PSP Policy Note # 1

An Overview of Private Sector Participation in Infrastructure

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The initial stage in the evolutionary process of infrastructure development in most developing countries is usually characterized by full government ownership of entities engaged in the provision of services such as water, telecommunications, power, and transport. Because most of these services have cost structures which inherently make them natural monopolies, the provision of these services has usually been subject to inefficiencies. Worse, because these services are usually viewed as entitlements necessary for survival, governments have intervened in their markets from time to time, subjecting them to moderate to severe price distortions, and unrationed public access, with such conditions persisting for long periods of time. Unfortunately, postponing compensating adjustments in the pricing or rationing of these services to avoid political and popular upheaval has usually come at the expense of state-run utilities and firms. Eventually, the financial strains these conditions create in public utilities turn into full-blown and/or growing fiscal time bombs. When uncompetitive conditions are allowed to persist for long periods of time, the cost to the present and future generation(s) of potentially bailing out the ailing firms constitutes a significant overhang on the national government, which may eventually have to be passed onto taxpayers anyway, and may even undermine efforts at genuine sectoral reform.

Countries wishing to avoid the increasing fiscal strain of continued public sector provision of infrastructure services are increasingly turning to several modes of privatization in order to pass on the challenges of infrastructure service provision to parties in better positions to assume the risks involved. These modalities range from greenfield structures, as in most build-operate-transfer (BOT)-type projects, joint public-private ventures, and concession-type structures. These structures represent varying degrees of private sector participation (PSP) in the provision of infrastructure services.

Aside from the desire to cut actual and potential fiscal costs (and actual and future political and social upheavals), encouraging private sector participation in infrastructure development has been driven in other countries by rapid economic growth, sometimes outpacing the government's capability to provide services exclusively and efficiently (such as in Asia). Bureaucratic systems and inefficient structures are increasingly being phased out in favor of private operation, ownership or both, which is perceived to be more efficient.

Private sector participation in infrastructure projects can be defined as modalities by which private institutions, such as project developers, contractors, creditors and others, are involved in the provision of infrastructure services. In the Philippines, private sector involvement in infrastructure has been motivated primarily by insufficient technical and financial capacity within the government to develop or upgrade infrastructure facilities that deliver essential

services, such as water, power, transportation, etc. to address needs of a growing economy. In some cases, the lack of government capacity has been manifested in the past in acute shortages of infrastructure services (as in the Philippine power crisis – the absence of supply). In other cases, the manifestation has come in the form of inefficiency in service delivery and inability to upgrade and improve existing facilities (as in the case of Metropolitan Waterworks and Sewerage System, MWSS). The unfortunate consequence is that infrastructure supply falls short of infrastructure demand. Two things can happen: existing infrastructure facilities, such as roads and trains, grow increasingly congested and this chokes off potential growth (and hastens the deterioration of the existing facility) or demand is not satisfied at all.

The opportunity costs of failing to address a country's infrastructure requirements are potentially large. It is well-known that infrastructure services create significant spillover effects for economic growth (as domestic industries utilize roads, water, power and other public services as inputs into production). Problems in the delivery of such services mean that the country does not fully reap the benefits from these spillovers. In quantitative terms, the benefits of well-functioning infrastructure services are potentially large. Real and social benefits may come in the form of improved health (for more potable water), increased productivity due to lower traffic congestion and electrification, and lower transportation costs. If the private sector is in fact superior to government in project development, and if the fiscal costs of PSP are outweighed by its benefits, then the country should be supportive of PSP.

The ratification of the Build-Operate-Transfer (BOT) Law, as well as the power crisis in the early 1990s appears to have hastened the proliferation of PSP in the Philippines. The BOT Law provided the government with a legal platform with which to hasten investments in the building of power plants to alleviate the crisis. The law attempts to address an important prerequisite for a stable investment environment – a legislated set of rules to govern specific investments. By attempting to standardize several aspects of the investment process and identifying levels of authority in the approvals process, the law reduces uncertainty in the project development cycle.

Notwithstanding the benefits of the BOT Law in enhancing certainty in the investment climate, several areas of uncertainty and concern remain in the area of PSP in the Philippines. These include:

a) Understanding the trends in BOT investment. Which events triggered significant trend shifts? Where these shifts caused by factors within the control of government? Where the shifts more consistent with changes in the macroeconomic environment? In other words, there needs to be an understanding of the extent to which changes in the PSP policy environment actually induces trend shifts.

b) What have been the most important lessons learned thus far in the BOT experience?

c) the absence of a unified framework with which to evaluate the costs and benefits of all forms of government support for projects with PSP

d) the lack of an analysis and appraisal of the ex post performance of existing PSP projects (versus ex ante expectations) – how have PSP transport projects (such as rail and toll road projects) actually reduced traffic congestion and/or lowered transportation costs? How have PSP water projects actually contributed to improved sanitation or health? Have PSP projects contributed to poverty reduction? How? There will be stronger incentives for advocacy if appraisal of existing BOT projects suggests the benefits meet or exceed expectations and net benefits exceed zero. (This would address the need to measure the costs of projects not undertaken, as cited in a previous policy brief). The above exercise would also be potentially useful as a guide to the Department of Finance in estimating the value of a government guarantee and other incentives, as the ex post benefits of PSP projects can be estimated. This can be compared against the fiscal costs of government support. This can also be compared against the benefits of government pursuing a particular project by itself (i.e., not resorting to PSP in a project).

e) In the absence of estimates on the actual benefits of PSP projects, some of the most important analysis will be addressing counterfactuals:

    - would the government have done better by doing a particular project itself?
    - would infrastructure investments have flowed without government guarantees and other forms of support?

f) If the benefits of PSP from above exceed ex ante expectations, why? If not, why not? What amendments to the BOT Law improve actual project performance?

g) PSP projects that fall outside the coverage of the BOT Law, such as joint ventures.

h) Modifying the BOT Law to address concerns of local government units (LGUs) and sectoral concerns.

i) Creating opportunities for PSP to mobilize domestic capital.

j) Given the current structure of the BOT Law and the roles played by other stakeholders in the project development cycle, what type of incentives face project developers who apply for projects (both solicited and unsolicited)?

In the absence of concrete answers to the above questions, improving stakeholders' appreciation of PSP in infrastructure starts with an introduction to the project development cycle. That will be the subject of the next policy brief.