

## Advance Funding for Infrastructure PPPs

### Cautions from Two Road Projects in Peru

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Public private partnerships (PPPs) for infrastructure projects require substantial initial funding that private operators in developing countries can rarely obtain in the domestic market. In 2005, in the context of two important road projects, the government of Peru introduced a financial innovation with two goals: improve the access of the projects' concessionaires to the international financial markets and book government support as an operating expense rather than debt. The innovations offered distinct advantages to the concessionaires while imposing a significant burden on the government, which has since stopped using them. Nonetheless, the new approach can still be useful in carefully limited instances to help solve the funding problem.

**\$826 million**

**Capital raised in the international financial markets in 2005-06 by concessionaires for two road projects in Peru**

### Public Financing for Transport PPPs—the PAO

Structural reforms initiated in Peru in the early 1990's led to a period of sustained economic growth in which the government turned to PPPs to generate investments in its airports, sea terminals, and roads. The government provided financial support to the PPPs using, among other instruments, Annual Payments for Works, or PAOs (Pago Anual por Obras). The PAO is a government obligation that, upon successful completion of the project, it will make a fixed number of equal annual payments to the concessionaire to cover construction costs. PAOs were considered to be sovereign debt.

### The Innovation—the Unconditional CRPAO

In 2005, the government awarded PPP contracts for two key road projects—IIRSA Norte, linking the coastal and Amazonian ports in the north of Peru;

and a large portion of IIRSA Sur, connecting Peru and Brazil.<sup>1</sup> To increase the attractiveness of these projects to the private sector and also reduce their impact on the public debt, the government took a new approach that would (1) give the projects' private partners greater access to the financial markets and (2) account for government obligations as operating expenses rather than as increases in sovereign debt.

Instead of providing a stream of payments at the end of a project, the government split the road projects into sections. Satisfactory completion of a segment had to be certified by a government regulator, after which the concessionaire received the right to a stream of annual payments for that segment.

That right to a payment stream was satisfied with a series of government obligations called Certificates of Recognition of Rights of Annual Payment for Works, or CRPAOs (Certificados de Reconocimiento de Derechos del Pago Anual por Obras.).

<sup>1</sup> Neither project involved World Bank financing.

## Critical Features of the CRPAOs

The CRPAO payment obligation was crafted with four characteristics designed to facilitate market access: they were transferable, unconditional, equal in rank to any other similar government obligation, and subject to cross-default.

First, the CRPAOs were freely transferrable, allowing the concessionaire to sell them or issue securities backed by the payment rights embodied in them. Thus, as work on the road projects moved forward, CRPAOs gave the concessionaire access to private sector funds required to finance additional sections of the project and thereby reduced the initial amount of capital that the concessionaire needed to raise.

Second, the payment rights embodied in the CRPAOs were unconditional—for example, they did not depend on construction of further sections of the project, and they were not affected by any subsequent discovery of a deficiency in the completed section. In short, once it issued a CRPAO, the government could not contest it.

Third, the CRPAO's claim on the government was equal in rank with that of any other CRPAO or similar instruments. Therefore, if the government issued a similar instrument but with stronger payment rights, those rights would also apply to all previously issued CRPAOs.

Fourth, CRPAOs were subject to cross-default: if the government defaulted on any CRPAO, the breach would be considered a default on all other CRPAOs (although payments could not be accelerated beyond the fiscal year of the default).

The CRPAOs were also crafted with the objective of shielding the government's credit rating: the two road concession agreements defined the CRPAOs as current expenses of the government's budget and specified that they were not a sovereign debt of the Republic of Peru.

## Effects of the Innovation

The CRPAOs provided clear advantages to the private concessionaires: much less need for initial financing, strong payment guarantees, and reduced risk arising from nonperformance (the regulator's

approval could not be overturned by any subsequent discovery of flaws in performance).

For the government, the CRPAOs were supposed to confer two distinct benefits: (1) generate more competition among bidders for PPP projects by making it easier for private parties to reach financial closure and (2) enable the government to provide financial support to PPPs without adding to the national debt.

In the case of the IIRSA Norte, the CRPAOs had no effect on the bidding because they were fashioned during negotiations with the winning bidder. But they helped the winner mobilize full financing even before the start of construction, backing the issuance of \$213 million of obligations on the New York stock exchange. In the subsequent case of the IIRSA Sur, the number of bids did not appreciably increase, but the CRPAOs enabled the winning bidder to raise \$613 million.

The effort to use the CRPAOs to shield the government's debt did not succeed. In the course of its Article IV consultation with Peru in 2006, the International Monetary Fund found that the CRPAOs were debt instruments. The government then refrained from using CRPAOs on any other projects because of the priority it assigned to reducing public debt.

## Lessons Learned

The financial power generated by the CRPAOs came at the cost of heightening the construction risks borne by the government. In addition, use of the CRPAOs for some projects might have made other projects less attractive for private operators given the CRPAOs' strong payment and cross-default provisions. Finally, use of the CRPAOs could not avoid adding to the national debt.

The misallocation of construction risks is arguably the most important drawback of the CRPAOs. Because of it, CRPAOs should be used only in rather limited, well-circumscribed circumstances, for example when local financial markets are undeveloped, and mobilizing the required financing might prove particularly challenging because government commitments lack credibility with private investors. The CRPAOs should thus be only a temporary device used to establish or re-establish confidence, not a permanent measure.

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