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Concept Paper:

HG Amendment to the PPI Project Paper

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Prepared by

USAID/Sri Lanka

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HG AMENDMENT TO PPI PROJECT

I. EXECUTIVE SUMMARY

Infrastructure in Sri Lanka, especially urban environmental infrastructure, is outdated and deteriorating. To maintain economic growth and achieve development targets, this infrastructure must be upgraded yet the enormous costs inherent in such plans exceed the GOSL's and donor agency resources. The concept of public/private sector partnerships in BOO and BOT schemes has been embraced by the GOSL. BOO/BOT schemes are one method of financing urban environmental improvements that will benefit a broad range of beneficiaries, *especially families earning at or below the national median income*.

The Promotion of Private Infrastructure (PPI) Project was approved and signed in September 1992. It authorizes US$7,000,000 in grant funds over a four year period to assist the Government of Sri Lanka (GSL) to develop a market to attract private sector financing for safe water, sanitary waste disposal facilities, roads and transportation, power plants, telecommunications facilities, and industrial estates. The Project will finance technical assistance and training, and feasibility studies. The host country contributions are estimated to be $2.5 million.

The project was designed with four components:

(1) Private Infrastructure Network Component;

(2) Public Awareness Component;

(3) Marketing Component; and

(4) Private Sector Window Component.

The proposed Amendment to the PPI will approve the use of up to US$ 50 million in Housing Guaranty resources to further the objectives of Component 4.

Component 4 involves developing a system to finance urban environmental projects through the private sector. HG resources will be used to advance the timetable for creating a financial window to access and leverage private resources for infrastructure. HG resources will also demonstrate the viability of generating debt and equity financing in the local financial markets to provide funding for environmental infrastructure projects identified under the PPI Project. This finance system could benefit infrastructure projects in other sectors as well.

The HG loan will be used to promote appropriate policy change which will help expand local financial markets and increase access to external private finance for environmental infrastructure. They will also provide resources, through a Private Sector Infrastructure Development Fund (the "Fund"), needed to finance the early projects. The ceiling on fund support for any project will be 30% of total costs. The project developer will provide the remaining 70%, through his own equity contribution and from other financing arrangements, both local and foreign.

HG resources will be authorized when actions are taken to improve the environment for local private finance of infrastructure. Discussions will be held with the GSL on a series of measures and actions which would improve the environment for local private finance of infrastructure. Agreement will be reached on measures which would be most effective and feasible, which together with a timetable, will constitute the Policy Action Plan. An annual evaluation will be conducted to monitor progress. After authorization, approval to borrow HG resources will be based on verification of actual loan commitments issued by participating local lenders to elegible projects.

Grant resources from PPI will support the development of the Policy Action Plan and structure a private sector infrastructure finance window. Grant resources currently earmarked for the Mission's Private Sector Policy Support (PSPS) Project will be used for activities related to local financial markets development, a necessary complement to the PPI objectives.

II. JUSTIFICATION FOR AN AMENDMENT TO THE PPI PROJECT

The proposed HG component will assist the PPI project by helping to promote supportive GOSL policies with respect to private/public infrastructure, augment funding directed to critical needs in urban environmental infrastructure and provide technical assistance for the development of local long-term funding sources.

A. The Need for Urban Environmental Infrastructure

Sri Lanka's economic future is threatened by failing and outdated infrastructure. Inadequacies in the fields of transportation, communications, power and airport/port facilities are well documented and deserve attention if desireable rates of economic progress are to be achieved. Urban environmental infrastructure needs are no less important and may well deserve priority treatment in the rank order of projects. The well-being of Sri Lanka's population is at stake, especially its below-median income families.

This amendment provides resources specifically for urban environmental infrastructure. At this time there are no waste water treatment facilities serving any town or city in Sri Lanka. (Several small plants have been built by industry.) Water supply is inadequate; in some cities capacity needs to be increased by 40 percent or more. The quality of water is poor as well, causing water borne diseases affecting children in particular. Solid waste collection and disposal is a major and growing problem in every town and city.

Yet infrastructure projects are enormously expensive and the GSL lacks the financial resources and institutional capacity to undertake these projects to improve the standard of living of its people and still sustain economic development. Furthermore, donor assistance levels are not adequate to fund such projects. The HG resources will provide and leverage private sector investments from within and without Sri Lanka that are clearly needed.

The private sector (including foreign investors) has demonstrated interest in some BOO and BOT and other joint venture infrastructure projects. Additionally, the GSL has demonstrated its interest in and committment to private provision of infrastructure as well as its interest in HG funds. It has created the **Secretariat on Infrastructure Development and Investment (SIDI)** within the Ministry of Policy and Planning to identify and promote BOO/BOT projects in the following sectors: 1) telecommunications systems, networks and services; 2) water supply, distribution, sewerage and drainage ; 3) power generation, distribution and related services; 4) highways and expressways, including roads, bridges, tunnels, interchanges and other; 5) airports, terminals and related aviation facilities; 6) port development and infrastructure including terminals, piers handling, storage and other services; 7) environmental and solid waste management projects including composting plants, collection facilities, incinerators, landfill and other municipal services and facilities; 8) rail and non-rail based transportation systems and facilities; and 9) other urban and rural infrastructure that the GSL views as priorities to support economic development activities. Other joint venture options will also be investigated.

B. The Lack of Long-term Funds for Infrastructure

The Promotion of Private Infrastructure (PPI) Project will assist the GOSL in key areas of policy development, project identification, consumer education and investor marketing. The PPI will also facilitate local and international financial participation in the Project through the establishment of a **Private Sector Infrastructure Development Fund (Fund)**. However, the PPI Project does not now provide support to address a critical need of infrastructure projects, which is long term local financing. The HG program will provide long-term (8-10 years) credit to BOO/BOT and other public/private joint venture projects that will also access considerable amounts of private finance from external and local sources. Local financing avoids foreign exchange risk. The HG program will help develop these local sources of funding that are not yet present in Sri Lanka.

The local debt market is dominated by issues of short maturities, particularly government treasury bills. Institutional investors such as insurance companies and pension funds which have raised large pools of long term investment capital are essentially captive institutions for short-term government securities. The flat to inverted yield curve of longer-term interest rates inhibits the ability of development banks, though relatively well run, to mobilize long-term local currency for on-lending. No long-term government bonds are outstanding, and the corporate bond market, at least until recently, has been moribund.

Sri Lanka's financial institutions are relatively diverse, but have not yet supported urban environmental infrastructure. They are capable of providing private borrowers with at least short term working capital. A host of policy and institutional constraints have, here-to-fore, made longer term financing from local sources problematic. Some interest rates are controlled and the use of market based monetary instruments is limited. The development of Sri Lanka's financial institutions has also been impeded by serious debt recovery problems, insufficiently rigorous central bank supervision, and inadequate accounting and auditing. The Policy Action Plan will address these issues.

The two state owned banks, the Bank of Ceylon and the People's Bank, own more than 60% of the commercial bank assets, but are technically insolvent when internationally accepted provisioning for bad debts is taken. As advocated by the World Bank, these banks need to be restructured after appropriate provisioning and recapitalization is completed. In particular, the two state owned banks need to be commercialized to improve the competitive environment of the sector, and the Bank of Ceylon needs to be privatized.

Local pension funds and insurance companies have successfully raised large pools of long term capital. However, government policy currently requires this money to be invested in short term government securities.

The two development banks, The National Development Bank (NDB) and the Development Finance Corporation of Ceylon (DFCC), while relatively sound and well managed, have not mobilized long term local currency funds, relying instead on IBRD and ADB loans for on-lending.

Limited domestic savings and the underdeveloped state of its financial markets implies that Sri Lanka will require foreign capital to finance large infrastructure projects and cost recovery techniques to assure their sustainability. (See Annex A for description of recent capital market activities.)

Another significant problem in Sri Lanka is the relative cost of debt and equity finance. After allowing for inflation, the net-of-tax real cost of debt has often been negative. (The easy availability of debt and poor debt recovery legislation are additional factors favoring debt financing by firms.) Equity financing, on the other hand, can be quite expensive.

The Mission's Private Sector Policy Support (PSPS) Project proposes to respond to the challenge of developing the local financial markets by introducing medium term (3 to 5 year) debt instruments in the form of corporate bonds and government securities. These efforts will help establish an appropriate interest rate structure for longer term debt and demonstrate the viability of raising funds in the local financial markets. But they will not meet the needs of infrastructure projects which require terms of at least 8-10 years. Indeed, the Mission's country strategic vision includes the establishment of self-sustaining development components. To this end, with respect to the provision of infrastructure, the devlopment of a long-term financing system is paramount. The proposed HG component will assist in developing these long-term sources of funds for urban environmental infrastructure by promoting a framework, or process conducive to such activity.

III. DESCRIPTION OF THE CURRENT PPI PROJECT

A. Goal and Purposes

The proposed amendment will not change the PPI Project goal and purposes.

The *goal* of the PPI Project is to modernize economic infrastructure in five primary sectors: power, water supply and treatment, telecommunications, transportation, and waste management and disposal.

The PPI project *purpose* is to assist the GSL to develop a market for private financing and management of economically important infrastructure. The amendment will further this purpose by focusing on local private financing of infrastructure that benefits a broad range of families including those earning below the median income.

A *sub-purpose* of the PPI project is to encourage and support US trade and investment in Sri Lanka's infrastructure development activities.

The proposed HG loan goal will be to modernize urban environmental infrastructure in Sri Lanka to improve the well-being of all its people. The HG's purpose(s) will be consistent with the PPI's and other Mission objectives.

B. Expected Achievements

The following measures of sucess are anticipated:

* A private sector financing window (Fund) will be established with capitalization from GSL and/or the Fund manager.

* One or more local long term lenders will provide resources from perhaps a private placement debt security instrument (bond) at market rates of return to raise local currency funds for on-lending to private infrastructure projects, through a loan of its own resources or other source to the project.

* Takeout financing agreements will be signed between the Fund manager and at least three other local lenders.

* One or more BOO/BOT or joint venture companies will raise equity financing for environmental infrastructure in the local markets.

* With respect to private sector infrastructure or municipal service projects with local government (ULG) partners, the GSL will provide revenue stream guarantees or other enhancements to the private sector to insure financeability.

* At least the local currency equivelent of $50 million, will be raised in the local markets for financing environmental infrastructure projects that benefit below-median income families.

C. Project Design

The Project is designed as a series of components:

(1) *Private Infrastructure Network Component* - to establish the GSL's policy and institutional framework to promote and implement public/private infrastructure activities;

(2) *Public Awareness Component* - to inform and educate Sri Lankans of the benefits of the BOO and BOT and public/private approach;

(3) *Marketing Component* - to engender the participation of the maximum number of qualified private investors; and

(4) *Private Sector Window Component* - to expand the role of the private sector in identifying, designing, and financing of infrastructure projects.

Considerable progress has been made on Components 1-3 as evidenced by the development of a Secretariat for Infrastructure Development and Investment (SIDI) within the Ministry of Policy and Planning and the issuing of Guidelines for BOO/BOT Projects in February 1993 (see Annex D).

Component 4 is intended to develop a system for financing urban environmental infrastructure that focuses on the private sector and accesses multilateral and bilateral donor funds through a private sector financial window. This window or fund is now in the formulation stage. SIDI is both screening and promoting new BOO/BOT projects; and is developing ideas for a Private Sector Infrastructure Development Fund (Fund) to provide long-term credit for urban environmental improvement projects. The use of the Fund is expected to serve as a catalyst in promoting private infrastructure projects that benefit low-income families among others; assist in overcoming the shortage of available local long-term financing and the difficulties of accessing foreign long-term financing. It is also intended to alleviate the fiscal burden on the GSL by leveraging, at least, at a 3:1 ratio level of investment.

The Fund will provide only 20 to 30 percent of the financing for any given project, with the rest coming from equity and private financing sources. Resources for the Fund are expected to come from USAID (HG loans), ADB, IBRD and other international and bilateral donors.

IV. DESCRIPTION OF THE AMENDMENT TO THE PPI PROJECT PAPER

A. Action Plan

The proposed Amendment to the PPI will approve the use of up to US$ 50 million in Housing Guaranty resources to expand and further the objectives of the PPI Project. HG resources will be authorized when actions are taken to improve the environment for local private finance of urban environmental infrastructure. Discussions will be held with the GSL on a series of measures and actions that will constitute a *policy agenda* which would improve the conditions for local private finance of infrastructure. Agreement will be reached on which measures would be most effective and feasible within the short and medium term. The policy agenda, together with a timetable, will constitute the Action Plan. An annual evaluation will be conducted to monitor progress. Approval to borrow HG resources will be based on verification of actual loan commitments issued by participating local lenders to eligible projects.

Some examples of possible items which might be included in the action plan are measures to:

- establish the criteria and process needed to qualify for Fund support.
- reduce disincentives or create incentives for bond issues for infrastructure. This would probably involve banks rather than municipalities at this time.
- increase the amount of local private finance available for infrastructure. This would probably be accomplished through bank bonds or revenue bonds issued on specific projects.
- lengthen the terms of loans. Currently no long term (8-10 years) are available in the market.
- establish appropriate tariff structures for solid waste collection, water supply and wastewater treatment and other urban services. This would improve the revenue stream for projects and increase the available resources for environmental infrastucture.
- set standards for enforcement of environmental infrastructure projects.
- determine the legal framework for BOO/BOT and other projects.

B. Grant Resources

Grant resources from PPI will support the development of an urban environmental infrastructure finance system that includes a private sector infrastructure finance window and that will assist in the development of environmental infrastructure projects. Within the PPI Project, $1.2 million of the $7 million of AID funded costs are targeted to the development of the private sector financial system. In addition, there are resources to draw upon for project identification and marketing, as well as management support.

The Mission's on-going Private Sector Policy Support (PSPS) project is currently providing valuable technical assistance in the development of local financial markets--activities directly related to the success of the PPI project. The PSPS project's activities are focused in four areas: 1) Market Oriented Policy Development; 2) Privatization of State Owned Enterprises; 3) Capital Market Development; and 4) Creation of a Venture Capital Company. The primary objective of the Capital Market Development Component is to develop the capacity of the market to broaden public equity participation in the economy and increase capital resources for investment. This component will be used to support the complementary objectives of the amended PPI.

Short-term TA and training for the first year will be targeted, but not limited, to the following:

<u>Financial Markets</u>

- Demand survey for long-term revenue bond funding

  Working with the Colombo Stock Exchange and SEC, the Fund Manager and Financial Markets project staff, consultants will interview commercial and merchant banks, life insurance companies, pension funds and other institutional investors and derive demand estimates (absorptive capacity) for long term (8-10 year) investment vehicles tied to environmental infrastructure project finance. **Level of effort: 6 person weeks.**

- Developing credit enhancements

  Working with demand survey findings, consultants will help develop credit enhancement mechanisms needed to obviate the need for GSL guaranties on the issuance of long term securities, and provide follow-up with relevant institutions to confirm findings. **Level of effort: 4 person weeks**

- Designing investor incentives with a view towards mitigating costs

  Using the demand survey data and level of credit enhancements to be made available on long term securities, consultants will identify a number of incentives that can be added to securities issues. The objective is to create incentives to invest with a view towards reducing or deferring overall costs to the borrower while working within the overall BOO/BOT objective philosophy (e.g., transfer of ownership/equity.) **Level of effort: 4 person weeks**

- Final securities design and follow-up

  Working with Colombo Stock Exchange, SEC, Financial Markets project staff and institutional investors, consultants will complete final design of long-term security and prospectus outline. **Level of effort: 3 person weeks**

<u>BOO/BOT Environmental Infrastructure Projects</u>

The PPI project currently has a resident advisor team in place and resources available to provide necessary TA in the following areas:

- Development of the Fund Implementation System

  Working with SIDI/CFED and the designated Fund manager, develop clear criteria and procedures for project access to the Fund. The purpose of this TA is to make the fund operational to respond to project funding requests. **Funds already earmarked.**

- Assistance in project design and development

  Working with the SIDI/CFED, the NWSDB and the Colombo Municipal Council, consultants will identify and refine new projects for HG funding. Currently, sewerage treatment for Colombo appears to be the most visible choice as it has been largely ignored in favor of easier water supply projects. **Funds already earmarked.**

Given that the availability of HG funds will accelerate the project finance process, new TA is contemplated as follows:

- Training in proforma financial analysis, cash flow management and interest rate risk mitigation

  Working with the National Water Supply and Drainage Board (NWSDB) and urban local governments (ULGs), consultants will provide training to enhance internal staff capabilities in the areas of financial planning, funds management and techniques to lessen interest rate risk brought about through the use of longer-term financing mechanisms. **Level of effort: 6 person weeks**

TA and training for years 2 and 3 will extend and enhance the above, and provide other needed assistance. However, reduced levels of effort are planned for years 2 and 3 in the financial markets area.

C. USAID Project Management

The Amendment to the PPI has several unique management requirements. First, management of the HG resources requires attention to both policy objectives, and oversight of the authorization and borrowing process. HG loans are made by the private sector in the U.S. on a competitive basis. They carry a U.S. government guaranty to the investor and, in turn, require a Host Country Guaranty.

Another consideration for project management is that grant support will come from two on-going Mission project, the PPI and the PSPS. The project manager will play an important role in coordinating and programming on-going activities, and building the particular support requirements defined in this amendment into the workplans of contractors. None of the above mentioned responsibilities are currently covered by PPI project management.

The Regional Housing and Urban Development Office (RHUDO) will cooperate with the Mission in putting in place the project management for this amendment.

D. Cost Estimates And Financial Plan

1. HG Authorizations and Borrowings

Authorizations would be made on the basis of progress on an annually updated the Action Plan. The proposed annual authorizations are shown below. The actual level of authorization in any given year will be adjusted to fit HG program requirements but should, to the extent possible, be at least at a level sufficient to cover anticipated demand. Eligible projects will receive financing through the Fund and these expenditures will be reimbursed by HG disbursements.

	Proposed HG Authorizations	Projected HG Loan Borrowings
Year 1	$ 10 million	
Year 2	$ 10 million	$10 million
Year 3	$ 15 million	$20 million
Year 4	$ 15 million	$20 million

2. Grant Resource Requirements

A summary breakdown of grant funding is shown below (note that a person week is estimated to cost approximately $7,000).

All amounts in 000's

	FY 94	FY 95	FY 96	TOTAL
Management	$250	$250	$250	$750
Short-term TA/Training				
Financial Markets	120	60	30	210
BOO/BOT Partners	42	42	42	126
Evaluation of Policy Agenda	15	15	15	45
TOTALS	$427	$367	$337	$1,131

3. Implementation Plan

a. Implementation Schedule

The design of the amendment is expected to be completed during May 1993. Delegation of authority to amend the PPI will be requested from AID/W during June 1993. The HG authorization will be sought in July 1993. The amendment will cover the period 1993-1996. Grant resources will be used as available until the PACDs of the respective projects (PPI and PSPS). HG resources will be available to borrow beyond the PACD of the Projects, if elegible expenditures have been financed, and if requirements for authorizations have been met.

b. Monitoring and Evaluation

The only additional requirement for monitoring and evaluation is the annual evaluation of progress on the policy agenda (action plan), as described previously. Otherwise, evaluation plans for the PPI remain unchanged.

V. PROJECT ANALYSIS

A. Project Identification and Demand for HG Resources

Water supply, distribution, sewerage and drainage as well as environmental and solid waste management projects including composting plants, collection facilities, incinerators, land fill, and other municipal services and facilities are eligible for financing through the Fund and may be counted as elegible projects for HG loan borrowings showing they benefit families earning below the national median income. The following HG elegible projects are considered likely to be structured as BOO/BOT projects and be seeking debt financing in the next three years:

Project	Year	Cost
Galle (So. Prov.) Water Supply	1994-95	$50 to 80 million
Colombo Solid Waste Composting	1994	$ 4 to 5 million
Colombo Water Supply/Distribution	1995-96	$70 to 80 million
Colombo Wastewater Treatment	1995-97	$80 to 100 million
Kandy Water Supply/Distribution	1996-97	$30 to 40 million

Assuming Fund financing at 20 percent of project cost, the demand for Fund resources (from these five HG eligible projects alone) would be $46.8 to $61.0 million. At 30 percent financing, $70.2 to $91.5 million will be needed in the Fund.

Demand for HG resources is projected to be strong. The GOSL seeks foreign currency and the local funding will be made available in local currency, thus eliminating any foreign exchange risk.

B. Administrative Analysis

1. Borrower of HG Resources

The Ministry of Finance (MOF) will be the borrower of record for HG loan on behalf of the GSL. The GSL will provide its soverign guarantee to the USG and will agree to borrow up to $50 million in HG backed loans over the next four to five years on terms and conditions outlined in the loan agreement, and to on-lend the local currency equivalent to one or more local financial institutions for environmental infrastructure project financing.

2. Manager of Local Currency on-lent from HG

One of the local development banks, either the National Development Bank (NDB) or the Development Finance

Corporation of Ceylon (DFCC) will administer the Fund on behalf of the GSL on a financially sound basis using its original capitalization and loans as well as reflows to create a sustainable source of long term credit for elegible projects. The Fund Manager will repay loans to the GSL at a rate sufficient to cover the currency exchange risk of foreign borrowing on its behalf. The Fund Manager will also raise funds in local financial markets for on lending to Fund projects on its own account and will enter partial loan takeout agreements with other financial institutions to further leverage Fund resources by encouraging them to originate elegible loans using thier own funds.

Although NDB is presently 30 percent government owned, it is undergoing partial privatization. While DFCC is fundamentially private, the two firms are quite similar in strategies and performance. They both appear to be profitable and are performing reasonably well in a subsector where financial performance is poor in most other countries, suggesting sound management. Although DFCC has grown faster than NDB over the past few years and is more than 20 years older, NDB controls 62 percent of subsector assets due to consolidation of an Rs 1.7 billion special fund associated with IDA and ADB lending for small and medium sized industry term investments. Without the SMI fund, DFCC is slightly larger than NDB and is growing twice as fast. It appears that either institution could serve as the Fund Manager. At this stage, both NDB and DFCC are willing to undertake the task of raising long term local currency for on lending which will be a requirement of the Fund Manager, but the choice will be made in consultation with GSL. In any event the project is structured to encourage both institutions to participate.

3. Key Players and Responsibilities

The following table summarizes the major players involved in the PPI project and their respective responsibilities:

Functional Entity	GOSL Counterpart	Fund Manager	Local Lenders	ULGs	BOT Firm
Specific Entity	• SIDI	• DFCC • NDB	• DFCC or NDB • Merchant banks • Commercial Banks	• NWSDB • CMC UDA	None yet identified
Responsibilities	• Feasible project identification • Referral to fund manager for financial engineering • Advise on GOSL action plan	• Manage Fund • Sources long-term funds for on-lending	• Source long-term funds for on-lending • Borrow from Fund • Lend to BOO/BOT firm for project finance	• Consult with SIDI • Contract for BOT firm for infrastructure services • Collection services from users	• Consult with SIDI • Project design • Develop local partnership • Borrow from local lender

C. Financial Analysis

1. Long Term Financing

At the present time, no long term debt financing is available for infrastructure projects other than through international donor loan programs. An end of project measure of sucess will be the level of debt financing raised for infrastructure projects in local financial markets. The project envisions funding for BOO/BOT infrastructure projects on the following basis:

Source of Funds	Percentage of Total Project Cost
Equity	20 to 30
Fund	20 to 30
NDB Bonds	10 to 20
Participating Local Lenders	10 to 20
External Lenders	40 to 00

A mimimum of 20 percent equity will be required (30 percent when IFC participates). NDB, DFCC and other local financial institutions (commercial and merchant banks) will be encouraged to make loans to eligible projects from their own funds through takeout agreements with the Fund Manager. The takeout financing from Fund will be at a level equal to the equity in the project, up to a maximum of 30 percent of total project costs. From its own funds, the Fund Manager will provide additional takeout financing for half of the balance (after deducting the Fund contribution) of the loan made by the participating local lender. For example, if total local lender needs were $16 million, $8 million would come from the Fund (provided that amount did not exceed the project equity), and the remaining $8 million would be financed by the Fund manager and the local lender(s) in equal $4 million portions. With such a system in place, the level of the funding from external lenders can be established by the borrower on the basis of the project's foreign currency requirements and the competitive cost of funds. See Figure 1 for an illustration of project financing sources and lenders for a hypothetical $40 million BOO/BOT project. For additional detail on the chronology of events that would transpire in a project cycle, see ANNEX B.

2. Revenue Collections - The Public Sector BOO/BOT Partners

The National Water Supply and Drainage Board (NWSDB) - is the principal agency in the water supply sector of Sri Lanka. It is responsible for the identification, design, construction and operation of almost all urban water supply projects and much of the piped water systems in the rural areas. The NWSDB is also responsible for disposing of waste water (currently sewerage is not treated--simply pumped out to sea.) The NWSDB was the key component of an ambitious USAID "Water Supply and Sanitation Sector Project" which ran from 1984 through 1990. During that time efforts were expended to upgrade the NWSDB in terms of management organization, philosophy, and corporate strategy with the goal of providing improved service and delivery at full cost recovery levels. The following table demonstrates that this goal was largely met:

	1984	1990
Piped water produced (M cu m/y):	155	219
Billed connections (thousands):	79	185
Operating & Maint. (O&M) expenses (Rs million):	179	425
Debt service (Rs millions):	33	123
Total O&M plus Debt Service (Rs millions):	212	548
Billings (Rs millions):	224	503
Collections (Rs millions):	56	422
Collections as a % of Billings:	25	84
Collections as a % of O&M and Debt Service:	26	77
Billing lag time (days):	180	30

Source: Final Report on Institutional Development of the NWSDB, Engineering-Science, Inc.

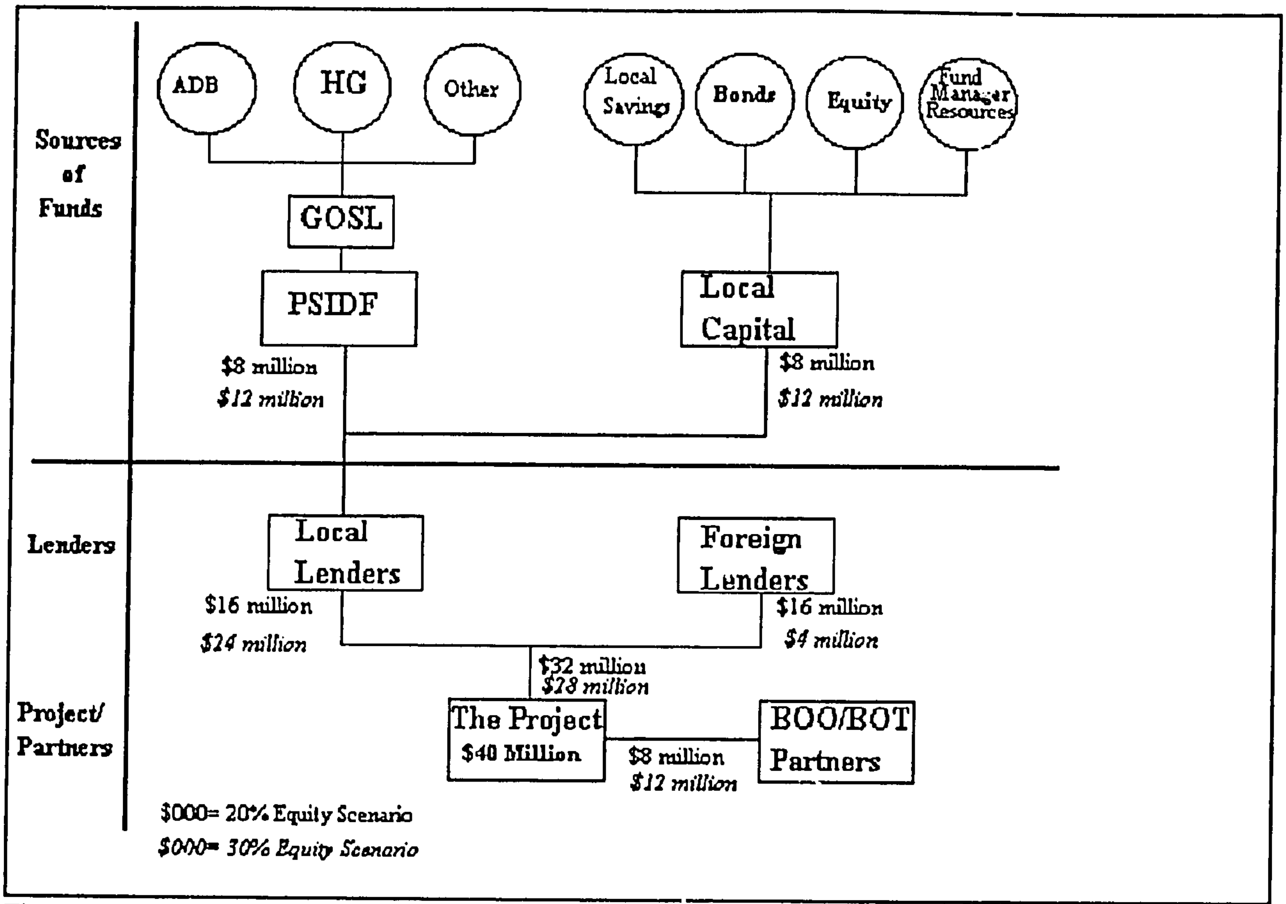

Figure 1- BOO/BOT Project Financing

As the above data demonstrate, good progress was made between 1984 and 1990, yet deficit operations were never eliminated during this period. Since 1990 however, more progress was made and, as a result, in 1992 the NWSDB was operating at a surplus of Rs. 145.8 million for the year (collections less O&M less debt service[1].) In summary, the NWSDB has placed self-sufficiency and financial viability as top priorities and is making important strides towards those objectives.

The NWSDB will be an essential party to any BOO/BOT project agreement involving the provision of water or sanitation as it is the apex organization for the provision of these services throughout the country . Currently, pre-feasibility studies are underway for the water supply project in the Galle district. These studies are funded under the SIDI/CFED budget and are coordinated through the NWSDB.

The Colombo Municipal Council (CMC) - is the largest Urban Local Government (ULG) in Sri Lanka. It provides government services to a city of over 670,00 people (1991 estimate), and the population of the metopolitan Colombo area is vertually double that of the municipality. The CMC is comprised of 14 departments with devolved authority reaching 6 Colombo districts. The CMC is responsible for solid waste

[1] Note: A factor in this success is the combination of grant funds and subsidized loans available to the NWSDB. Future private sector BOO/BOT operations will have to account for market rates of return and smaller amounts of concessional funding.

collection and disposal, and for sanitary and storm sewerage services. Water supply is the responsibility of the NWSDB although the CMC engineering department acts as the NWSDB's agent with respect to hook-ups and maintenance of lines. The table below summarizes the CMC's financial characteristics.

COLOMBO MUNICIPAL COUNCIL FINANCIAL CHARACTERISTICS

Pop.	Recurrent Revenue 1991 Rs000	Recurrent Revenue per capita 1991	Recurrent Exp 1991 Rs 000	Recurrent Exp. per Capita 1991	Recurrent Sur/(Def) 1991 Rs000	Recurrent Sur/(Def) per Cap. 1991	Capital Expen. 1991 Rs000	Capital Expen. per capita 1991	Staff Size	Staff per 1000 pop.
672,263	566,824	843	633,929	943	(67,104)	(100)	157,278	234	12,000	18

Collections of user fees for services such as solid waste collection are practically non-existent. For example, total expenses in 1991 attributable only to waste collection in Colombo's 6 districts totalled Rs. 106.5 million. Revenues from collection fees, reflecting a recovery rate of barely 10%, amounted to Rs. 0.7 million, leaving a deficit of Rs. 105.8 million.

Thus, any designs for a private solid waste program might focus on post-collection operations, but should contain technical assistance to structure a user fee collection system. The CMC would be the key contractor or BOO/BOT public sector partner for the proposed composting project and for any other solid waste management projects in the area. While similar projects may arise in other ULGs, none are projected at this time. However most ULGs outside Colombo do a reasonable job of collecting local revenues (see the financial characteristics of secondary towns in the Annex C).

ANNEX A:

Constraints to Long-term Lending

Sri Lanka's financial institutions are relatively diverse. They are capable of providing private borrowers with at least short term working capital.

A host of policy and institutional problems, however, make longer term financing vertually impossible to provide from local sources. Some interest rates are controlled and the use of market based monetary instruments is limited. The development of Sri Lanks's financial institutions is also impeded by serious debt recovery problems, insufficiently rigerous central bank supervision, and inadequate accounting and auditing.

Dissussions with local financial institutions indicate that the maximum amount of capital that could be raised for a BOO/BOT project would be about $10 million, repayable in 3 to 5 years. This amount and tenor is too little and too short for most BOO/BOT projects.

I. The Debt Market

The local debt market is dominated by issues of short maturities, primarily government treasure bills. No long term government bonds are outstanding and the corporate bond market, at least until recently, has been moribund.

The two state owned banks, the Bank of Ceylon and the People's Bank, own more than 60% of the commercial bank assets, but are technically insolvent when internationally accepted provisioning for bad debts is taken. As advocated by the World Bank, these banks need to be restructured after appropriate provisioning and recapitalization is completed. In particular, the two state owned banks need to be commercialized to improve the competitive environment of the sector, and the Bank of Ceylon needs to be privatized.

Local pension funds and insurance companies have successfully raised large pools of long term capital. However, government policy currently requires this money to be invested in short term government securities.

The two development banks, The National Development Bank (NDB) and the Development Finance Corporation of Ceylon (DFCC), while relatively sound and well managed, are unable to mobilize long term local currency funds for onlending. Instead, they have to rely on IBRD and ADB loans for long term local currency onlending.

Institutional investors such as insurance companies and persion funds are essentially captive institutions for government securities.

Limited domestic savings and the underdeveloped state of its financial markets implies that Sri Lanka will require foreign capital to finance large infrastructure projects.

Foreign Commercial Debt - This is normally a very important source of financing for private sector infrastructure projects, which by nature are fairly highly geared. The scope for private foreign debt financing of BOO/BOT projects is limited by Sri Lanka's high levels of foreign debt (over $7 billion) and the reluctance of foreign commercial banks to take project risk in Sri Lanka.

External Debt Outstanding by Type of Creditor
(in US$ Million)

Commercial Banks	$747.4
Supplier Credits	18.9
Multilateral Donors	2,787.9
Bilateral Donors	3,403.5
Private Non-Guaranteed	179.9
TOTAL	$7,137.5

Source: The World Bank

Direct Foreign and Portfolio Investment - Foreign equity in the form of direct investment can be attracted, depending on the structure of the particular project.

Considerable interest exists among foreign portfolio investors for share owership in Sri Lanka companies. This demand for shares can support infrastructure projects indirectly when Sri Lanka companies come to market to raise equity capital related to BOO/BOT projects. As a part of its privatization program, the GSL was able to sell majority ownership, primarily to foreign investors, in a number of companies through open bidding on the stock exchange.

Despite low wages and a strategic location, Sri Lanka has remained a marginal recipient of foreign direct investment. During the last 12 years, Sri Lanka has received an annual average of US$ 40 million direct foreign investment. This amount has been declining in recent years due to the perception of increased country risk as a result of the ongoing civil conflict. Uncoordinated policies and the discretionary nature of approval procedures have also hindered foreign direct investments.

Debt for Equity Swaps - A debt for equity swap is a mechanism for financing equity from foreign commercial bank debt. Debt for equity swaps have featured prominently in a number of privatizations and restructuring and could be of value in securing equity for BOO/BOT projects, but at the present time Sri Lanka does not have a debt for equity program in place.

II. The Equity Market

The Colombo Stock Exchange (CSE) has evolved substantially during the last two years. While it can play a potential role in infrastructure project financing, the plausible amounts that could be raised remains small in relation to estimated needs. But, with development, over time the CSE could over grow as a source of finance for environmental infrastructure projects.

The Colombo Stock Exchange (CSE) Prior to 1990 - To better appreciate the remarkable transformation that has occurred at the CSE, one should consider its condition prior to 1990. In 1985, the perennially moribund stock market was reorganized. In 1987, the Securities Council Act created, for the first time, a regulatory body charged with ensuring orderly markets and protecting buyers of listed equity and debt securities. The Security Council (now called the Securities and Exchange Commission or SEC) also advises the government on the development of the capital markets.

Operations on the CSE were initially slow and cumbersome, mainly because they were manual and paper based. This limited the efficiency and timeliness of share transfers. Even before the recent rise in trading in 1990 and

1991, the CSE experienced settlement difficulties.

Other, more daunting, problems were of a structural nature. Many local companies were unwilling to list, thus limiting the supply of shares on the market and reducing liquidity. Interest rate and tax policies actually encouraged companies to favor debt over equity financing. Most of the companies which did list did not trade actively, and there was little float in the market. None of the brokers operated outside Colombo, and the services they provided to clients were limited. Investment research and portfolio management skills were virtually non-existent.

The demand for shares was also severely limited. The public was generally unaware of the potential benefits of investing in shares. Those who were aware of the potential benefits, frequently lacked confidence in the market, and tended to favor less risky, albeit lower yield, bank deposits. Institutional investors, which should have been a significant source of demand, were typically government owned, and served as captives for low yield (in real terms) government debt. Foreign portfolio investment was effectively eliminated by a 100% tax on purchased shares.

The CSE after 1990 - Since then, the changes at the CSE have been dramatic, both technically and in terms of trading activity. In other areas, particularly with respect to regulatory and institutional development, the process has necessarily been more evolutionary. In 1990, the CSE was the second best performer in the world after Venezuela and has continued to appreciate strongly since then.

Several government decisions were vital to the market's "takeoff." The most important of these occurred in 1990. In June of that year the government liberalized foreign portfolio investment by abolishing the 100 percent tax on share purchases by foreigners (subject to the limitation that their aggregate share holding not exceed 40 percent of the issued holding).

Almost immediately, this triggered a surge in foreign interest in the market. This captured the attention of the CSE, the brokerage firms and the Sri Lankan investing public, and led to a rapid rise in shares that had previously been undervalued. Officials at the CSE report that there are now over fifty foreign funds approved to invest in the market.

The government implemented other supportive measures as well. For example, it revised the capital gains tax on listed shares, abolished the ad-valorem stamp duty on shares, withdrew the withholding tax of 15 percent on dividends, and withdrew the wealth tax on listed company shares.

Progress on the regulatory front was substantial during 1991, though more remains to be done. The key amendments to the Securities Act include the following:

- The SEC was given responsibility for regulating unit trusts.
- Responsibility for insider trading was put under the SEC. Previously, this area was addressed in the Companies Act.
- A takeovers and mergers code has been drafted, approved by the MOF and the FTC, and is being reviewed by the Legal Draftsman. It is expected to help reduce instances of "creeping" takeover abuses.

Domestic Securities Firms - Brokers and others readily admit that corporate finance is still not well developed in Sri Lanka, but are interested in exploring its potential further. Essentially, securities firms earn all of their revenues from brokerage. In response to the rising trading volume, these firms expanded rapidly during 1991 in terms of staff, business volume and number of offices. This would be the ideal way of addressing the problem of distributing shares outside of Colombo and is bound to stimulate more activity in the stock market.

Technical Developments - The Central Depository System (CDS) went into operation on September 2, 1991. The share prices of all companies can be readily viewed on any of several terminals. The system also provides investors with monthly account statements and information generated by the CDS is sent to individual companies on an as-needed basis, for example, when dividends need to be paid. Moreover, because the CDS records the time sequence of trades as well as the identity of which brokers are transacting those trades, the CSE has unprecedented ability to monitor insider trading.

Supply of Shares - While demand for shares in Sri Lanka has grown steadily, the supply, with the exception of those created through privatization, has lagged. The CSE is attempting to encourage as many new companies as possible to list.
As in other markets, Sri Lankan companies in deciding whether to list or not, must consider the benefits and costs. There is a direct fiscal incentive to list, namely, the corporate tax rate in Sri Lanka is only 40 percent for listed companies as compared with 50 percent for private companies.

The difficulties in getting companies to list in other emerging markets have been well documented. Generally, there is widespread reluctance to widen the ownership of family owned and run companies for fear of loss of control. Certain firms also fear the disclosure requirements of being listed, especially in instances where they have a history of underpaying their tax obligations. In Sri Lanka as elsewhere these concerns have limited new company listings and the availability for sale of shares held by family members in existing listed companies.

Another significant problem in Sri Lanka is the relative cost of debt and equity finance. After allowing for inflation, the net-of-tax real cost of debt has often been negative. (The easy availability of debt and poor debt recovery legislation are additional factors favoring debt financing by firms.) Equity financing, on the other hand, can be quite expensive.

As other countries have demonstrated, some of the reasons for reluctance begin to ease once prices on the stock market begin to increase. However, an additional constraint is often that the corporate finance skills needed to take a company public are as yet poorly developed. Many companies are still poorly informed about both the process and possibilities.

Demand for Shares - Domestic brokers generally contend that foreign investors have been the driving force behind the exchange during the last year. They describe their domestic clients as "speculative." That is, they do not invest on the basis of the fundamental value or earnings potential of a firm. Thus, to date they have seen little need to undertake research on the market. The result is that, with the exception of John Keells, Forbes and Walker, and the Merchant Bank of Sri Lanka, local research is still not available. However, given the strong foreign interest in the market, there is a growing incentive for local brokerage firms to develop these capabilities. And gradually that seems to be happening. The main constraint at this point is a severe storage of trained securities analysts.

Institutional Investors - Still missing from the demand side of shares are domestic institutional investors. The largest pension funds in the country are the Employees Provident Fund (EPF) and the Employees Trust Fund (ETF). These are still captive instruments of government policy. EPF is by far the larger of the two. The labor commissioner estimates that the EPF collects roughly 400 million rupees per month. Currently, both EPF and ETF invest all their funds in either treasury bills or government owned corporations.

Although technically these funds could diversity, both are subject to directives from the Ministry of Finance which basically determines investment policy. To give an idea of how dependent the government is on the EPF, its director estimates that the EPF funds 60 percent of the government deficit. In that light, it seems unlikely that the investment policy will be allowed to change soon. Unfortunately, both funds earn a negative real return on their investments. Obviously, this is unfair to the beneficiaries of these funds and ironically, the directors of both funds readily acknowledge that the situation should change.

There are some provident funds that pre-date the ETF and EPF, but compared to the EPF they are very small. Although there are about 150 accounts in total, the aggregate inflow of funds per month is less than 100 million rupees. Unlike the EPF, these funds can invest in high yield securities but there are caveats to this. Every year, for example, the labor commissioner must approve the accounts to ensure they are sound investments. He notes that in the past there have been instances where funds have been mismanaged.

The government has begun to address the Exchange's obvious need for greater institutional participation, by recently passing legislation which permits the formation of unit trust, which are expected to play an important role in generating demand. Several firms, including the DFCC and Capital Development and Investment Corporation, Ltd. (CDIC), are applying for licenses to set up unit trusts. The incentives offered under the legislation include a five year tax holiday, no capital gains tax and no withholding tax.

Private insurance companies are just beginning to invest in the CSE but they are still small and subject to limitations on the percentage of paid in capital they are allowed to commit to equity. Meanwhile, the two largest insurers remain state owned and, like the state pension funds, are captives of government policy with respect to their investment decisions.

Clearly, rules governing the investments of private sector insurance companies need to be adjusted to allow more equity investment. Public insurance companies can be privatized, and the investment policies can also be changed to permit greater equity in their portfolio.

ANNEX B:

<u>Sample Chronology of Events of a Typical Project</u>

1. Project Identification: SIDI working with GSL, ULGs and line ministries identifying potential BOO/BOT projects. Initial concepts are proposed through the preparation of a Project Paper which is reviewed and discussed with relevant parties. If the Project Paper indicates that the project has merit, a pre-feasibility study and timetable will be envisaged.

2. If the pre-feasibility study is commissioned a team of professional engineer,s economists, architects etc. will be employed to carry out the study. The study will cover an analysis of the assumptions in the Project Paper with more in depth analysis to ensure that there is a potential transaction under a BOO/BOT basis.

3. Assuming that the pre-feasibility study indicates that the project has merit, the next phase in the process will be to coordinate a conceptual design of the proposed project. With the conceptual design, the project can be ready for the bid process.

4. The bid process entails a comprehensive marketing and pre-qualification procedure. Potential bidders are canvassed and the project is advertised in the manner necessary to attract the maximum number of bidders for the project. Once the bidders are identified, requests for qualification (RFQ) questionnaires are sent out. The responses to the RFQ are carefully reviewed and evaluated for both technical capability, responsiveness to the requirements of the RFQ and the financial capability of the bidders. Once the firms are short listed, a notice advising both the short listed and non short listed firms of the selection is forwarded along with a timing on when they might expect a request for proposal (RFP).

5. Once the RFP is approved by the concerned line ministry along with the conceptual design, all details are forwarded to the short listed bidder. From there a complete bid package is expected which will outline their bid, the technical method they will use to construct, define their operations procedures, training programs, safety programs, environmental record and finally their ability to finance. As part of the bid package, each bidder will be offered the opportunity to work with SIDi and the Fund manager, to initiate applications from both foreign and local lenders. The Fund manager will be in a position to assist in structuring local lending consortia.

6. Once the final bidder is selected and an official letter of intent is issued, the Fund manager along with SIDI will work directly with the selected bidder to obtain financing. Local lender will issue construction/permanent commitment based on the following funds sources:

(a) Fund: 50% of local funding needs up to a maximum of the owners equity in the project (estimated 20-30% of the total costs).

(b) Local capital: these funds can come from locally mobilized long-term sources. These can include savings, equity funding, long-term revenue bonds and any other form of long term financing. It is expected that the Fund manager will lend a minimum of 25% of the local funding needs.

    i.e. if local funding needs are $16 million, then the Fund manager will contribute $4 million, the Fund will contribute $8 million (provided that that amount does not exceed the project equity position) and the balance, $4 million, will have to come from local lender resources mentioned above.

7. The construction/operations joint venture team will secure foreign financing for the balance of the funding needs. This external funding will be of a nature that excludes and actual GSL involvement of any

direct nature (such as direct guarantees, government to government grants, etc.). Except in rare instances it is anticipated that the GSL will only provide indirect undertakings for the project.

8. Bulk Purchase Agreement and Concession/Implementation Agreement along with associated ancillary agreements signed and completed. Detailed design, construction and operations commences.

ANNEX C:

Financial Characteristics of Secondary Towns

Cities or Urban Local Governments (ULGs), are semi-autonomous corporate entities, regulated by Provincial Councils, with an elected council. The operation of municipal councils (larger ULGs), urban councils (smaller ULGs) and pradeshiya sabhas (smallest ULGs, formerly town councils) are run on a day to day basis by the Chairman of the Council, assisted by the Vice Chairman and the Secretary, who is appointed by the Government. In a sample of 16 ULGs studied by the ADB, all serving secondary towns, staff size ranged from 49 (Moneragala) to 623 (Galle). Self generated revenue averaged about 66 percent of total revenues, with the balance coming from the Government as revenue grants; 10 of the 16 ULGs were generating a surplus on revenue account ranging up to 42 percent of total revenues. ULGs' primary revenue sources include property taxes, water rates, rents and fees from other services, and revenue grants from central and provincial governments, which cover part of staff costs. The characteristics of the 40 ULGs (all secondary towns) selected for assistance under the ADB Urban Development Projects are shown in the table below.

Characteristics of ULGs in 40 Secondary Towns

Name of ULG	ULG Pop. 1991 Nos.	Recurrent Revenue 1991 Rs.000	Recurrent Revenue Per capita 1991(Rs)	Recurrent Expenditure 1991 Rs.000	Recurrent Expenditure Per capita 1991(Rs)	Recurrent Surplus(Deficit) 1991 Rs.000	Recurrent Surplus(Deficit) Per capita 1991(Rs)	Capital Expenditure 1991 Rs.000	Capital Expenditure Per Capita 1991(Rs)	ULA Staff size Nos.	Staff per 1000 Population
Weligama	19,403	13,103	675	13,085	674	18	1	787	41	154	8
Ratnapura	45,090	44,427	985	41,994	931	2,433	54	250	6	443	10
Galle	83,585	54,853	656	55,006	658	(153)	(2)	15,437	185	623	7
Hambantota	9,866	7,717	782	9,022	914	(1,305)	(132)	120	12	81	8
Nuwara Eliya	26,762	25,022	935	18,246	682	6,776	253	6,598	247	378	14
Beruwala	25,325	19,498	770	18,908	747	590	23	0	0	164	6
Horana	9,704	10,157	1,047	12,035	1,240	(1,878)	(194)	1,636	169	131	14
Ambalangoda	16,948	8,075	476	7,379	435	696	41	3,208	189	132	8
Kurunegala	27,599	58,766	2,129	52,857	1,915	5,909	214	929	34	572	21
Gampola	23,864	25,150	1,054	21,688	909	3,462	145	4,262	179	239	10
Anuradhapura	38,867	17,908	461	20,932	539	(3,024)	(78)	3,932	101	519	13
Matara	42,410	47,684	1,124	46,540	1,097	1,144	27	13,587	320	334	8
Nawalapitiya	13,728	15,668	1,141	13,734	1,000	1,934	141	28	2	50	4
Bandarawela	4,828	8,495	1,759	8,287	1,716	208	43	3,108	644	105	22
Wattegama	4,577	3,489	762	4,599	1,005	(1,110)	(243)	573	125	30	7
Kuliyapitiya	6,059	7,851	1,296	6,343	1,047	1,508	249	1,330	220	99	16
Kegalle	17,487	16,318	933	15,953	912	365	21	1,600	91	100	6
Chilaw	24,174	11,101	459	10,594	438	507	21	1,046	43	191	8
Minuwangoda	7,380	9,551	1,294	9,077	1,230	474	64	502	68	49	7
Polonnaruwa	15,193	6,944	457	6,020	396	924	61	68	4	102	7
Jaela	27,866	8,090	290	5,889	211	2,201	79	1,267	45	35	1
Matale	30,044	48,379	1,610	49,377	1,644	(998)	(33)	1,385	46	75	2
Moneragala	2,219	6,010	2,708	5,059	2,280	951	429	205	92	49	22
Trincomalee	52,123	14,295	274	11,782	226	2,513	48	113	2	262	5
Balangoda	11,543	11,188	969	10,357	897	831	72	230	20	50	4
Kandy	107,525	285,808	2,658	219,567	2,042	66,241	616	19,949	186	500	5
Badulla	35,335	21,643	613	18,007	510	3,636	103	641	18	50	1
Gampaha	12,272	23,981	1,954	22,474	1,831	1,507	123	37	3	233	19
Hatton	12,339	15,910	1,289	14,614	1.184	1,296	105	55	4	50	4
Tangalle	12,176	3,413	280	3,445	283	(32)	(3)	16	1	50	4
Kalutara	35,136	15,438	439	15,416	439	22	1	1,595	45	224	6
Peliyagoda	29,320	8,205	280	7,453	254	752	26	1,696	58	27	1
Panadura	34,839	12,373	355	14,080	404	(1,707)	(49)	100	3	243	7
Seeduwa	17,237	8,810	511	5.515	320	3,295	191	5,719	332	113	7
Puttalam	25,655	16,795	655	15,765	615	1,030	40	841	33	50	2
Haputale	2,609	2,644	1,014	2,336	895	308	118	1,324	508	30	11
Talawakelle	5,044	4,000	793	3,900	773	100	20		0	50	10
Wattala	23,034	7,340	319	7,993	347	(652)	(28)	1,251	54	30	1
Negombo	70,531	40,336	572	38,156	541	2,180	31	10,215	145	513	7
Kadugannawa	1,733	1,837	1,060	1,888	1,090	(51)	(29)	201	116	30	17
Total	1,011,427	968,273	957	865,371	856	102,901	102	105,841	105	7,160	7
Top 24	575,101	488,522	850	464,406	808	24,145	42	61,971	108	4,917	9

Source: World Bank and [illegible]

ULGs will be a signatory agency on contracts for BOO/BOT Projects which provide municipal infrastructure or services such as water, sanitation or solid waste management. In the projects envisioned for financing in the initial phase of the Project the municipal councils of Galle, Colombo and Kandy will be signators but only the Colombo Municipal Council will have a significant role in collections as NWSDB is responsible for rate setting and collections related to water service in all areas except Colombo.

ANNEX D:

Sri Lanka BOO/BOT Guidelines

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FOREWORD

A well developed economic infrastructure in the form of a good network of road and rail transport, an adequate supply of safe water, an adequate and uninterrupted power supply, a modern telecommunication system, a system of waste disposal which is environment-friendly, port facilities which are not congested and other necessary economic infrastructure facilities are essential pre-requisites for higher levels of investment and growth. Inefficient and outmoded systems are counter-productive; they retard economic growth, deter investors and have an adverse effect on the quality of life of the people.

The development of the infrastructure in all the sectors to the desired levels and managing them in a cost effective manner call for capital and entrepreneurial skills on such a massive scale that the Government would not be able to mobilise in the short or the medium-term, without recourse to local or foreign commercial borrowing. The Government has therefore, decided to seek private sector participation in infrastructure development.

The involvement of the private sector in infrastructure development, which has come to be known as the BOO/BOT strategy, has been resorted to with encouraging results in both developed and developing countries. The process of project development is nevertheless complex. The success of a project would depend on the skillful structuring of a partnership arrangement among the parties involved; the Government, the investors and the lenders, while bearing in mind the interests of the users of the facility, the legal, technical and financial considerations and more importantly, the impact on the community and the environment.

These Program Guidelines seek to set out the procedures to be followed and the considerations which should guide projects from the stage of conceptualisation to execution. It is hoped that they would be of use to both the prospective investors and the state agencies intending to promote BOO/BOT projects in their respective sectors.

Dr P Ramanujam
Director General
Secretariat for Infrastructure
Development and Investment
87, Horton Place
Colombo 7
Sri Lanka

Telephone: (94-1) 693761, 696947, 694618
Fax : (94-1) 696952, 694601

February 15, 1993

PUBLIC-PRIVATE PARTNERSHIP IN INFRASTRUCTURE DEVELOPMENT

Program Guidelines for BOO/BOT Projects

1. BACKGROUND AND GENERAL POLICY

1.1 There is an urgent need to improve the infrastructure facilities in Sri Lanka to match international standards in order to cope with the higher levels of anticipated investments in industry, agriculture and the service sectors. Further, it is widely accepted that a well developed economic infrastructure, among other things, creates employment, promotes local and foreign investment and transfer of technology, fuels business productivity and expansion and contributes greatly to the improvement of the standards of living of the people and their access to social and economic services. Conversely, an inadequately developed or inefficiently performing infrastructure stifles economic activity and affects the quality of life of every section of the community.

1.2 The ability of the Government to finance the required infrastructure facilities is limited by the amount of revenue that can be generated from the available low income base of the country and increasing world wide competition for funds through donor assistance. Also, there are competing demands on Government resources arising from the need to maintain a reasonable standard of social welfare. Hence, in pursuance of the accepted policy of the Government of encouraging private investment in the economic development of the country, it is now proposed to attract private investment in the development of infrastructure facilities.

1.3 The Government therefore, seeks the collaboration of the private sector, local and foreign, on mutually beneficial terms in the development of the infrastructure on Build-Own-Operate (BOO) and Build-Operate-Transfer (BOT) or other appropriate variants of Public-Private partnership arrangements.

1.4 In promoting private investments, the Government will endeavour to maintain a proper balance between the need to provide a satisfactory service to the public at reasonable cost while safeguarding their rights to existing alternative services and to ensure an adequate return on investment.

1.5 During BOO/BOT operations the Government will extend all appropriate assistance for the successful operation of the program, in a spirit of healthy and beneficial co-operation between the public and the private sector.

1.6 In determining the terms of the BOO/BOT projects, the Government will negotiate with the objective of providing satisfactory services to the public at reasonable costs, while providing the private sector owner/operator with a risk-adjusted return. In the case of projects initiated by the Government, a tendering process will be conducted to secure such services at reasonable cost to the consumer by encouraging competition among potential private sector participants, while ensuring that their return on investment is reasonable but not excessive.

1.7 Power generation, Communications, Transportation, Ports, Water Supply and Drainage, Shopping Complexes, Industrial Estates and Waste Disposal are some areas where the potential exists for such projects.

2. MAIN FEATURES OF THE BOO/BOT PROJECTS

2.1 BOT Projects are contractual arrangements whereby the Contractor undertakes the construction, financing, operation and maintenance of a given infrastructure facility for a given period of time, during which, the Contractor is allowed to charge the facility users tolls, fees, rentals and other charges sufficient to enable him to recover project costs, operating costs and a risk adjusted return on his investment. Upon termination of the contract he transfers the facility to the Government in a condition and at terms determined in the original agreement.

2.2 These projects will normally involve only non-recourse financing and the funds for the project will be raised without any direct state guarantee of repayment. Instead, the investors in and the lenders to the project company must look to the revenues and efficient operation of the project for the return on equity and servicing of their loans.

2.3 In a BOT project, after a period of operation, subject to terms of negotiations, the new facility may be transferred to the Government. Where the Government is satisfied with the operation of the project during the concession period by the owner/operator, the Government may consider extending the concession on mutually beneficial and acceptable terms, or re-negotiate or re-tender the project. Alternatively, the agreement between the Government and the private sector may stipulate that the project will be pursued on a BOO or other suitable basis from the outset.

2.4 Normally, the Government will identify a project and invite the private sector to submit proposals in conformity with Program Guidelines and project specifications together with their own technical, organisational and financial approach. Private sector investors may also advance proposals on their own initiative. If such a proposal appears to have the potential to make a significant contribution to infrastructure development while meeting the criteria applicable to BOO/BOT projects, the Government may enter into negotiations with a view to developing a viable project.

3. INSTITUTIONAL FRAMEWORK

3.1 The focal point of the BOO/BOT program is the Secretariat for Infrastructure Development and Investment (SIDI) established within the Ministry of Policy Planning and Implementation. SIDI is responsible for all aspects of project development in collaboration with key policy and implementing Ministries.

The SIDI is primarily be responsible for:

i Identifying appropriate projects and preparing profiles that may be suitable for implementation under BOO/BOT or other basis, in co-operation with implementing agencies and building an inventory of such projects;

ii Ensuring that proposed projects meet established socio-economic, technical, and environmental policy criteria;

iii Ensuring that proposed projects conform to the Program Guidelines and governing legislation;

iv Administering, in collaboration with the relevant Ministries and key implementing agencies, the process of project development;

v Negotiating with Investors, with input from relevant Ministries and other implementing agencies, on project proposals and providing recommendations on decisions to accept or reject; and,

vi Overseeing and monitoring the progress and assisting in the smooth execution of projects.

4. ELIGIBLE INFRASTRUCTURE PROJECTS AND SECTORS

4.1 Some infrastructure projects which are deemed to be financially viable and in general conformity with the Program Guidelines for execution on BOO/BOT or other appropriate variants are construction, rehabilitation, modernisation, improvement and expansion in the following sectors:

i Telecommunication systems, network and services;

ii Water supply and distribution, sewerage and drainage;

iii Power generation, distribution and services;

iv Highways and expressways including bridges, tunnels, interchanges etc.;

v Airports, terminals and related aviation facilities;

vi Port development including terminals, piers, handling, storage and other services;

vii Industrial estates including services to support commercial and non-commercial activities;

viii Environmental and solid waste management projects including composting plants, collection facilities, incinerators, landfill and other municipal and rural services and facilities;

ix Rail and non-rail based transportation systems and facilities; and

x Other urban, municipal and rural infrastructure that Government views as priority areas of development to support economic development activities.

5. INTEGRATION OF PROPOSED PUBLIC/PRIVATE PROJECTS WITH TRADITIONAL PUBLIC SECTOR INFRASTRUCTURE ACTIVITIES

5.1 In order to ensure that public/private projects are pursued in an integrated manner with traditional and ongoing infrastructure project activities that cannot be advanced on a BOO/BOT or other basis, SIDI will have an overview of infrastructure development in the country.

5.2 The line Ministries/Agencies traditionally responsible for infrastructure development will, in co-operation with SIDI select priority projects that can be pursued on a BOO/BOT basis and provide technical input on data, specifications, and requirements so that documents and procedures for solicitation of bids can be developed. SIDI and the relevant line Ministry/Agency will also develop a ranking system so that projects which can be pursued on a BOO/BOT basis could be ranked in order of priority and potential for implementation. Projects which come up without Government solicitation, but do not lend themselves to implementation on BOO/BOT basis may be undertaken by the Government on a traditional basis, thereby facilitating project development efficiency and eliminating overlap and competition for financial and technical resources.

6. THE PROCESS OF PROJECT DEVELOPMENT AND APPROVAL

The process of project development and approval takes two forms depending on whether the proposals are solicited or unsolicited.

6.1 Solicited Proposals

6.1.1 In this type of project, the Government through SIDI and the relevant line Ministries/agencies will identify eligible and viable project candidates, develop bid documents, and tender eligible projects to the private sector through a competitive bid process using public advertisement. SIDI and the relevant line Ministry/agency will then review, evaluate, rank and determine project candidacy and bidders using established bid evaluation criteria.

6.1.2 After the bid evaluation stage, the best proposal or proposals will be selected and approved in principle, and a Letter Of Intent (LOI) issued by SIDI in consultation with the relevant line agency. LOI will enable the bidder to move to the second stage of the project process. In the second stage, the bidder will take the following steps:

i Initiate action to establish a project company incorporated or registered in Sri Lanka;

ii Seek required approvals and consents;

iii Initiate an environmental and social impact study;

iv Prepare an implementation plan;

v Finalise and document equity and loan arrangements;

vi Prepare and submit the final technical and financial proposal.

6.1.3 Upon compliance with all aspects of project development in the second stage, bidders will go through the negotiation stage, at the end of which the Government, if satisfied with regard to project viability and compliance with established criteria, may grant approval of terms and conditions of contract and execute agreements binding parties to financial arrangements and construction of the facility in question.

6.2 Unsolicited Proposals

6.2.1 The second form of Public/Private Partnership process involves the acceptance of unsolicited proposals from the private sector to undertake projects on a BOO - BOT or other appropriate variant basis. It is vital for the success of the BOO/BOT program to provide an opportunity for the private sector to identify and structure projects on their own initiative. This is in recognition of the fact that the private sector proposers may have better bottom line cost control capability, knowledge of new technologies, or special insight into market solutions to development problems, than known to the public sector.

6.2.2 Evaluation of unsolicited proposals shall be conducted using the same rigorous criteria as in the normal government initiated proposals. Unsolicited proposals will be entertained for the eligible sectors listed above provided that they:

i are consistent with Government Policy;

ii do not conflict with the Government's plan for solicited proposals; and iii meet the same threshold level of criteria in order to comply with Program Guidelines including minimum technical criteria, economic parameters, environmental and social impact criteria, financial viability, operational viability, marketability, and pre-qualification criteria of the firm in question.

Proposers of unsolicited projects are urged to discuss them at an early stage with SIDI and the relevant line Ministries/agencies, who will offer guidance on whether the projects appear to be in fulfillment of the above criteria.

6.2.3 If an unsolicited project meets the initial conditions described above, and if the proposers are prepared to proceed with the development of a detailed proposal, SIDI will provide the proposers with a Statement of Proposal Requirements (SPR). SPR will give detailed guidance on the sectoral specifications and requirements that any proposal needs to meet in order to advance to the second phase of the process. Additionally, guidance will be given on the format in which the proposal shall be submitted.

6.2.4 At this stage, SIDI will also provide the proposer with a letter acknowledging the submission and Terms of Reference (TOR) to prepare a detailed proposal. In the interest of promoting program transparency and integrity, SIDI will register and/or announce publicly the receipt of the proposal and that the Government has offered TOR to proceed accordingly.

6.2.5 The issue of TOR, letter of acknowledgement, and public announcement, do not represent in any way a commitment by the Government to the project. Only after a final and more detailed proposal is evaluated and approved will the Government provide the proposer of an unsolicited project with a Letter Of Intent (LOI).

6.2.6 In the case of proposals submitted in response to TOR, SIDI will consider reimbursing a portion of the cost incurred in carrying out project feasibility studies as a means to further encourage the active participation by the private sector in the project development cycle.

7. EVALUATION OF PROPOSALS: SOLICITED AND UNSOLICITED

The evaluation of proposals, solicited or unsolicited will be guided by the same criteria. The initial stage in the evaluation of proposals is to determine whether:

i the bidders or proposers have the technical, financial and operational expertise and experience to successfully implement the project. Greater weight will be given to bidders or proposers who have experience in the sector in question and with public/private partnerships;

ii the project can be successfully financed in conformity with the Program Guidelines, i.e., on a non or limited recourse basis with no sovereign financial guarantees of repayment;

iii the project can stand the rigorous test of compliance with all social and environmental impact guidelines;

iv the project can yield significant social, economic, and financial returns and provide a product or a service to users at the least cost possible and with acceptable terms and conditions;

v the project offers some intrinsically unique or valuable asset that benefits the country and consumers alike. Examples would include projects that provide higher levels of employment, address key environmental or acute infrastructure needs, intend to train a number of nationals over a given period of time and projects that re-invest in the human, financial, and technical resources of the country.

SIDI would endeavour to avoid taking longer than sixty days to evaluate solicited and unsolicited proposals, so that the private sector receives a determination in an expeditious and efficient manner.

8. LETTER OF INTENT (LOI)

8.1 Once proposals, solicited or unsolicited, are evaluated and projects are approved in principle, the next stage is to reach agreement between the Government and the bidders or proposers on the terms of issuance of LOI.

8.2 LOI confers on the project bidders or proposers, some degree of exclusivity in relation to the project for a period of time long enough to enable the sponsor to finalize the project proposal. LOI determines the period of exclusivity, spells out any changes to the original proposal that must be made in order to remain in compliance, and defines what technical inputs are required in order to reach project finalization and negotiation.

8.3 LOI provides the proposer and/or successful bidder with assurances, for a specific period of time, that the Government will not re-invite or accept any competing projects thereby penalizing entrepreneurship and risk. On the other hand, in cases where the proposer and/or successful bidder cannot comply with the terms of LOI or if negotiations are unsuccessful, LOI provides the Government with the right to pursue the project through the public bidding process.

8.4 In brief, LOI grants protection to the proposers or bidders against any violation of their intellectual and financial investment for a specified period of time, thereby rewarding initiative, originality, and creativity. It also provides the Government with an avenue to pursue projects in the event of non-compliance, non-performance and unfruitful negotiations.

9. PRE-QUALIFICATION CRITERIA AND MINIMUM STANDARDS

In all cases, bidders or proposers wishing to undertake infrastructure development in partnership with the Government must meet certain pre-qualification criteria.

9.1 Ownership

The bidders or proposers can be domestic or foreign or joint ventures and will be governed by the same regulations as other enterprises which qualify for concessions under the Board of Investment (BOI). However, before entering into any contract in Sri Lanka, a foreign venture should acquire legal status in Sri Lanka by either incorporating a company under the Companies Act of Sri Lanka or registering itself under Part xiii of that Act as a company incorporated outside Sri Lanka but having a place of business in Sri Lanka.

9.2 Experience or Track Record

The bidders or proposers must possess adequate experience in the sector in question as well as with projects structured and operated in this manner. Consortium arrangements will be evaluated on the basis of the individual and collective experience and expertise of the firms in question. Key personnel must also demonstrate experience in managing and implementing projects of this kind.

9.3 Financial Capability

In all successful public/private partnerships, financial stamina and strength of the bidders or proposers are key ingredients to project success. Successful bidders or proposers will demonstrate the ability and experience to structure and complete financial packages that are viable and are designed on a non-recourse or limited recourse basis. Evidence of financial capacity to mobilize domestic and foreign resources, debt and equity, will be a de rigueur element in the advancement of any project.

9.4 Minimum Standard and Specifications

All bidders and proposers must meet certain minimum standards regarding specifications and performance and the delivery of certain goods and services as determined by SIDI and the relevant line Ministries/agencies. In the case of solicited proposals, SIDI and the relevant line Ministries/agencies will outline the minimum standards and performance levels that successful bidders must meet.

10. ECONOMIC PARAMETERS

10.1 In order to evaluate all projects with uniformity and to provide sponsors with an adequate basis to develop financial and economic proposals, all bids will be evaluated on a present value basis. Pre-qualifying project sponsors must calculate their financial and economic rate of return with the following economic parameters in mind:

- i inflation and discounting rates;
- ii foreign exchange rates;
- iii maximum period of project construction;
- iv fixed term for project operation and collection of user fees;
- v adjustable tables to reflect changes in charges; and
- vi minimum period of repayment.

10.2 At this juncture, the Government programme on BOO/BOT projects will be guided by pre-qualifying projects and proposers who provide the proposal with the least cost basis and that profitability should not be the determining consideration. In this case, a higher profit/lower cost bid is preferable to a high cost/reasonable profit bid as long as the discounted value of revenues is lower and satisfies the required design and performance standards. A bid with the possibility of a good return for a lower cost infrastructure facility is preferred to a lower return/higher cost alternative.

11. BID DOCUMENTS

11.1 In the case of solicited projects, SIDI in cooperation with the relevant line Ministry/agency will prepare bid documents for the project to guide the bidder in preparing pre-qualification statements and bid proposals. These bid documents shall consist of the following:

- i Instructions to bidders;
- ii Project purpose and objective;
- iii Technical standards and specifications and minimum economic parameters;
- iv Statement of proposal requirements;
- v Environmental and social compliance assessment;
- vi Draft contract;
- vii Pre-qualification criteria and procedures;
- viii Bid evaluation criteria (and sectoral BEC as applicable).

12. BIDDING PROCEDURES

12.1 A pre-bid conference shall be conducted by SIDI at least sixty days before the deadline for the submission of bids. At this conference, potential bidders will have the opportunity to seek clarifications on the scope of work, bid documents, bid evaluation procedures, contract terms and conditions and any other non-proprietary information that may be required to submit high quality bids.

12.2 SIDI will be responsible for receiving and publicly opening the bids at the stipulated time and place and will evaluate all bids as to their conformity with the requisite standards, criteria, and prices.

13. AWARDS

13.1 Upon evaluation, SIDI and the relevant line Ministry/agency will recommend to the Cabinet for approval, the award of the contract to the bidder that combines low cost and most favourable technical, economic, and social value approach.

13.2 The Government reserves the right to reject any and all bids that are not in compliance with the interests of this program and accept any offer that is most advantageous to the Government. Moreover, if no bids are viewed to be in compliance, the bidding could be declared suspended.

14. PERFORMANCE BONDS AND BID BONDS

14.1 In submitting bids for projects, bidders are required to submit authentic bid bonds as specified in the bid documents, which serve to guarantee that the bidder, if selected, will enter into a contract with the Government, according to the terms and conditions of the tender.

14.2 In some cases, performance bonds will be required in order to ensure and guarantee compliance with meeting certain project milestones by the contractor throughout the life of the concessions. In other cases, performance will be governed by fluid arrangements, whereby penalties and rewards are contractually a part of meeting or failing to meet pre-determined project performance standards.

15. ALLOCATING RISKS AND RESPONSIBILITIES: INCENTIVES, CONCESSIONS AND OTHER FORMS OF SUPPORT BY THE GOVERNMENT

On a case by case basis, the Government is willing to provide the successful bidder or proposer with some or all of the following concessions and incentives with a view to providing high quality and low cost infrastructure to the public of the country:

15.1 Concessions and Incentives

15.1.1 In order to pursue BOO/BOT, or other techniques in the eligible sectors, the Government is willing to consider granting fiscal incentives, concessions supportive of of the unique nature of infrastructure investments, and/or franchises. In view of the compelling technical and financial characteristics, the long-term nature of BOO/BOT projects, and the variety of risk sharing involved between all parties, project companies may be eligible for a variety of incentives and concessions as determined by the contract. The length of the concession period will be determined by the characteristics of each individual project.

15.1.2 BOO/BOT projects, depending on the merits of each case, may be eligible for the following tax incentives and concessions which are to be negotiated and agreed with projects individually:

i Tax Holiday;
ii Concessionary rate of income tax based on turnover;

iii Exemption from income tax on dividends to non-resident shareholders;
iv Exemption from income tax on dividends to resident shareholders during tax holiday;
v Exemption from income tax on royalties;
vi Exemption from capital gains;
vii Exemption from customs duties, turnover tax and excise duties at point of importation in respect of project related goods for the exclusive use of the project; and
viii Others to be negotiated.

15.2 Performance Guarantees by Government

In order to ensure project viability, certain performances by Government agencies may be required. These include performance in the supply of goods or services, to grant certain licences, purchasing of certain goods or services, conversion or exchange of Rupees into convertible currency, and/or provision of any other necessary inputs vital to the success of the project. The Government of Sri Lanka will consider providing any or all of these performance guarantees only if they would facilitate the selection of viable least cost projects in the interest of the public good.

15.3 Financial or Equity Contributions

Depending on the nature of the project and the structuring of the security package to ensure project success, it may be in the interest of the public good as well as the project, to have the Government provide certain levels of financial support, direct or indirect, or equity participation in projects on a case by case basis.

15.4 Logistical or Physical Facilities to be Provided by the Government

In some cases the Project may require the Government of Sri Lanka to provide certain logistical/physical facilities or support to contribute to project success. This can include, but is not limited to rights of way and other servitudes, part of a physical structure, donation of certain land or assets, etc.

15.5 Approval of Designs

The Government will approve appropriate designs and plans prepared by bidders or proposers and/or other contractors, if SIDI and the relevant Line Ministry/Agency are satisfied with their conformity to program and project objectives.

15.6 Approval of Tolls/Fees/Tariffs/Charges, etc

The Government will approve all tolls and fees determined as fair and appropriate to project viability in accordance with the least cost/high profit concept of the bid award. Moreover, in recognition that long term arrangements require adjustments in fees and tolls, the Government will provide, in the bidding documents and contracts, a formula where adjustments to tolls, fees, charges, etc., can be instituted as required.

15.7 Enhancement of the Security Package

As noted above, all public/private projects must be undertaken with limited or no recourse to project lenders in the occurrence of project failure or abandonment. While, project risk allocation must be agreed to on a case by case basis, the Government will consider enhancing the security package provided to lenders/investors in order to realize viable projects and successful long term results. The Government, on a case by case basis, is prepared to enhance the security package by assuming or providing protection against certain risks such as:

- i Protection against force majeure;
- ii Protection against changes in tax regimes;
- iii Allow adjustments in tolls, charges, and fees and mitigate negative movements affecting such rates;
- iv Ensure convertibility of local currency and remittance of foreign exchange to cover imports, debt service, dividends and capital; and
- v Provide performance guarantees in concert with the performance guarantees provided by the private sector.

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