects — is likely to be welcomed by lenders and/or the financial markets. Private investors have more to lose if a project fails or goes over budget, as they have more "skin in the game." They often bring greater cost discipline to a project than the public sector and are less inclined to invest in “pet projects” that curry favor with the voting public and require a disciplined approach during construction.

Other benefits of P3s include: committed financing during the construction period — and frequently during the bid phase of projects; the inclusion of experienced Project Finance banks, who will carefully consider the feasibility of a project and help develop a financing structure that works. This is in addition to providing financing for such projects using their balance sheets and via capital markets. Private investors can also help when it comes to dealing with construction, regulatory issues and managing the entire group of lenders to a project.

In general, private investment can bring greater investment rigor and scrutiny to infrastructure projects. Depending on how the partnership is structured, the private sector takes on part or all of the commercial/market risk of a project. However, that does not mean that the government loses control or ownership over the project and its assets. But in contrast to many tax-exempted financing structures, it protects the users from unexpected toll increases, as the rate mechanism is typically inflation indexed for P3s, whereas tax-exempted transactions have a rate covenant, which can force a substantial increase in tolls when needed. At the same time, private investment generates taxable income, whereas the municipal market offers tax subsidies.

The commonly-held assumption is that infrastructure projects with a high level of financial involvement from governments are more likely to appeal to private investors. While this helps mitigate demand risk (i.e. revenue risk) and development risk, it can also create political and regulatory risk. Investors may, in fact, prefer to invest in projects that are less regulated, or where government involvement is not overbearing.

However, there still needs to be a determination that the private sector can build the project and run it at a lower all-in long-term cost than the state could, or at least deliver the project faster than a Public procurement. Private investors may have more “skin in the game” (equity risk), which is a strong incentive, but that doesn’t guarantee high quality, efficient infrastructure development that benefits the public.

Governments should not assume that P3s will save the public money without proper structuring. After all, private investors are in it to make a profit. And although average cost overruns for P3 schemes are below that of “traditionally procured” projects, to help mitigate against any unanticipated delays, events, cost overruns or unplanned risks, a clear contractual framework with the appropriate protocols needs to be put in place before a project begins.

The Bond Buyer Commentary

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