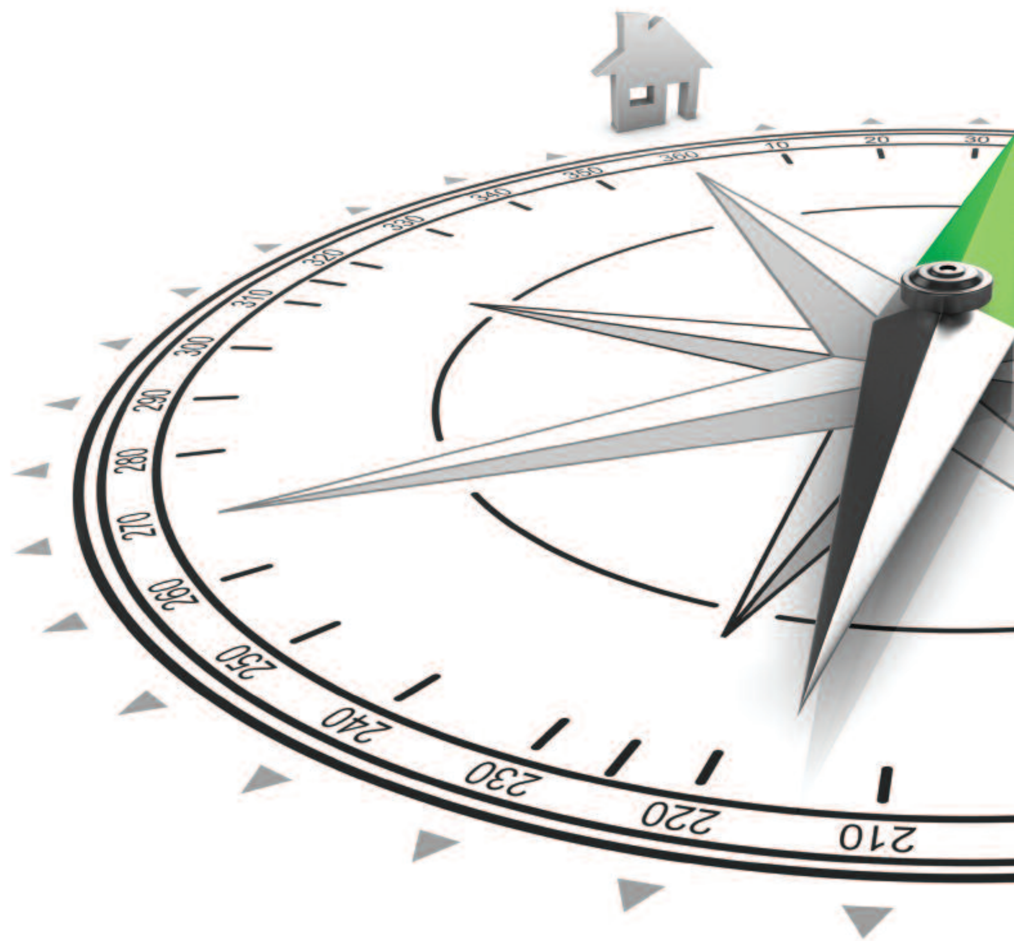


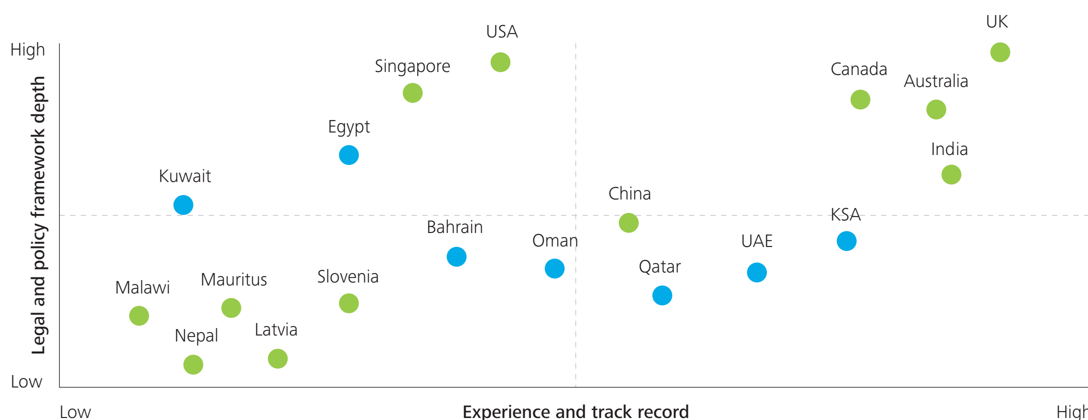
The project fi
East and West

If there is one defining feature of major public sector construction projects over the last two decades in developed economies, it is the irrepressible rise of the Public Private Partnership (PPP) as a way of executing major projects. How does the Middle East, the liquidity-rich Gulf in particular, compare?

nance compass

The key inertia behind any PPP is project finance, the key funding mechanism required to undertake any major capital or infrastructure investment. Since 1992, the PPP Forum estimates that 630 Private Finance Initiatives (PFI) in the United Kingdom alone have been put in place, covering an investment of some USD 100 billion. The U.K. has historically been a forerunner in the field of PPP, but less so more recently as project finance became too expensive. Across the Gulf Cooperation Council (GCC), PPP is at a more embryonic stage. Across the region, there has been little PPP activity in historically core PPP sectors such as transport, health and education, particularly since the crash in 2008. The map below clearly shows where GCC countries rank in terms of PPP maturity globally and highlights the need for a much better regulatory framework.

Comparison of global and MENA countries on PPP maturity



Source: Markab Analysis

Project finance, in and of itself, is highly volatile with finance rates ranging from single digit figures to rates in the mid-teens, depending on a number of variables, including existing relationships with funders or prior experience. What this means is that the viability of those projects funded by project finance are extremely susceptible to financial market swings or the propensity to risk afforded by project finance lenders.

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The situation in the Gulf

In the GCC, the opposite is true. Whilst there may be liquidity in the market, the terms of borrowing are heavily stacked in favor of loans from the Treasury. As with most other markets across the globe, project finance is expensive and unless the financial terms or the project itself are an attractive proposition to the private sector, then this will remain the case.

The very nature of a PPP, of course, relies upon the availability of project finance and the ability for a scheme to pass a "value for money" test. Traditionally, PPPs have been an ideal way for the public sector to transfer risk to the private sector or for those without the land or capital up front to fund a scheme.

The pass or fail test for the PPP relies on whether value for money is achieved and affordability underpins this. However, as the cost of finance has risen, PPPs have in turn become much more expensive for the public sector.

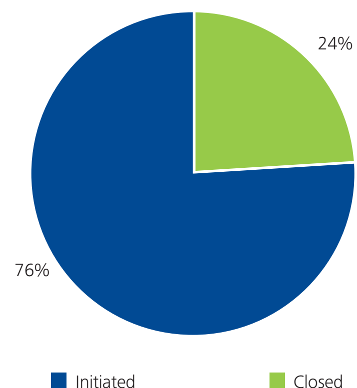
Governments across the GCC typically have the resources to fund large-scale capital projects, thereby obviating the need for project finance in the first place.

Indeed, the very term "project finance" means different things in each geographic location. Across the GCC, project financing is typically a short-term, direct funding stream to facilitate a construction project, typically 3-5 years. This contrasts sharply with the more traditional term project finance, which is a much longer-term view in more established PPP markets, such as India, Europe and the U.S.

When cynicism meets irony

Moreover, there is widespread cynicism about the viability of PPPs in the region as the majority of PPPs that actually close are restricted to major Infrastructure, Water and Power Projects (IWPP). Other PPPs that are either proposed or under due diligence invariably fail to close.

PPP deals initiated and closed in the GCC region (2005-2011)



Source: Deutsche Bank, "The challenges and potential for private financing of infrastructure in the GCC," May 2011

Yet, ironically, at a time when the availability of project finance has been significantly hindered by the tightening of global credit markets, calling its viability into question, there are several factors that could see it, and PPPs, rise once again to prominence.

Across the GCC, this might be particularly relevant. While many GCC countries have the financial resources to facilitate their own projects, they do not always have the skill base to undertake huge infrastructure projects and may instead opt to use a PPP to harness the expertise and appetite for risk of the private sector.

Major IWPP schemes benefit from private sector involvement, for instance, as the size and complexity of these projects dictate innovation, significant human resource and direction. The most notable examples of this can be found in Qatar, Kuwait and Saudi Arabia most recently.

Lowest cost driven by market forces

The most obvious mistake is to view the cost of a project purely in terms of a fixed price established through the bidding process. As discussed earlier, PPPs are major, 15-25 year investments funded through long-term finance. The original rate of borrowing may be re-financed and/or may change at pre-determined intervals throughout the course of the borrowing. If margins at the outset are tight, then the first place to look is often the build costs, which could have ramifications in the long-term.

A contractor constrained by bringing in a project on budget with tight margins might easily look for ways to cut their own costs, whereas collaboration between two parties, even in the GCC, may actually become a mutually beneficial partnership which may derive enormous long-term advantages.

Of course, choosing a more expensive bid is no guarantee that such adversarial relationships will not emerge and careful project management is always a means by which to avoid this. It is clearly more of a risk when competition is so fierce.

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In the GCC, amidst a backdrop of political cynicism about PPPs and their perception of giving control to the private sector, the argument for providing genuine value for money resonates just as loudly as it does in struggling markets elsewhere. If the public sector in GCC countries cannot see the potential benefits that a private sector partner can bring to a major infrastructure project, then there is little hope for PPP, in the region.

Conclusion

This leads us full circle. Adopting project finance to fund a PPP and construct a project through a long-term partnership with the private sector is one of the best ways to achieve sustainable and profitable, operational growth – even in the GCC.

The subtle distinction between lowest cost and value for money must not be lost in the current economic climate. It is inevitable that cost has become a major factor, but innovation and flexibility are also needed to create new ways of getting things done on major infrastructure projects. By breaking down traditional barriers of mistrust in the private sector, the right investors will come to the fore, and with the right consultant who is experienced in this sector, it is a recipe for success.

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