Fillip or flop?

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The government of the Philippines stole a march on its regional neighbours in November 2010 with a groundbreaking PPP programme; the most ambitious yet unveiled in South East Asia. President Benigno Aquino identified more than 50 projects to be potentially privately financed, in a bid to relieve the states weighty debt burden and deliver infrastructure investment.

The project list was as varied as it was broad, covering transport, health, education and infrastructure. Details, for the most part, were sketchy but proposals included: a new port in Cebu; a new railway in Mindanao; the R-7 expressway; a programme of primary and secondary school PPPs; the Philippine orthopedic centre; and the Kaliwa Low dam project.

Out of the scores of projects though, just 10 transport schemes were earmarked as priorities for the first phase of the programme. This restrained launch has attracted plaudits. Harvey Weaver, a projects partner at Ashurst, says there appears to be a great political will to develop PPPs and that the government has taken a sensible approach to rolling out the programme.

The government has not started with some grandiose pie-in-the-sky plan but has identified some decent, reasonably-sized projects that could be procured and financed quite realistically, he remarks. Many of the projects, of course, were not new ideas. Most have been in the planning stages for years but were intended as traditional build-operate-transfer (BOT) arrangements to be financed by the state.

A lot of the projects were initially structured to be financed as official development assistance but the new administration wanted to broaden private sector involvement so shifted the model to a PPP, suggests Sol Castro, managing director of transaction advisory firm CFP. As such, the authorities were faced with the task of repackaging the projects into the new structure, which is not that simple, as the transactions were designed to be publicly financed and did not have the necessary government approvals.

Aquino needed to change the law. He implemented executive order 8 in September 2010, which amended the existing legislation to allow private capital to fund infrastructure projects. The order also ditched the old BOT centre, which was the government body overseeing infrastructure projects, and replaced it with the PPP centre, which was part of the countrys central planning unit, known as the National Economic Development Authority (NEDC).

In addition, the government pledged to provide co-financing for up to 50% of the value of any PPPs (either through direct loans or multilateral investment) while projects worth more than Ps1 billion ($23.5 million) would be eligible for some tax relief.

Banks too were given lending powers for infrastructure. The previous rules said that a bank could not lend a single borrower more than 25% of that borrowers net worth, referred to as the single borrowers limit (SBL). The government established a separate SBL facility (also for 25% of a companys equity) specifically for PPP projects.

Philippine market giants such as San Miguel Corporation and Metro Pacific Investments Corporation have, due to their aggressive extension policies, high funding requirements and might reach their SBL with individual banks shortly, explains Martina Dampf at Singapore-based infrastructure investor Plektics.

Under the new regime, any project debt can be classed under a separate SBL. The move has been welcomed as a way to diversify local companies investment profiles and encourage them to borrow for PPPs. As many of the potential sponsors [of PPPs] are well-established names and already with lines with local banks, the separate SBL for PPP will help us finance the projects, remarks Ed Francisco, president of BDO Capital.

Implementation limitations

The reforms have gone some way to encourage investment but are still short of enticing major international interest. Doubts remains as to whether the government can attract foreign entrants to local PPPs, or whether the market will become the preserve of domestic players. The Philippines constitutionally caps foreign ownership of any company deemed to be a public utility at 40%. While there is no clear definition of the term, toll roads and airports currently usually fall under the category.

Large-scale investors would naturally expect not to be reduced to a 40% restriction and this topic has been an issue in the past for international investors, says Dampf. The head of the PPP Centre, when asked about potential changes to the foreign ownership restriction replied that no changes are currently foreseen. This rule could change when new competition legislation is introduced (possibly by 2013) but, at present, international investors are limited to minority stakes with the few leading local players that could deliver PPPs.

There are only a handful of companies that are Philippine-owned that have the financial and technical resources to participate in large PPP projects, says Pearl Liu, a partner at Quisumbing Torres. The participation of foreign companies therefore increases the chances for a successful implementation of a PPP project. In our experience, the 40% foreign equity restriction is a roadblock for foreign investors.

The Philippines has a spotty infrastructure track record. Political interference led to lengthy debates over toll rates for the South Luzon Expressway contract, which was awarded to Malaysian sponsor MTD Capital, for instance. The most notorious example, however, is the third terminal at Ninoy Aquino International Airport (NAIA), which was awarded to local concession company Piatco, in which German giant Fraport held 30%.

The BOT contract was cancelled in 2002 and ruled void by the supreme court the following year. The intervening years have seen many (on-going) court battles, as the sponsors attempt to claw back compensation for the contested decision. Dampf claims the latest ruling only offered the concessionaire a fraction of what it was seeking in compensation. The unfortunate proceedings have been followed by international commercial banks even more closely and caused additional reluctance for investment, she says.

In the wider context, the Philippines is also trying to shake off a reputation for corruption and bureaucratic inefficiencies. The process of changing the country is a gradual one but the administration is moving towards more political transparency.

The government recognises the need to improve the systems and capacity for preparing bankable PPPs, said Neeraj Jain, country director for the Asian Development Bank (ADB) in the Philippines, earlier this year. An unpredictable policy environment, right of way land acquisition issues, financing gaps and a lack of clarity regarding government support have all undermined the development of PPPs.

Aquino pledged that the government would provide investors with protection against regulatory risk in order to develop infrastructure projects that would be funded by the user fees. Part of this was to avoid such complications, although he stressed that commercial and market risk will be borne by investors.

Some believe that such political and regulatory hurdles are one of the key challenges in delivering PPP. At present, many infrastructure sectors are regulated by bodies that are not fully independent of government and not equipped to regulate the private sector effectively, which means pressure (or worse, corruption) can affect projects. A good example is the reforms in the power sector, which went through a similar process, Castro states. This was achieved through contractual progression and industry restructuring, which saw the regulator become totally independent, serve fixed terms and any appeals going to the supreme court rather than the president.

Peso source

While the limit on foreign ownership and political problems have dulled international interest, the local sponsors and banks are poised to benefit. Indeed, while a large number of international banks attended the launch of the PPP programme, which showed their interest, most of the announced projects are very localised and of a size that local institutions can digest without international input.

There is a feeling that many of the current PPP projects are of such a size and regional nature that it will be local sponsors and banks rather than international players that are keen on these deals, Ashursts Weaver adds. International involvement involvement is likely to come in the larger, more complex transport deals or where there is a need for particular international expertise that the local players dont possess at present.

Multilaterals are, instead, likely to be more heavily involved in the early stages of PPP. The Asian Development Bank and World Bank have both said they will support the push while governments, including Australia, Canada and the UK, have provided grants to support the PPP centre. The multilateral banks will play a critical role, Castro states. Firstly, they will provide technical assistance for the PPP centre and other government agencies to develop and implement the programme. Secondly, the government understands that the PPPs will not be commercially viable without some type of support such as guarantees and co-financing. The natural port of call for this will be the likes of the IFC, the World Bank and the ADB.

As seen in the NAIA Terminal 3 controversy, multilaterals can also provide more stability for commercial lenders and negate some of the risk in such investments. Without involvement of multilaterals and the relative security such involvement provides, international commercial banks will likely still be hesitant at the moment, Dampf continues.

Questions remain as to whether the Philippines actually needs international commercial banks. Most of the smaller PPP deals will inevitably be financed in pesos, which favours local banks. Since revenues will be in pesos, peso-denominated loans are now readily available from the strong local players so foreign banks will find it hard to provide competitive terms and mitigate currency risk. Even historic deals, like the North Luzon Expressway (NLEX), were financed initially in US dollars but refinanced in both dollars and pesos.

The local players led by Banco de Oro (BDO), Bank of the Philippine Islands and Metrobank have been vocal in their support of PPPs and enjoy strong liquidity too. They are comfortable with debt/equity ratios of 60-70% and familiar with non-recourse facilities for similar schemes (such as the Tarlac-Pangasinan-La Union toll expressway project, which closed earlier this year with a P11.5-billion term loan facility led by BDO, the Development Bank of the Philippines and Land Bank of the Philippines).

Non-recourse lending in the Philippines is in line with many comparable markets in terms of financing. Long-term tenors tend to run between 12-15 years but existing power plants have secured debt of 20 years or more. While pricing is in line with places like Thailand, as yet no PPP deals have closed, so there is no benchmark in terms of pricing the projects.

Confidence boost?

Progress in PPP execution has been halting. Five of the PPPs were due to enter bidding this year: the Daang Hari-South Luzon Expressway link, Metro Rail Transit (MRT) Line 3, the Light Railway Transit (LRT) Line 1, the second phase of the NAIA Expressway and the connector road for the North Luzon Expressway-South Luzon Expressway.

Political will, it seems, has not been enough to push the deals through. If anything, the government may have been a bit too quick off the mark, as was suggested by the delayed tender for the biggest scheme, the LRT/MRT project, for a 12km extension to the LRT Line 1 system southward to Bacoor and joining the line with MRT 3.

Early indications were positive; sources claimed that over 40 companies expressed interest with eight bids (including foreign firms Mitsubishi Corporation, CAF SA Construcciones Y Auxiliar de Ferrocarriles SA Padilla, Marubeni Corp, Sumitomo, Serco and Finmeccanica) poised to enter the tender in July. The process was postponed, however, to allow the potential investors more time to study the details of the project. The tender was pushed back to at least October with the market now waiting to see if appetite has waned.

Two of the five other 2011 schemes the NAIA Expressway and the North Luzon Expressway-South Luzon Expressway also look set to slip into 2012. The most advanced PPP is the Daang Hari-South Luzon Expressway link. Pre-qualification launched in July and bids were due in by 19 September, but the future is harder to predict.

It looks like only four or five PPPs will even make it to the prequalification stage by the end of 2011, Castro warns. The contracts will probably not be awarded for another six months with a further six months at least to work on the financing. As such, I am not expecting any PPPs to close until late 2012 or early 2013.

To compound matters, the PPPs are facing a time limit too in relation to SBL. It is to be noted that the change to the SBL is only valid for a three-year period, thus it is no long-term solution to secure financing and/or help conglomerates with their capital requirements, Dampf says. However, it will in the short term greatly help domestic conglomerates to be competitive. Francisco adds that while the SBL deadline is rather tight the bank can live with it. He continues: Hopefully the government will extend the SBL, given the delayed rollout [of projects].

The summer saw other stumbling blocks. The NEDC bemoaned a shortage of PPP experts (it launched a recruitment drive in September) and the chief of the PPP centre, Philamer Torio, quit in late summer, with deputy executive director Cosette Canilao temporarily taking charge. Such factors have prompted some observers, search as advisory firm Forensic Solutions, headed by ex-justice secretary Alberto Agra, to publically ask the government to review scores of risks potentially affecting the sector, including corruption, feasibility studies, tax, foreign exchange and succession risks.

It is good to have a pipeline of projects but in the short term the country needs to get one or two deals financed, or else there is a danger the PPP programme will lose momentum, Weaver concludes. As a result the deals will need to be sensibly structured to make sure the risk transfer to the sponsors and lenders is realistic. If not, potential investors will be deterred and will look to invest elsewhere in the expanding Asian infrastructure market.

Optimism is still healthy for the long-term outlook, though. I believe all the projects will still succeed when they eventually launch, Francisco says. But for 2011, the only project that might still be doable is Daang Hari.

Only when some PPPs are closed, debt is in place and the tenors and pricing are established, will the market know if the programme is a new beginning for the Philippines infrastructure market. Failure to deliver on the ambitious plan will only add a further disappointing entry into the countrys troubled infrastructure history.