

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Report of the Asia-Pacific Infrastructure Partnership Dialogue with the Philippines

Office of the Advisory Group Chair

PURPOSE	For information.
ISSUE	APIP dialogue with the Philippine Government
BACKGROUND	In 2010, the APEC Business Advisory Council (ABAC) proposed a regional structure to enable governments and the private sector to frankly and objectively discuss complex matters related to infrastructure finance and enhance understanding of the issues and risks they face. This structure, the Asia-Pacific Infrastructure Partnership, would involve key officials, experts from multilateral development banks, and senior private sector experts from a wide range of fields relevant to infrastructure PPP. The first dialogues were held with the governments of Mexico and Peru on 24 August 2011 in Lima, followed by this dialogue with the Philippine Government, held on 5 October 2011 in Manila.
PROPOSAL	N.A.
DECISION POINT	Note the report.

The Asia-Pacific Infrastructure Partnership Dialogue The Philippines Round

5 October 2011

Makati Shangri-La Hotel Manila, Makati Room

Makati City, Philippines

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Background

In 2010, the APEC Business Advisory Council (ABAC) proposed a regional structure to enable governments and the private sector to frankly and objectively discuss complex matters related to infrastructure finance and enhance understanding of the issues and risks they face. This structure, the Asia-Pacific Infrastructure Partnership, would involve key officials, experts from multilateral development banks, and senior private sector experts from a wide range of fields relevant to infrastructure PPP. The first dialogues were held with the governments of Mexico and Peru on 24 August 2011 in Lima, followed by this dialogue with the Philippine Government, held on 5 October 2011 in Manila.

This dialogue was hosted and sponsored by ABAC Philippines and the Makati Business Club, in collaboration with the Philippine Government and the National Competitiveness Council. The dialogue was attended by key cabinet secretaries and senior officials from the Philippine Government, members of the APIP private sector panel, experts from multilateral development banks (MDBs) and local resource persons involved in infrastructure development. A list of participants is provided in Annex A.

Introduction

For the Philippines, an archipelago of many islands, the lack of infrastructure is clearly a critical constraint to growth, poverty alleviation and improved competitiveness, particularly in the agriculture and services sector. Although posting a respectable average annual GDP growth of 4.4% (and 2.3% per capita GDP growth) over the past 15 years, the economy lags behind many of its Asian neighbors. Within the region, the Philippines ranks low in the quality of basic infrastructure, including those for energy, water, roads, air transport and rail transport. Poor infrastructure, which constrains private investment and entrepreneurship, is the major factor behind the economy's underperformance.

The Philippines' underinvestment in infrastructure has been largely a function of fiscal constraints, reflected in the high cost of servicing public debt and low tax revenues as a portion of GDP. Political considerations have supported a tendency to manage fiscal problems through expenditure cuts rather than revenue increases. Private savings, on the other hand, have been growing as a result of a continued increase of overseas remittances. With this accumulation of savings, there is growing opportunity for private financing to help address the lack of infrastructure. Recent improvements in the Philippines' global competitiveness rankings are also attracting renewed foreign investor interest.

The Philippine government is now banking on PPPs as a key supplement to public resources in developing infrastructure. The Philippines has been one of the first economies in the region to successfully harness PPPs, which experienced rapid growth in the 1990s, reaching its peak in 1997. This rapid growth came to an end with the Asian financial crisis and a marked deterioration of the fiscal situation and political environment that contributed to increased regulatory, demand and foreign exchange risks.

Upon its assumption of office, the Aquino administration sought to take advantage of renewed interest in PPPs that started shortly before the outbreak of the Global Financial Crisis. President Aquino assigned a key role to PPP in the government's development strategy, not only to supplement the government's limited infrastructure budget, but also to harness private sector technology and expertise in developing high quality and cost-effective infrastructure. To this end, the president established a PPP Center to facilitate development, implementation and monitoring of projects, and directed the government to explore various financing schemes to fund projects. Several major projects worth an estimated US\$3.4 billion have been announced for roll-out in 2011.¹

Key Challenges

1. Seizing the opportunities

Past negative experiences, such as those related to a key airport project (NAIA Terminal 3) and an urban rail project (MRT 3) that has left the public subsidizing a large debt have heightened officials' sensitivity to political risks. With a view to rebuilding public and investor confidence in Philippine PPPs through successful initial projects, the government has taken a very careful approach that has prevented a quick roll-out of announced projects. Increased preference for solicited projects over unsolicited ones that have been perceived as susceptible to corruption has also resulted in government assuming more responsibility for feasibility studies. This has required more time, as officials work with various aid agencies to upgrade public sector skills in undertaking such studies.

At the time of the dialogue, only one project has been bid out so far, accounting for roughly 1% of the total estimated cost of all priority PPP projects scheduled for roll-out in 2011. Several are at various stages of feasibility study, and the government expects to launch more projects in 2012. There is concern that such delays have dampened the initial enthusiasm that has been reawakened among investors for Philippine infrastructure. More seriously, there is concern that the window of opportunity for the Philippines to attract foreign investments may be closing, as the worsening global financial and economic situation rapidly erodes the emerging market premium that the Philippines hopes to capitalize on and which may not be there in years to come, as the market becomes more risk averse.

These considerations argue for extraordinary efforts to expedite the process of rolling out PPP projects in order to revive the initial momentum and to capture opportunities that may soon be lost, while ensuring that projects are properly studied and prepared. The private sector strongly supports the objective of ensuring the commercial, social and environmental viability of projects before being offered to investors. It is especially important that initial model projects succeed to build public and market confidence and avoid acute political backlash that could harm long-term business opportunities. In the current global financial context, however, the private sector advises the government to strike a healthy balance between speed and proper preparation, avoiding the pitfall of over-analysis, and to prioritize doable over transformational projects, building a pipeline to follow the first successful project.

2. Improving regulatory consistency

Consistency of the regulatory environment is a paramount consideration for private sector firms and investors looking to invest in PPPs. The enforceability of long-term contracts is a major concern for the private sector, which expects that covenants in such contracts are honored through leadership transitions at the national, local and agency levels. Greater regulatory transparency and certainty, such as through minimizing reviews of already approved projects and amendments to already agreed terms and conditions, have important bearings on investors' risk perceptions and the level of returns they will require.

¹ These include two light rail transit (LRT) projects (US\$1.75 billion), four airport projects (US\$0.37 billion), four major toll roads (US\$1 billion) and a PPP education project to build 10,000 classrooms (US\$0.23 billion).

It was acknowledged that such negative examples as the NAIA 3 Airport Terminal have gained much attention in the media, even as most PPPs in the Philippines have proven to be successful and profitable, and that the Philippine Government has been able to honor contracts even in the face of intense domestic political pressure. The privatization of water utilities, for example, has improved the quality of services, brought down prices and provided ample returns to investors. Philippine toll road projects and all the PPP projects in the energy sector have been profitable. The case of NAIA 3, where offshore arbitration panels have ruled consistently in favor of the Philippine Government, underscores the problems that can arise if foreign companies get entangled in complex legal procedures around constitutional limits on foreign ownership in certain sectors. Foreign companies that have carefully selected partners and consultants and steered clear of similar constitutional issues have generally been able to avoid legal problems.

Given the negative impact of such high-profile incidents on the Philippines' image, the Aquino Administration is keen to improve the regulatory and legal environment. Features that the private sector considers important include, among others: (a) the ability of government to properly address at the onset project completion risks, right-of-way risks and other political and regulatory risks and to provide ample protection for project finance lenders to mitigate these risks; (b) the provision of clear information on the form of and risks related to government subsidies on projects made available for private sector participation; (c) appropriate protections for private sector proponents in case promised subsidies are withdrawn or when the project fails to gain legislative approval or appropriations; and (d) adequate protections for continuity of contracts over the long term.

A clear master plan based on a coherent vision can help the private sector get a better sense of strengths, viability and potential impact of projects, and to gear up internal resources, including people, research, training and funding, and can increase the Philippines' attractiveness. Such a master plan would prioritize and harmonize projects at the economy and local levels, and clearly identify how each project fits into the overall infrastructure plan and how resources will be allocated to each. The private sector will be able to more effectively participate in infrastructure development if it is regularly updated on the projects lined up for PPP and how each project fits into the larger plan and given an updated timetable.

3. Funding the viability gap

One challenge the Philippines is facing is that there are many projects involving substantial components that are not commercially viable. To deal with this issue, the government is looking at a two-step hybrid concept that involves the government building the commercially unviable component and bidding out the rest to the private sector. This is intended to help avoid politically unpopular excessive subsidies paid to the private sector or excessive financial risks that may arise if the project is undertaken as a classic PPP, while taking advantage of low-cost funding available to governments, including ODA. Examples given include an airport where the government builds the runway, considered as the unprofitable portion, while the terminal is bid out to the private sector, and a railway where ODA is used to package a better project.

The hybrid concept works well where line agencies have the technical capacity to prepare and position projects that are attractive to the private sector. Where such technical capacity is lacking, however, there is significant risk of failure, with projects ending up not being attractive to the private sector. An alternative that may be considered is to factor in public subsidies into the bidding process. In successfully addressing the viability gap, it is important for the government to get sufficient inputs from industry, such as by holding pre-proposal, pre-bidding and pre-structuring conferences with the private sector. In addition where low-cost funding is to be introduced to the project it is important that such funding and its terms is brought to the attention of the private sector early so that complementary terms and structures can be bid by interested private sector parties.

4. Designing well-structured projects

Where there is a disconnect between the price the public is willing to pay and the price available in the market, government can provide a solution by either putting money on the table or taking risks off the table. A good understanding of the risks that parties are able to bear is essential for designing well-structured projects. Understanding that the private sector is capable of dealing with pure commercial risks but ill-equipped to deal with others, such as inability of the public sector to comply with obligations due to government or political actions or inaction, for example, is important for designing solutions, such as creating a guarantee fund that can expeditiously provide direct compensation to the private sector in such an event. Introducing incentives for both parties to avoid a default, such as through partial guarantees, can also be helpful.

Among other ways by which projects can be made bankable and risks shared in a balanced manner are: (a) continually re-assessing the risk profile of projects in reference to traditionally acceptable infrastructure risks carried by global banking institutions; (b) continually reviewing risk allocation to ensure risks are carried by entities that are in the best position to manage and mitigate them; (c) formulating clear terms of reference for each project as a basis for further assessment of risks by private sector partners and financial institutions; and (d) reviewing the timetable for the bidding process and benchmarking it to global best practices to ensure these are realistic and workable and to encourage wide participation.

5. Attracting long-term investments

Long-term investors play an important role in the development of infrastructure. The experience of Japan in the 1960s, when the government started to build the network of bullet trains and expressways, provides a useful reference. Sources of long-term investment, such as the pension system and postal savings, helped accelerate the growth of Japanese infrastructure.

Currently, in addition to huge overseas remittances, there are opportunities for the Philippines to tap capital looking for long-term yields, as the population ages and yields disappear in developed economies such as Japan and Australia. Attracting such funds will require a robust pipeline of projects and secondary markets. Multilateral institutions can also facilitate the entry of long-term investors, for example by lending the first tranche and inviting the private sector to invest in the second tranche, providing long-term loans with repayment schedules to meet specific requirements and combined with private finance to make projects viable, or offering a currency swap facility for financing projects to address currency risks.

The Philippine Government is working to further develop its growing debt market, and particularly private issuance. Among measures being undertaken are the launch of benchmark long-term bonds, credit enhancements and promoting access to bilateral and multilateral funds for priority projects. Consideration is being given to the issuance of inflation-linked bonds and the merger of the local stock and bond exchanges. Development of capital markets where funds can be raised in local currency can enable foreign banks to play a larger role by addressing exchange rate risk.

The government is discussing with regional banks the establishment of Philippine infrastructure-focused funds, and is considering the possible issuance of bonds by a government financial institution to attract money especially from overseas remittances and lend them on to infrastructure projects to facilitate more stable user fees. The Philippines is also watching the development of the ASEAN Infrastructure Fund under the auspices of the ADB. This fund has the potential to mobilize a significant portion of Asian savings, in particular central bank reserves, by providing a highly rated vehicle that can allow these reserves to be recycled toward infrastructure investments.

Governments can best design ways of attracting such investments by talking directly to debt and equity investors and not just to investment bankers. The Philippine Government is open to such discussions to help it create the instruments that can attract investments and is willing to further

improve existing incentives for PPP projects, which now already include duty free importation of operating equipment and income tax holidays.

The Philippines can also benefit from experiences elsewhere in designing infrastructure funds that provide equity, debt and/or guarantees. Such funds have been useful in catalyzing private investment where they have been designed to focus on priority sectors or to mitigate risks that the private sector finds difficult to assume, such as demand risk in toll road projects. Among such experiences are the Treasury Infrastructure Finance Unit (TIUF) operated by Infrastructure UK to assist projects that are temporarily unable to raise sufficient debt finance, the P3 Canada Fund; France's Caisse des Depots et Consignations; and Korea's fund that guarantees a certain percentage of projected annual revenues for ten years.

Another issue that can be studied is the possibility of introducing exemptions on single borrower's limit (SBL) for exposures of banks and on the ceilings on bank loans for DOSRI (directors, officers, stockholders and related interests) for PPP project funding, to address current regulatory limitations to meeting substantial funding requirements for such projects (particularly in the case of major companies that operate bank subsidiaries that could support infrastructure initiatives). One idea is to review whether the current relief of 3 years can be extended to 5 or 7 years to give ample time for project launch, construction and stabilization while enabling banks to sell down the loan or notes to qualified institutions that do not take project finance risk.

6. Improving legal and institutional frameworks

The government is currently working on amendments to the existing Build-Operate-Transfer (BOT) law. Following are some of the key issues:

- ♦ *Projects of national significance.* One important issue being considered is giving the president the power to designate certain infrastructure projects as "projects of national significance," which will enjoy various tax and regulatory incentives and will be protected from becoming the subject of judicial reliefs such as temporary restraining orders (TROs), preliminary injunctions and preliminary mandatory injunctions. The inclusion of this provision in the amendments to the law will significantly improve the environment for PPPs.
- ♦ *The bidding process.* The current BOT law provides for two basic procurement procedures: solicited and unsolicited proposals. The solicited proposal route suffers from capacity constraints in terms of design and implementation and focuses on inputs rather than outputs, limiting the ability of the private sector to provide innovative solutions. Unsolicited proposals give the private sector an opportunity to identify PPP projects with significant public benefits that may not be evident to government at the outset, but has been viewed as susceptible to corruption. Changes to improve the unsolicited proposal route are currently being considered as part of the amendment. Another idea that needs to be explored is how to ensure value for money (best mix of quality and effectiveness for the least outlay over the period of use), for example, through an interactive bidding process similar to the systems being used in Australia and Canada. Central to this concept is the establishment of a baseline for comparison (e.g., a public sector comparator) used to determine whether the private sector can provide higher quality and lower price for the same service compared to the public sector. Under an interactive process, bidding for a project can take place once analysis has shown this to be the case for a particular service, thus helping bidders gain a clearer understanding of government requirements, avoid incurring significant costs arising from misunderstanding and minimize the need for any re-bid process based on design matters.
- ♦ *Contractual arrangements.* The expansion of contractual arrangements under the BOT Law could also be considered to expressly include joint ventures, management or service contracts and lease or the hybrid model to offer more options for private sector involvement without subjecting them to unnecessary legal risks.

An effective institutional framework is one that provides adequate and timely information and a straightforward, transparent and efficient approval process for PPPs. Global or regional firms that seek out opportunities across a number of markets can be attracted to the Philippines if provided adequate and detailed information that can allow them to undertake due diligence for bidding on projects. In 2010, the government reorganized the former BOT Center as the PPP Center and transferred under the National Economic Development Council. The government also provided an enhanced project development and monitoring facility to be managed by the PPP Center as a revolving fund to support implementing agencies in structuring, preparing and competitively tendering PPP projects that are bankable.

7. Improving capacity

Building institutional capacity to enable the public sector to deliver well-structured projects is an important concern of the Philippine government. Preparing complex infrastructure projects require technical expertise in addition to sufficient budget allocation. It is necessary to further build on existing skills and capacities in public agencies managing these transactions. Government agencies, including the PPP Center, are very much affected by civil services rules, particularly in relation to compensation limits that make it difficult for them to attract and retain sufficient numbers of technical experts in legal, accounting, engineering and other relevant fields.

The Philippines can significantly benefit from technical assistance and sharing of best practices. There are a number of ongoing technical assistance projects that are expected to enhance the capacity of the PPP Center and other relevant agencies. There is an existing wealth of knowledge and expertise on PPPs within both public and private sectors around the world that can be readily made available. Given its diversity and strong links to the private sector and multilateral institutions, APEC can be an effective platform for the sharing and dissemination of such knowledge and expertise to member economies.

Various experiences on outsourcing of aspects (e.g., planning, approval) of the PPP process could be studied, through organizations staffed by technical experts hired outside civil service requirements in an independent unit. Some precedents may be examined. Infrastructure UK is majority owned by the Treasury with review and approval functions related to the business cases of relevant contracting authorities, governance and approval over any derogation to the standard form or model contracts. Korea's Private Infrastructure Management Center is a government funded think tank responsible for the formulation of national development plans, whose review of projects is a condition for approval of unsolicited proposals and concession agreements.

Third parties such as international financial institutions play important roles in balancing the interests of public and private sectors. Voluntary advisory bodies, including the APIP private sector panel, can also be helpful to the government. The PPP Center is being assisted by a panel of advisers to help develop properly studied projects, and is continually seeking inputs from the private sector. There is room for the government to further develop strategies with the private sector, multilateral development institutions and other relevant entities to provide appropriate capacity building and advisory services, particularly in assessing financial viability to help advance the evaluation and approval processes for projects.

It would also be useful for the government to host policy dialogues with potential long-term investors. This has proven to be important for the success of various projects in the past, exemplified by the San Roque power project, participants were able to identify the appropriate support needed from government to close the viability gap.

Conclusion

Foreign investors see the Philippines as a good location offering good opportunities in a region with a long-term economic growth story, and are encouraged by the current government's stated desire to attract more private engagement in infrastructure and efforts to improve the PPP environment. However, the Philippines is competing for investors' attention with many other

markets within and outside the region, with which it is still in the process of catching up. The global financial and economic situation also continues to deteriorate and may not for long continue to provide a favorable environment for investment in emerging market infrastructure. It is thus important for the Philippines to move quickly to seize opportunities while they are still available.

Investors looking at infrastructure favor markets with stable fundamental regulatory frameworks that enhance the private sector's confidence in the market. The private sector understands that for such a stable environment to be created and maintained, the general public and their political representatives must also be convinced of the benefits of PPPs. Both public and private sectors have an interest in a balanced framework that allows the private sector to obtain reasonable returns over the life of a project while providing the public with more efficient and affordable services. Sensible and well-structured initial projects followed by an attractive project pipeline can help ensure credibility and strong public and market support for the Philippines' PPP program.

The private sector is an important supplement to government in infrastructure development, providing capital, technology and expertise. Effectively harnessing private sector engagement through well-designed projects can help the Philippines achieve its ambitious infrastructure development goals. Non-commercial dialogues with the private sector can help the government design such projects, based on reliable information about the market and how the market views the opportunities and risks, and provide a more attractive environment for PPP. The APIP seeks to provide a vehicle for such dialogues and hopes to continue the collaboration with the Philippines and the other APEC member economies to build an efficient infrastructure for the Asia-Pacific region.

ANNEX A
LIST OF PARTICIPANTS

From the Philippine Government

Hon. Cesar Purisima, Secretary of Finance
Hon. Gregory Domingo, Secretary of Trade and Industry
Hon. Rene Limcaoco, Undersecretary of Transportation and Communications
Ms. Cosette Canilao, Executive Director, PPP Center of the Philippines
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APIP Panelists and Associates

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Mr. Michael Cooper, Director, Project Finance, HSBC Malaysia
Amb. Takuma Hatano, Executive Vice President, Toyo Engineering Corporation
Mr. Gary Judd, Queen's Counsel and former Chairman, ASB Bank
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Mr. Jeffrey Woodruff, Executive Director, American Chamber of Commerce
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