Chapter 5

Project financing in the economy

Project financing and the privatization agenda

By the early 1980s, project finance became a clearly identifiable profitable subsector of the banking world's revenue streams. From airport projects and nuclear power projects in Iraq, copper extraction in Brazil, to extracting oil and gas in Cameroon, and basing petrochemical facilities in developing countries with nascent legal codes, banks were lending billions of dollars to finance the extraction of natural resources from developing countries.

Two key factors have fuelled the substantial increase in the use of project financing techniques over the past two decades.

- First, the developed economies' tremendous demand for cheap energy and mineral resources, and the meeting of such demand by exploiting natural resources in poor countries with weak governments, typically in diverse and remote geographical areas.
- Second, the massive transfer of capital, predominantly debt capital, to the poor countries (euphemistically known as emerging markets). An undoubted factor here is that these countries often have only nascent legal systems, which is an incentive to multinational corporations to abandon less profitable economic activities in home countries that are more greatly regulated.

Until the early 1970s, much of the financing of infrastructure development in emerging countries came from government sources, such as the host country government, multilateral institutions and export financing agencies. The shift towards using private sources of capital is the logical result of the ideological agenda underpinning privatization and the rollback of the state on the presumption that it is an impediment to progress and the will of human beings as manifested in elections, and public policy is an impediment to economic efficiency. We recall US ideologue Grover Norquist's words on the role of the state, who says 'I don't want to abolish government. I simply want to reduce it to the size where I can drag it into the bathroom and drown it in the bathtub' (http://www.atr.org/atrnews/052501npr.html). This provides the backdrop to explain the privatization agenda, which depends on project finance techniques.

Economic models fostered by the IMF and credit rating agencies, both nominally appendages of the US politico-economic system, meant that there was an increasing pressure to rely on private sources of capital. Moreover, the issues of sovereign risk as perceived by the US credit rating agencies who control access to the international financial markets meant that states were reluctant to tap the financial markets for fear of having their credit ratings lowered and access to financial capital made difficult due to increased costs or lowered credit ratings. The granting of, or level of credit ratings, moreover, appears at times to be linked to the various peregrinations of US foreign policy goals.

Geoff Anderson, in 'Standard bearers for the markets: international credit rating agencies, new actors in politics and public policy in the Australian states' (PhD, Flinders University, in progress) argues that this has significant implications for the development of public policy and the management task within the public sector. It also gives rise to a further set of issues surrounding the relationship between governments and the rating agencies. In particular, how the threat of a downgrade or promise of an upgrade has been used by governments as part of their political communication strategy both externally to the electorate and internally to the public sector. And what of the agencies themselves, how valid is their approach and methodology?

Anderson notes that the use of comments by rating agencies to pursue a particular political agenda is discussed by Hayward and Salvaris (1994) in their article 'Rating the states: credit rating agencies and the Australian state governments' (*Journal of Australian Political Economy*, vol. 34, no. 16), which also raises some questions concerning the agencies' methodology. Andrew Fight's *The Ratings Game* (Chichester: John Wiley and Sons, 2001) has a more extended, and damning, critique of the way the agencies operate. The role of ratings in shaping the 'image' of a government is discussed by Michael Kunczik (2002) in 'News media, images of nations and the flow of international capital with special reference to the role of rating agencies', *Journal of International Communication*, 8, no. 1.

While the trade press attributes this trend to the belief that the private sector is 'more efficient than multilateral institutions and public entities in infrastructure development' (without defining what 'efficient' means or providing proof of same), the reality is that it has been a concerted 20 year campaign by business-politico partners in partnership with credit rating agencies to impose models leading to the dismantling of the state and state legislation block by block and by all means possible, whether media, regulatory, competition legislation or the financial yardsticks used by US appointed arbiters of the international financial markets, and apply pressures to espouse economic mechanisms developed in the USA and fostered by the US business-politico network. Very little of the arguments espousing the efficiency of the private sector are grounded in economic facts but they are presented as such in a media and financial press that exhibits the objectivity and investigative acumen of the '*Völkischer Beobachter*'.

With the penalization of the state in getting involved in infrastructure projects, especially poor states with weak and typically non-elected governments, it is hardly surprising that they try to avoid the accusations of state interference in the economy by conforming to the established status quo and relying on more expensive and demanding private capital.

Indeed, this heralds the weakening of national sovereignty and its subservience to the exigencies of transnational private capital, with its short term commercial focus rather than any electoral mandate. Juxtaposing such short termism (indeed, the banks are subject to this short termism via the rating and share analysts who issue various pronouncements on the share price and creditworthiness of these banks) upon infrastructure projects of a long term nature obviously leads to a skewed appreciation of what properly constitutes long term sustainable development.

It also leads to notable fiascos such as the California energy collapse fostered by Enron, the privatization of Britain's third world rail network, or deficit-ridden Eurotunnel. That, however, is another story. The key point is that the confluence of these events means that there has been a shift in financing from the state to the private sector.

It is fair to say that this shift is not the result of careful consideration or performance assessment but rather is ideological in nature, coercive in its implementation and rapacious in its distribution of lucrative fees to consultants, accountants, lawyers, bankers and credit rating agencies, who present themselves as the agents of economic efficiency.

In the meantime, if natality rates fall, morality rates increase, communities and transport systems collapse and incidents of deteriorating hygiene and epidemics manifest themselves, this does not figure in the corporate media like CNN, or Bloomberg as it is irrelevant, if not detrimental to the propagation of an upbeat soundbite. For the apparatchiks of newly constituted states, power and the maintenance of attendant privileges, all too often fuelled by bribes and the transfusion of foreign aid projects, are more important than addressing issues of public dissatisfaction, especially when no electoral mandate is necessary to maintain power. Parties objecting to the imposition of such agendas are given meaningless labels such as 'anti-democratic' or 'terrorist'.

Newly constituted states in Central Asia, operating in an imploded vacuum with no inherited state sector, are natural candidates for being dragooned to this new world order, presented to a disenfranchised populace as 'progress' from the previous 'inefficient' systems.

The strongman of oil-rich Azerbaijan, straddling the strategic Caspian to Mediterranean BTC (Baku Tbilisi Ceyhan) pipeline route, and the

US-groomed English-speaking president of Georgia (where the pipeline continues its meanderings to the Mediterranean) provide an interesting illustration of how to establish the appropriate conditions precedent for a project financing. In 2003, Mr Aliyev, son of the deceased octogenarian former president of Azerbaijan, squeaked past the post in a contested election which US observers deemed did not warrant a vote recount since Mr Aliyev Jr did not 'request' one. In neighbouring Georgia, by contrast, the 2003 election irregularities resulting in the re-election of another octogenarian, Eduard Shevardnadze, to the Presidency were rapidly spotted by US observers and new elections 'arranged under international election monitors' since this was an amenable pretext to legally oust the recalcitrant apparatchik in favour of the younger and anti-Russian US protégé Saaskavili.

At the time of going to press, we have again seen the application of the 'democracy franchization process' in Ukraine, where a media savvy opposition and marketing apparatus contested the legitimacy of the 2004 elections (coincidentally supporting the US agenda of bringing Central Asian oil to market bypassing Russia) funded by US aid money to the tune of US$ 65 million (Associated Press, 11 December 2004).

The developed world's incessant appetite for raw materials such as oil, combined with the emergence of China as a key energy consumer for example, offers the prospect of even more brutal competition and manipulation of governments for these resources. The Iraqi geopolitical projects of President George Bush against the backdrop of 'peak oil' set the tone for the future.

As the project finance market matures, so the number of refinancings of project loans increases. This can be due to several reasons. First is that the project financing occurs at the early stage of the project when the risk is higher. As projects come on stream and the risk profile decreases this may warrant negotiating a new refinancing facility in order to lower funding costs. Secondly, the financial restrictions may be less restrictive than the risk control measures incorporated in the initial project finance documentation. These restrictions may be in financial ratio terms as well as in the ability of the now operating project company to enter into new business arrangements. Finally, the banks may wish to modify their commitments based upon a reassessment of the risk and remuneration of the on-stream project.

Competition between banks for this lucrative business is increasing. Traditionally, private commercial banks have been the largest source of funds. New banks, however, are targeting this sector and developing new relationships in order to generate loan business. These newcomers (including quasi-sovereign banks) are naturally willing to accept greater risks than private commercial banks in an effort to break into the market. This competition has led to thinner lending margins, less stringent collateral requirements, more generous maturity schedules and possibly greater credit risk.

The private sector lenders naturally take a dim view of these gatecrashers, and claim that this unwelcome competition threatens the stability of the market. A more likely explanation is that they resent the newcomers upsetting a cartelized market with well-established pecking orders.

The project finance environment will be meeting new ambiguities and challenges. As the botched British Rail privatization and Enron meltdown illustrate, continuing to rely on the private sector to deliver on mission critical infrastructural requirements in order to satisfy ideological imperatives is rapidly becoming an expensive indulgence with, indeed, little value added, since no coherent long term development is possible. Extending the Private Finance Initiative (PFI) to every appendage of the state such as schools, hospitals and prisons will not only run out of steam in a limited market but rapidly generate its own obvious set of contradictions as it becomes evident the private sector is no better equipped to run reliable mission-critical services than the state, and indeed possibly worse. Mentioning the state of the British railways and rail maintenance for example rapidly brings to mind the word that no one dares utter – nationalization.

Pursuing ideological imperatives in the face of contradicting evidence can only be a short term phenomenon since the resultant logical contortions will become increasingly evident to all and foster its own set of contradictions.

Looking abroad, the current volatile environment of franchised democratic movements, crusades and jihads continues to cloud the political and country risk concerns of lenders and render risk assessment of new transactions difficult. Sustaining market demand for such high risk loans remains a speculative endeavour at best, while, with all eyes are now looking covetously to the Gulf and Iraq, the long term realities may impose their own order.

Project finance tables

The following tables illustrate the positioning of project financing as a component of overall bank lending.

Table 5.1 is interesting in that it conforms that the main industry sectors for borrowing are the financial sector (typically refinancing existing debts into more advantageous structures) and the ‘big 4’ of infrastructure categories (power, telecommunications, oil and gas, and transportation). The next major sectors are domestic consumer-driven retail trades and construction activity.

Tables 5.2–5.4 are all broadly similar with the observations made in Table 5.1, with the exception that Computers figure prominently in Asia Pacific, no doubt driven by the fact that this geographic zone is the major manufacturing centre for IT equipment. Despite the fact that much computer equipment features the logos of well-known Western companies, the reality is that the components are manufactured to specifications by Asian manufacturers, who require considerable investment in plant and infrastructure.

The UK PFI model

The Private Finance Initiative (PFI) was launched by the UK government in 1992 as another step in the dismantling of the state, seen as an impediment to economic efficiency and unfettered speculation since it

Table 5.1 Industry volume table for global syndicated loans in 2003

	Total amt (US$ m)	*No.*
Finance	283 892	596
Utility and power	178 139	361
Telecommunications	148 113	229
Oil and gas	121 299	348
Retail	93 053	269
Transportation	91 488	285
Real estate	88 030	418
Automobile	86 962	136
Construction/building	71 699	308
Food and beverage	69 765	214
Healthcare	68 950	242
Insurance	66 046	110
Computers	62 558	287
Consumer products	58 349	193
Services	51 027	206
Leisure and recreation	44 663	110
Metal and steel	43 346	148
Chemicals	42 130	161
Publishing	37 589	72
Dining and lodging	32 949	76
Forestry and paper	29 489	79
Holding companies	27 415	55
Government	19 813	54
Machinery	19 569	103
Mining	18 781	68
Aerospace/aircraft	16 668	20
Defence and aerospace	16 285	19
Other	13 340	29
Textile	10 521	84
Agribusiness	6 142	29
Unclassified	561	5
Total	1 918 631	5 311

Source: Dealogic, 2003

is not sufficiently under the control of private capital. By 1996, more than 1000 potential projects, with an total value of some GBP 27 billion, had been 'identified' in the UK, a veritable bonanza for project finance banks, lawyers, consultants, PR firms, advertising firms, corporate logo

Table 5.2 Industry volume table for US syndicated loans in 2003

	Total amt (US$ m)	*No.*
Finance	168 074	247
Utility and power	82 862	184
Oil and gas	73 783	216
Telecommunications	65 376	104
Retail	53 987	154
Healthcare	51 649	190
Real estate	44 768	252
Food and beverage	43 159	111
Insurance	42 061	75
Consumer products	38 372	111
Computers	34 126	114
Automobile	30 289	68
Leisure and recreation	29 951	75
Services	24 942	139
Construction/building	23 839	142
Transportation	23 666	83
Chemicals	19 605	65
Metal and steel	16 927	67
Dining and lodging	16 226	45
Machinery	15 199	50
Publishing	14 542	34
Forestry and paper	13 930	37
Defence and aerospace	11 000	13
Holding companies	9 205	19
Textile	7 677	47
Aerospace/aircraft	6 848	10
Government	5 535	10
Other	4 842	14
Mining	4 841	21
Agribusiness	3 159	15
Unclassified	320	2
Total	980 757	2 712

Source: Dealogic, 2003

designers, specialists and other players. The initiative grew from the idea that private contractors should not only build infrastructure but also be responsible for maintaining and servicing it since governments are, in the PFI *weltanschauungen* it seems, ineffectively and inefficiently staffed.

Table 5.3 Industry volume table for EMEA syndicated loans in 2003

	Total amt (US$ m)	*No.*
Finance	77 660	208
Utility and power	72 070	102
Telecommunications	68 602	60
Transportation	49 086	93
Automobile	45 740	30
Construction/building	38 537	77
Retail	31 436	53
Real estate	30 859	97
Oil and gas	29 084	69
Services	20 993	36
Publishing	19 050	24
Food and beverage	17 174	44
Dining and lodging	16 122	21
Insurance	15 637	19
Chemicals	14 356	38
Metal and steel	14 223	31
Healthcare	13 710	29
Leisure and recreation	12 483	18
Consumer products	11 177	37
Forestry and paper	10 059	19
Mining	8 516	19
Other	8 288	9
Holding companies	7 580	19
Computers	7 224	29
Government	6 256	27
Defence and aerospace	5 236	5
Aerospace/aircraft	3 651	4
Machinery	1 873	11
Textile	1 443	14
Agribusiness	1 350	7
Unclassified	223	2
Total	659 699	1 251

Source: Dealogic, 2003

The thinking was that the subsequent outsourcing of the responsibility to maintain public infrastructure to the private sector would be another welcome reduction in the role of elected governments to provide services in favour of private sector entities whose statutes would specifically

Table 5.4 Industry volume table for Asia–Pacific syndicated loans in 2003

	Total amount (US$ m)	*No.*
Finance	26 733	121
Computers	19 636	139
Utility and power	17 654	54
Transportation	14 478	94
Real estate	12 208	67
Telecommunications	11 297	48
Holding companies	9575	12
Automobile	9274	32
Construction/building	8553	86
Consumer products	8144	40
Oil and gas	6851	36
Chemicals	6263	46
Metal and steel	5833	35
Food and beverage	5658	43
Retail	5579	52
Services	4792	29
Forestry and paper	4103	18
Healthcare	3591	23
Mining	2671	19
Machinery	2423	41
Government	2264	9
Leisure and recreation	2154	16
Insurance	1988	1
Agribusiness	1633	7
Publishing	1473	9
Textile	1360	22
Dining and lodging	525	9
Other	200	5
Defence and aerospace	49	1
Unclassified	18	1
Aerospace/aircraft	0	0
Total	196 980	1 114

Source: Dealogic, 2003

require them to be run in accordance with profit-driven motives. Thus the scenario arose in which the management of a particular road, hospital, building, railway line or prison might motivate the builder to build it as cheaply as possible, charge the state the maximum for the service and expend the minimal financial resources required to maintain the facility in an effort to maximize profitability and garner favourable stockbroker share recommendations. Whether the state should abdicate its responsibility for the fostering of a transport, health and educational infrastructure in favour of entities whose statutes make it illegal for them to be run on anything other than the profit principle gives rise to concerned debate.

Parties to a typical PFI transaction are:

- **Treasury** The Treasury funds PFI projects and its officials are responsible for 'policy developments'.
- **Private Finance Panel and 4Ps** PFI for central government projects is promoted by the Private Finance Panel (PFP), a quasi-governmental body funded by the Treasury, and PFI for local authorities by the Public Private Partnership Panel (the 4Ps).
- **Government agency** A PFI project can fall under the auspices of either a central government department, a local government body that derives its authority from central government, or a quasi-governmental body such as the National Health Service.
- **Project company or contractor** A number of private sector companies will form a consortium and set up a project company or contractor, usually a special purpose vehicle, to tender for the PFI transaction.
- **Funders** Most of the funding in UK PFI transactions has come from banks providing loan facilities.

The theory is that, after a period of the contractor managing the asset (so as to gain a return on their capital investment), the asset is returned to the public sector. Most PFI contracts are of long term duration, however, and signed UK projects range from 7 to 99 years, meaning that the problem of managing what will then be ageing and crumbling infrastructure will be well past the time horizon of the elected officials who implemented these schemes, and will thus be someone else's problem.