

# Financing infrastructure services in India

The IDFC in India was set up to lead private capital to commercially viable infrastructure projects in India. Nasser Munjee is at the helm.

The existing conditions and the institutional forms we have developed for infrastructure services in India in recent years are defined in the belief that a vast majority of consumers of services have affordability constraints, and that these services must be provided at lower than marginal cost, cross-subsidised by other commercial consumers. This is certainly true of power, telecom, water and transport services. As the demand for services increases, there is rarely enough capital for maintenance, let alone for new capital expenditure, resulting in the continuous deterioration of service quality standards.

On the other hand, with rising commercial tariffs, substitution effects lead to static or less than optimal growth of network services (rail to road, captive power plants etc.), leading to ever increasing demand-supply gaps and impacting the capacity of the system to generate surplus for new investment.

The Infrastructure Development Finance Company (IDFC) is strongly of the view that we need to develop proactively a new approach that sequentially and humanely breaks this cycle through private participation and a greater degree of competition.

The process itself will require very different framework conditions, which define not only the end objectives but also the methods by which they will be achieved. The essence of the new approach will involve three key constituents – producers, investors and consumers. In particular, the consumers will play a pivotal role in the definition of a new system, as they will in the end define the quality of service desired and will also underwrite the cost of service provision.

The new can never be created without

some impact on the old. Over the years we have developed major infrastructure networks designed to serve users; these have, over time, transformed themselves partially into social security systems for the large number of employees that now characterise them. Poor quality services, sometimes costing millions to consumers and the economy, are continuing to be tolerated because we have not worked out a system of compensation to those who might be affected by reforms.

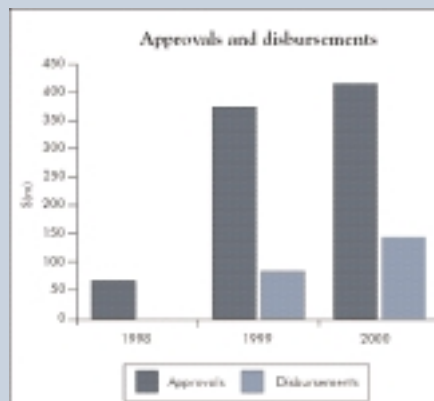
Reforms will require restructuring to ensure efficient services to consumers at competitive costs. Too often we opt for the second or third best options simply because the legislative issues involved in alternative – and more appropriate – options are more difficult.

IDFC is committed to investing substantial financial and human resources to develop the conditions which will make infrastructure development occur in the Indian context. We will require policy decisions which help us break out of the old paradigm that we have been so used to operating within, and, boldly and courageously, replace it, with a new



Nasser Munjee

FIGURE 1



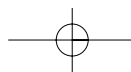
one; one that is more relevant to our time.

The problems posed by underdeveloped infrastructure networks and services cannot be addressed piecemeal – they need clearly established principles of policy. IDFC is helping to develop these new framework conditions which will prove central to any sustainable success of an infrastructure development initiative.

IDFC was established in 1997 with a mission to:

- lead private capital to commercially viable infrastructure projects;
- provide a strong policy advisory role to government to meet this objective; and
- develop and strengthen the connectivity of infrastructure projects to markets and institutions.

IDFC completed two full years of operations in March, 2000. Since inception, it has approved financial assistance to 34 projects aggregating \$854m. Of this, disbursements including guarantee commitments were made to 12 projects aggregating \$226m. At the end of the 1999/2000 financial



year, IDFC had approved financial assistance to 20 projects aggregating \$415m. Disbursements during the year were \$143m to 11 projects.

IDFC also broadened its initial focus of power, roads, ports and telecommunications into a broader framework of energy, information technology, integrated transportation and urban infrastructure.

### **Energy**

The energy sector continues to suffer from a hangover of the Indian public sector, with only scattered and minuscule initiatives from the private sector. Well-defined and stringent public-private partnerships need to be created in this area if it is to be successful in the medium term. The problems in respect to infrastructure finance in energy relate to the stand-off between public and private sectors.

While hard contractual relationships have been defined to tackle some of the issues between private and public sectors, weak contractual arrangements persist within the public sector itself. Unless the latter are overcome, the former has only a slim chance of success.

IDFC has been actively working with progressive state governments in planning for reform initiatives in respect of the policy framework governing the power sector. IDFC played a pivotal role in the preparation of the report of the government of Karnataka's high level committee on escrow cover to independent power projects (IPPs). On the regulatory front, IDFC has been actively interacting with and responding to documents released by the Central Electricity Regulatory Commission (CERC) and various state electricity regulatory commissions.

IDFC believes that its multi-pronged and focused approaches towards reforming the power sector would ultimately translate into desired investment opportunities.

### **Telecoms and IT**

IDFC has recognised acquisition financing resulting in consolidation of operations in cellular services as a new financing avenue for the next few years. In the financial year 1999/2000, assistance was approved for acquisition of

### **Subordinate debt and mezzanine finance**

Subordinate debt comprises a third tier in a company's capital structure as these securities combine the financial characteristics of debt instruments with those of equity in varying proportions. The key parameters to judge subordinate debt would be seniority of claim on cash flows; seniority of collateral claim/recourse on assets in case of liquidation; maturity structure/repayment flexibility; coupon structure/repayment flexibility; and, *inter se* agreement between subordinate debt provider and the senior debt provider. The structure of the instrument provides advantages to all the participants viz sponsors (equity providers), senior lenders and subordinate debt providers. In the area of project finance, subordinate debt can be used to finance the cost of the project, cost overruns and working capital. IDFC has considered the concept of subordinate debt in BSES Kerala Power Limited, a power utility in Kerala. ■

cellular licencees operating in two circles and one metro circle by a leading cellular service provider in a consolidation process.

This represented the first major acquisition financing in the Indian telecom industry. IDFC also provided project finance assistance to a cellular operator in the lucrative metro circle. The situation amongst fixed line service providers (FSPs) was, however, not as satisfactory and business models were yet to be established. Only three out of eight licencees commenced operations, and two of the licencees are yet to achieve financial closure. Certain critical issues such as the Telecom Regulatory Authority of India (TRAI's) recommendations on revenue sharing, tariff rebalancing, access deficit and universal service obligation levy are yet to be resolved.

### **Integrated transportation**

In the roads sub-sector, the model concession agreement (MCA) for small road projects prepared by IDFC was

approved and circulated by the Ministry of Surface Transport (MoST) to all state public works departments (PWDs). Further, the concession agreement for the Jaipur-Kishengarh capacity augmentation project, was finalised. This would be considered a model agreement for the building of four or six lanes on a National Highways' projects to be developed on a direct toll format. IDFC is providing advisory services to the National Highways Authority of India (NHAI) and some of its projects, which includes development of model concession agreements – one based on an annuity concept and another on shadow tolling.

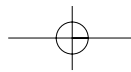
In ports MoST approved and adopted IDFC's recommendations on the entry and bid evaluation criteria for private sector projects in major ports. IDFC also prepared a process outline for corporatisation of the Ennore port – the first major port in the country to be corporatised. IDFC also provided advisory assistance to various project sponsors.

### **Urban infrastructure**

Of the various urban services, IDFC has focused on water and wastewater services, because of the potential for improvement in coverage and quality of service. The company is playing a key role in the committee for operation and maintenance of rural and urban water supply schemes, constituted by the government of Maharashtra. The committee would *inter alia* suggest a comprehensive package of reform measures, including a road map for private sector participation in water supply and sewerage in the state. To begin with, the committee has identified some districts in the state where private sector participation

### **Consolidation in the telecom sector**

- Bharti Group took over the operations of JT Mobiles (cellular mobile service provider in Karnataka and Andhra Pradesh) and has also bid for Skycell in Chennai.
- Hutchinson bought a 49% stake in Essar's Sterling Cellular (Delhi metro license).
- Tata Communications in AP and Birla AT&T in Maharashtra and Gujarat agreed to merge.



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will be solicited in operating and maintaining the water supply.

In southern India IDFC provided the Tirupur Water Project take-out finance for a deep discount bond, which enabled the project to access capital markets almost immediately, combined with a structure that back ends the payment profile, thereby assisting project cash flows. The local population will receive subsidised water and sewerage facilities, though they will be charged user charges. Tirupur is the first example of a public-private partnership in the water sector but still does not provide a template for future activities in water sector investments in towns and cities.

IDFC concluded an agreement with the Asian Development Bank (ADB) for a line of credit amounting to \$30m for financing urban and environmental infrastructure projects. A steering committee consisting of the Ministry of Urban Development (MoUD), the Ministry of Finance and the participating financial institutions was constituted, so as to facilitate development of urban infrastructure projects.

IDFC participated in setting up two infrastructure funds – the Feedback Infrastructure Fund (FIF) and the Gujarat Infrastructure Fund (GIF). The FIF is expected to finance infrastructure project development activities in India, addressing a major gap in infrastructure development. By participating in the equity of the asset management company of GIF, IDFC intends being the catalyst in infrastructure projects in the state of Gujarat, which is one of the leading investment destinations in the country.

### **Policy advisory role**

We live in an age where knowledge is often as critical a factor of production as land, labour and capital. It is instead the comparative advantage of our ability to combine technologies and economics with a knowledge of 'how things work' that facilitates the strong linkage between IDFC and India's policy makers. Their views have attained a congruence with those of our policy advisory group over the past year. There has been considerable success in restructuring activities in diverse infrastructure

### **Take-out financing**

Ability to design instruments best suited to address the risk profile of infrastructure projects and consequentially allocate these risks to participants best suited to assume them will address some of the specific issues arising in the complex field of infrastructure finance. Commercial banks willing to finance infrastructure projects face maturity mismatches, as they typically have a shorter time preference owing to their liability profiles. In view of such issues, IDFC and the State Bank of India – India's largest commercial bank – have jointly agreed to participate in a new financing structure – 'Take-out Financing'. This would invite banks and others to participate in infrastructure financing for a specific term and at a preferred risk profile that suits them, with IDFC standing behind the structure and willing to take out the obligation after a specific period. IDFC has initiated the process in some infrastructure projects in the IT, integrated transportation and urban infrastructure sectors. ■

sectors through a series of vision and position papers: the focus has now shifted to initiatives in specific sectors, notably power and transport as well as financial sector reform.

IDFC serves as the secretariat to the prime minister's task force on infrastructure, and has been actively involved in preparing model concession and bidding documents for road services. We have engaged reform-oriented states in their attempts to restructure their policies and institutions. This involvement has thus far concentrated on the power and water and sanitation sectors.

IDFC's key strength lies in its ability to mobilise expertise from various sources to solve problems. We do not hesitate to tackle problems just because we do not currently have the technical expertise. Instead, we use our networking and problem-solving skills so as to be able to assemble technically competent teams to respond to evolving problems. Managed correctly, this process is an effort in joint learning, and is an essential ingredient in maximising our comparative advantage.

To this end, we have constituted the 3i Infrastructure Network with the objective of 'leading intellectual capital to commercially oriented infrastructure development' and building a sustainable resource network for infrastructure studies.

We want the ideation process to be inclusive, not exclusive, and as a result, joined hands with the academic community in this enterprise. We visited the Indian Institute of Management in Ahmedabad and the Indian Institute of Technology in Kanpur with this intention

and found willing partners. Nearly a dozen professors are actively associated with what has come to be known as the 3i network.

The network undertakes projects that have strong implications for infrastructure development and is also applying techniques developed for other disciplines such as 3D virtual reality modelling and simulation to infrastructure development. The network has established a website and will be producing a comprehensive annual *Infrastructure Development Report*.

### **The way forward**

IDFC will continue to play the catalytic role for which it is uniquely equipped in the dynamic infrastructure environment of India. The innovative financial products that have been introduced in the two full years of operations are indicators in respect of its position on the cutting edge of infrastructure finance. Equally, if not more, important is its role as an intellectual catalyst. It is not a business to seek out new ideas, to popularise new notions and strive for effectiveness. Frequently, what clients need most is not simply investment – it is advice.

IDFC's role as a knowledge bank facilitating interactions with various government organisations and regulatory institutions for the incorporation of international best practices. ■

*Nasser Munjee is Managing Director and Chief Executive Officer of Infrastructure Development Finance Company in India.*

