Policy Note Nº 9

"Development and Financing Public Investment through Public-Private Partnerships"

Center for Financial Stability

December 2007

Executive Summary

Argentina's economy has been growing over the past four years at annual rates of close to 9%. Sustaining the current process of economic expansion requires quantitative and qualitative improvements in investment. One of the main challenges for public policy in our country is to promote investment in the area of economic infrastructure and public services, which will expand existing capacity and reduce operating costs for the private sector.

The current system for developing public investment and infrastructure faces the need for: i) alternative sources of budget funding, given that the public budget is constrained by current expenditures; ii) improving the efficiency of mechanisms for design and implementation; and iii) increasing the levels of investment taking its composition into consideration.

This scenario results in the need to deepen the analysis of alternative instruments and methods of financing within a market framework. Therefore, the analysis of the possibilities offered by Public Private Partnerships (PPP) may be a policy objective for overcoming the aforementioned restrictions.

The objective of PPP is to outsource the production of a good or the provision of a service that would be traditionally provided by the public sector. Under this partnership, the goal is to spread the risks inherent to a project in an optimal fashion between the parties involved, by: i) previously defining by contract the final cost of the investment and of the operation of investment associated with delivering the service, ii) increasing the "value for money" linked to public sector spending; and iii) ensuring better service.

The form of PPP of global interest is that which includes contracts of Design-Build-Finance-Operate (DBFO). The basic concept of this scheme is the distribution of roles and responsibilities between the private

and public sectors in order to achieve adequate efficiency and quality in the delivery of a service to civil society. During the period of development, the private sector is responsible for designing and constructing the asset, financing the work, maintaining the asset and providing the services derived from it, without the public sector abandoning its responsibility for the general provision of that service (education, medical care, etc.).
It is necessary to clarify that a PPP scheme is only an option for implementing infrastructure projects and is not an appropriate solution in all cases. It is necessary to consider a series of economic, financial and legal factors that determine the advisability of implementing this arrangement: i) laws and legal frameworks that help or hinder the development of PPP and ii) the possibilities offered by the capital market. These aspects are developed in this paper.

In Argentina, the National Government established in 2005 a framework for promoting the development of different forms of PPP through: i) Decree No. 966/06 of the National Executive Power (PEN), which approved the Scheme for Private Initiative and aims to motivate individuals to participate in infrastructure development, and ii) Decree No. 967/06-PEN, which established the national PPP scheme aimed at developing infrastructure and services.

On the other hand, the National PPP Scheme, unlike the Scheme for Private Initiative, provides that the developer of infrastructure projects is the State. Such partnerships should be organized as corporations, trusts or under any other form suitable for financing through a public offer in the capital market.

Regarding the potential of capital markets in Argentina, there are various instruments for financing the development of infrastructure projects through PPPs: i) shares; ii) corporate bonds; and iii) financial trusts.

In general, Argentine stock and bond markets have little depth and liquidity compared to those of other emerging and developed economies. This could restrict the development of PPPs in our country. In this case, we stress the use of financial trusts as an alternative source of fresh funds, particularly after the crisis of 2001. The main advantage of this type of instrument is the mitigation of insolvency risk of the issuer since issued securities are backed by the portfolio of loans and guarantees incorporated in the process.

The North-South Gas Pipeline is an antecedent to the development of infrastructure through a financial trust with public offering in the capital market - Gas Financial Trust I. Its objective was to address investment in transportation and gas distribution according to the terms established by Decree 180/04-P and Resolution

185/04-Ministry of Federal Planning, Public Investment and Services. Private financial trusts were established and their trusted assets were constituted through a trust fund formed by tariff charges, resources from special credit programs with international organizations, and contributions from direct beneficiaries. The operating companies were *Transportadora de Gas del Norte* and *Transportadora de Gas del Sur*. The program consisted of a financial trust in which the securities were placed in the capital market in order to allow private companies, international organizations and the National State, that funded the first trust, to transfer the investment to the market.

In December 2006, $630,000,000 worth of Debt Securities was placed in the capital markets. The result was so positive that offers totaled $1.269 million. Institutional investors held tenders worth more than double the amount bid. While pension fund managers held 65% of tenders, they were left with only 35% of the amount awarded, while 52% was taken by foreign investors.

Below is a diagnostic summary of issues that address the implementation of PPPs along with a set of recommendations for correcting and/or preventing existing or potential problems, promoting the development of this system for financing and implementing public infrastructure projects in our country.

Diagnosis	**Recommendation**
An inadequate level of investment relative to GDP in Argentina for sustaining growth rates that would improve national income per capita. At least a third of total investment is not productive. While it has grown in recent years, the performance of public investment is less than that of other economies.	Deepen the process of investment growth to achieve the desired objectives and improve the quality of its composition. This is achieved by adopting a sustainable macroeconomic program accompanied by a plan for long-term public investment, legal strengthening, and adopting best practices in regulatory issues for public services.
Although fiscal results had improved, public budgets are largely determined by the structure of current expenditures at the expense of spending on public direct investment (PDI).	Find alternatives to the usual sources of budget financing to address investment needs. Their viability will remain contingent on the government's commitment to continue to strengthen its fiscal discipline, on which their ability to pay depends.
The PDI recorded the lowest performance levels relative to other expenditures (transfers of capital and consumption).	Make mechanisms for developing public investment more efficient.
Rationing of government credit, which limits its ability	PPP is an alternative form of public investment that

to implement projects.	uses not only funding from the private sector, but also takes advantage of its capacity to manage (higher user fees, investment consistent with requirements for effective management and maintenance) within a framework for a long-term partnership.
In conventional contracting schemes between the private and public sectors there are delays and cost overruns, which in some cases reach 40% of the initial contracted cost. As a result, increases in that order are applied to the evaluation of this type of contract.	In PPP contracts, the payment made by the public sector to the private is against service delivery or the availability of assets agreed upon initially.
The success of PPP is not guaranteed because it depends on the correct identification of investment needs and project evaluation, as well as a clear institutional political commitment.	The guaranteed success of PPP requires: • Selecting a sector where there are relevant and adaptable international experiences. • Encouraging projects that have an adequate investment scale and confirmed private sector interest, which can be used for market research. • Analyzing the final cost of the PPP approach compared to a traditional contracting and accounting treatment of the final project (public debt, investment or current expenditure). The PPP method will be strengthened not only by a strong government commitment, but by the possession of financial reserves sufficient for meeting implied future obligations.
International experience shows that the identification, development and implementation of the most advanced type of PPP require the early development of authorized national legislative and regulatory structures. It is essential to establish regulations specific to each area such that private sector participation may be possible. The effectiveness of these schemes requires the development of institutional structures for monitoring and regulating private operators.	The regulatory process should address these key areas: • The general legal framework in which the public sector operates. • The transparency and reliability of its relations with the private sector. • The control and proper use of public funds. • The creation of a legal and procedural framework for bidding and negotiation, and their orderly administration. • The need to design institutional structures for monitoring and regulating private

	operators.
PPP is based on the concept that a group, organized as a consortium, is in charge of the DBFO project. The State or the users pay for the service performed (payment for initial capital invested and its return, plus project maintenance costs) during the period of operation rather than upon the delivery of results. The financial arrangements for PPP projects call for adapting funding techniques based on limited warranty schemes to be used in non-traditional sectors such as health, education, security. There are few examples within the region of schemes with sophisticated contracting and financing.	PPP schemes must have the following characteristics: • A specific legal and economic entity must isolate the PPP risk of economic entities invested in it, as well as the state, and must be subject to corresponding supervision by the state. • Derivation of the constructing and operating risks of separate companies. • High level of leveraging. • Creation of mechanisms for credit improvement through the participation of monolines (specialized insurers) and specific collateral. • Channeling funding through bonds. • Role of rating agencies for strengthening bond issues.
The level of sophistication of the contractual and financial structures considered in the implementation of a PPP project depends largely on the capacity of local capital markets. Many countries in the region, among them Argentina, have shallow and illiquid capital markets, affecting stock as well as bond markets.	The development of domestic capital markets is crucial step towards creating a sustainable supply of capital for investment. This is achieved by increasing the variety of instruments potentially available, their depth in terms of amounts and deadlines - especially in local currency, developing institutional investors and hedge markets, adopting principles of corporate governance, regulation, tax treatment, and supervision consistent with best practices. The financing structures for PPP projects should respond preferentially to: • Long-term financing taking into account the total life of the grant. • Amortization scheme adapted to the project's cash flow. • Maximum financing in local currency to reduce exchange rate risks. • Fixed-rate financing at the extent possible. • Understanding and acceptance of project risk by investors. • Preference for schemes with limited

	collateral.
The case of Argentina highlights the rise of financial trusts as instruments of financing. However, public trusts and public trust funds are *sui generis* in their characteristics, in that the settlor and the trustee do not necessarily differ. In some cases these pseudo trusts could distort and discredit the use of financial trusts as a useful financing mechanism.	Render a law specific to public trust funds, which will determine the objective criteria for their establishment and control, and clearly differentiate the settlor from the trustee and specify their respective responsibilities and tax treatment.
Public trusts have extra-budgetary features because the Budget of the National Administration, validated by the Financial Administration Act No. 24.156/92, does not include public enterprises or trust funds. This has resulted in a lack of control over the implementation of these funds. The Law of Fiscal Solvency No. 25.152/99 establishes that financial flows generated by the formation and use of trust funds shall be included in the Budget Act, and states that the creation of trust funds that are fully or partially integrated with government assets and/or funds would require legal ratification. Nevertheless, there are currently a number of trusts generated from administrative decisions that are excluded from budget annexes.	There is a highlighted need to create mechanisms for rendering accounts to ensure transparency in the use of all public trust funds through periodic public reports.
In terms of taxation, financial trusts advanced significantly, but not with respect to public trusts and "ordinary" trusts (collateral, property, administrative, etc.). To illustrate some of the controversies caused by the limited regulation of these types of trusts, we address the examples of the tax on Bank Debits and Credits (BDC) and the Minimum Presumed Income (MPI) tax. Because the trust is a private legal entity and is itself subject to tax, the entire cash flow is subject to BDC tax at a rate of 1.2%. As per the MPI tax, collateral trusts are subject at a rate of 1% of the trust's asset value regardless of the trust's economic performance. BDC treatment has led to gray areas in the case of public funds. Relying on the independence of trust	Advance tax legislation to create a specific framework for public and "ordinary" trusts.

assets, tax authorities claim that the exemption enjoyed by the state is nontransferable to current accounts held by these types of trusts. Nevertheless, because these trusts are tools for carrying out State functions, there are opinions in favor of treating these arrangements as exempt.	