TAB O

12. "Financing Privatization" by Rex E. Pingle

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FINANCING PRIVATIZATION

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It is a pleasure to be here with you today, and to have an opportunity to discuss with you ways of financing privatization. During the next half hour, I'll give some examples of techniques being used by Governments in many countries, to pay for the ever expanding need for public infrastructure and services. We'll spend a few minutes discussing how these ideas can be implemented, and the requirements for a successful municipal financing program.

However, first I'd like to explain who I am, and why I am here. I work for a company called Lazard Freres & Co., New York. Lazard, as many of you know, is an "Investment Banking" company in the United States. We raise capital for companies, and Governments to meet their investment needs.

In the area of municipal finance, we are one of the largest advisors to municipalities and Government Agencies in the United States. We offer advice and raise funds for several cities, including Washington, D.C., as well as for Agencies in public power, water, sewage and transportation. In the U.S. Government's sale of Conrail, we represent the U.S. Congress. Internationally, we advise Governments, Government Agencies or State Enterprises in two dozen countries. Most of our clients are discussing ways of "privatizing" existing assets, or ways of financing new infrastructure without relying on Government investment. Another dozen countries currently are in discussion with us on how we can assist them in similiar ways, to reduce capital expenditure budgets, to finance from private sources, to reduce Government involvement in existing or future projects and programs.

We have confidence that these ideas and techniques can be applied virtually anywhere, to reduce the financial needs of the public sector. This can be done whether or not a Government has chosen to support a program of "privatization". Even when a Government intends to continue public sector ownership, certain of these programs can be structured to lower financial constraints, to improve management and efficiency, and to reduce cost of services delivered.

In the United States, Municipalities and Government Agencies are legally permitted to raise money separately from the national Government. Two major revenue sources are used to finance infrastructure and services: 1) The first is taxation. This can be general taxation, through an income or sales tax, or specific taxation, such as property or sewer taxes. For example, in most American cities, real estate taxes pay for public education.

The second major revenue source is fees charged to users of a particular service. Examples include charges for water, bus or subway fares, bridge and tunnel tolls, airport landing fees, and real estate development lease rights over public transport facilities.

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The first category of revenues, taxation, is used by a Municipality under its general revenue authority. The second category, specific fees, often can be allocated or placed under the control of separate agencies. These agencies are given the independent authority to raise money, construct projects, and collect fees to repay debt, separate and distinct from the municipality.

In the United States, a major area of public sector investment in infrastructure is in municipal services. Here we have many examples of private financing, and management of these services. Water, sewer and waste recovery facilities are financed regularly through bond issues secured by a revenue stream based on user fees.

In the New York City Region, we have the Port Authority of New York and New Jersey, which owns John F. Kennedy Airport, LaGuardia Airport and Newark Airport, as well as the George Washington Bridge, several shipping terminals, and the World Trade Center - a major real estate complex. The Triborough Bridge and Tunnel Authority owns the Triborough Bridge, the Verranzano Narrows Bridge, the Queens-Midtown Tunnel and other facilities. The Metropolitan Transit Authority runs the subway and bus systems. The New Jersey Turnpike, and the New York State Thruway, each have their own independent Authority to borrow money and to build projects.

These techniques can be implemented anywhere a capital market exists. Until recently, this has limited the potential for such financial structures to North America, parts of Europe and Japan. However, through the work of international organizations like IFC, and we like to think partially through efforts of companies like ourselves, capital markets are growing in many developing countries.

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As just on example, let me describe what is happening in Turkey, a country where many exciting developments are taking place.

In Turkey, where a true capital market is beginning to develop, major accomplishments leading to the development of the capital market since the election of Prime Minister Ozal, include the issuance of Government Treasury bills at auction; the successful issuance of revenue participation certificates for the Bosporus Bridge, and the Keban Dam, among others; and the legislation providing for stock brokerage firms and leasing companies.

These developments have come quickly. Change will continue at a rapid pace. As inflation declines - as people are given a wider range of investment alternatives, as people develop more confidence in the growth that has taken place in Turkey since 1981, the capital markets will broaden, and deepen, and will offer increasing opportunities for the raising of funds by Municipalities and other Public Borrowing Agencies.

Let me describe a few activities involving Turkey's capital market that we're doing right now, which may surprise you. First, we are working on the privatization of Turkish Airlines, and are well along in planning a sale of stock to employees and to the Turkish public. The Prime Minsiter first mentioned this in a press conference in September. We are confident of the success of this sale, because of the attractiveness of the issue. A good sign of this is the positive responses we've had internationally in our preliminary review leading up to an issue. We expect when the issue is sold, in Turkey, it will have a major effect on the Turkish securities markets.

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Second we are working on financing of power plants to be built using the Prime Minister's build-own-operate concept. A private investor group has committed $250 million of equity and we are raising $850 million of debt. The only Government support is a long-term contract to purchase electricity. We are reserving ten percent of the equity for sale to the Turkish public. Because of the structure and attractiveness of the project, we have confidence in the prospects for sale. I should mention that we are in discussion with Governments in six countries, who have approached us about implementing a simiiliar scheme. In half of these cases, the countries have a philosophical bias against private ownership of power generation. However, the ability to improve implementation while reducing Government expenditure makes a compelling agreement that overcomes other prejudices.

One year ago, bonds were sold secured by the revenue from the Bosphorus Bridge. No one believed Bridge Bonds could be sold. At that time we estimated over a period of years, revenue could be raised sufficient to finance a large portion of the second bridge over the Bosphorus. One Municipal Bond expert in New York recently suggested that if the Bosphorus Bridge revenues were properly structured, under the control of an independent authority, with audited accounts, within a few years the Bosphorus Bridge Authority could be raising major amounts of money in the international capital markets, to support other infrastructure development.

The fact is, the situation for Turkey, in the domestic markets, and in the international markets is quickly changing. The techniques I'd like to describe will be available to you, the Municipalities, any in other countries, much sooner than you may believe. Now is the time to begin thinking of new alternatives to your traditional ways of financing infrastructure whose governments adopt a privatization strategy.

The traditional way of raising money, still used all too often in most countries, is simply - call the Treasury. Use political leverage. Negotiate for funding for local costs, and get a Treasury guarantee on foreign borrowing. Talk to contractors and vendors, get supplier credits, and apply that Treasury guarantee.

That method is both damaging, and unnecessary in many instances.

First, such a system hurts the country. Everyone complains about inflation. Yet every time funds are demanded from a national Treasury, it affects the public sector borrowing requirement, and raises the public sector deficit. We all should be working together to lower the deficit.

Second, it hurts the development of local infrastructure. Each municipality knows its priorities, and urgent local needs. If each can organize financing and project implementation largely or totally without financial support from a national Treasury, projects will start more quickly, and are more likely to proceed on schedule, and within budget.

Third, it raises costs, at least for financing. By requesting financing by suppliers, based on a guarantee, there is no incentive to reduce financing costs. Furthermore, you create a situation where several contractors or suppliers compete for funds for the same project against all other Turkish projects being financed from the same pool of money.

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Let's look at some of the new financing alternatives:

1. Good Planning

A portion of the national tax revenue or local revenue from general taxes can be allocated to fund local needs. The use of this revenue should be carefully planned for maximum benefit. In 1975 New York City almost went bankrupt because of bad planning, in spite of an enormous tax base. Lazard Freres & Co., put together a plan to refinance some $18,000,000,000 in debt, which kept the City solvent. More important, controls on spending and a careful planning process were put into place to maximize the use of the City revenues. Each Municipality should plan carefully, to obtain maximum benefit from the revenue allocated.

2. Charge Users

You can charge user fees on a wide range of services, to expand the revenue generation potential beyond the general tax base. Also, in this way, the immediate beneficiaries of services will help pay for their development.

3. Tap Local Markets

You can look at ways of tapping the developing capital markets. You may say no municipal finance market exists. I'd respond, a market takes supply and demand. I see the problem in most markets as one of lack of supply of issues from quality borrowers other than the national Treasury. Demand usually exists, but it takes a properly structured issue to tap that demand.

4. Finance Projects Based on Their Revenues

You can consider financing techniques beginning to be used in many countries such as project financing and leasing. I'll come back to this.

5. Support Joint Private/Public Development

You can consider joint public sector-private sector development. I understand an area of waterfront land in New York, Boston, Baltimore, and Istanbul has been developed with private capital. A few years ago in East Asia I was involved in a major port development done entirely with private money. Today, we are looking at a similiar structure for a major port financing in the Middle East. In the United States we are currently building a sewage disposal plant with private funds. The municipality guarantees an inflow of sewage, and pays a processing fee, which is sufficient to amortize debt and pay the owners a return on their investment.

Let us look at a few specific ideas for financing. Let us take public transportation as an example.

Let's face it. Urban transportation systems rarely pay for themselves totally out of transit fares. I keep hearing from the Municipalities, transportation can't be financed on a project basis. A Government debt guarantee is required.

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Perhaps this is true, but I don't think all of the alternatives have been explored. Here, I'm going to make everyone unhappy with me - suppliers, contractors, bankers, and Governments - because I'm going to advocate a range of ideas that will involve much more work in the short term. However, I can assure you of benefits in the long run.

You have done your studies, of route, capital costs, and passenger usage. You have estimated the optimum fare that can be charged. Fare revenue comes to 40 percent of the amount needed to pay for the project.

What other revenue can be used to support the cost of the system?

1. Rent Facilities

Besides the transit system itself, a major asset is the real estate and public facilities involved. In New York, advertising space on the sides of bus stops, and on buses, is sold. The bus stops themselves are often a concession granted to a private developer, who then sells ad space, giving a percentage of revenues to the Metropolitan Transit Authority (MTA). Thus MTA was saved the expense of building bus stops and earns revenue from the ads. Concessions for everything from restaurants to newsstands are leased at bus or subway stations. At J.F.K. Airport, the terminals themselves are leased to airlines. This lease or concession revenue adds to the cash flow used to finance facilities.

2. Develop Real Estate

A second supplemental source of revenue is the real estate, itself. This is particularly important in subway development, where the development rights around major stations are extremely valuable. Also, air rights over tracks, where appropriate, have a value.

3. Enact Supplemental Taxation

A third source could be new taxes. Two types of taxes offer particular appeal. One requires the assistance of the Government. A tax on gasoline, for highway development has created a fine national highway system in the U.S. Such a tax also encourages gasoline savings in this era of energy conservation. But funds from such a tax should also be used to fund transportation alternatives. In urban areas, funds should be partially allocated to fund urban mass transit.

A second type of tax that I've always found appealing has been applied in Singapore. I know my friends at the World Bank have also done considerable analysis of that tax. It's a tax on cars entering the center city of Singapore. The tax is quite high, and is applied to all vehicles. Taxis buy a daily sticker, and charge the passengers who go to the Center. Corporations buy monthly stickers. Few individuals pay the price. The tax encourages use of public transportation. It reduces urban traffic congestion. The funds can be used to build a better urban public transport system.

4. Try New Financing Techniques

Where adequate leasing laws exist, take advantage of them to lower your capital requirements. 35 percent of all capital formation in the United States comes from equipment leasing. Such laws exist in many countries. In principle, these laws make it attractive for private companies and individuals to invest in equipment and rent it to the user. Governments should take advantage of this. In New York, many of the City buses are actually owned by another entity, and leased to the Metropolitan Transit Authority.

In the Islamic world, structuring across much of Africa and Asia, leasing not only provides certain incentives for capital investment, leasing can be structured to avoid interest, thus offering an investment that conforms to Islamic principles. The Islamic Banking Institutions offer a good source of funds, for properly structured investments. This can be done through a lease financing, where depositors actually own the equipment and share in the profits of renting the equipment to a Municipal Government. A range of equipment, from refuse trucks to transit equipment can be financed this way.

Presently we are offering some innovative techniques for the leasing of major projects, that has received attention, and interest from half a dozen Governments, again many of who are not trying to privatize but who are willing to allow private ownership when a compelling financial advantage, and reduced budgetary requirement is possible.

5. Offer Private Concessions

In Santiago, Chile, the bus system used to be awful. A few years ago, the City turned the buses over to private owners. Bus drivers now own their buses, and run their routes as a business. The City maintains quality standards, and in general sets routes. The routes have become concessions. Now buses are clean and run on time. The City of Santiago is spared the cost of buying buses and maintaining service.

These represent a few ideas on urban transit. We could go through a similiar list on virtually any infrastructure project you may wish to develop. That's the structural side. Let's spend a minute on the market side.

The entire key to raising money is confidence. Lenders need to be confident of being repaid their loans. The Investor must be confident that he receives a fair return on investment. The public must have confidence that bonds bought will have interest paid when due and bonds will be redeemed at maturity.

This confidence doesn't come easily or quickly. Yet the benefits are substantial. Countries and their Municipalities should be laying a base today, to tap domestic markets, with the intention of tapping international markets in a few years. If Governments today start conforming to accepted international standards for borrowers, the perception of investors will improve significantly within their respective countries. Once a track record is developed with those standards, borrowing on international markets can be done successfully.

No capital market has developed anywhere in the world without high standards of information and disclosure. The individual investor is conservative. He needs to be made confident that he knows the risks, that no risks are being hidden, that he understands the transaction completely. The international markets require such detail to assure the individual investor that he knows the nature and risks of his investment. Borrowers who are prepared to make the effort to set up an independent legal structure, audit accounts, and fully disclose information on the transaction will be rewarded by having a much greater range of financing offers, for more projects, at lower rates of interest. Governments that adopt international standards for borrowing now, will be accepted by the international capital markets sooner than those who delay because it's easier not to make the effort. In turn those Governments who make the effort will have significantly better financing options than those who don't. The Governments should prepare a solid base for future financing efforts.