PUBLIC-PRIVATE PARTNERSHIP CENTER

# Philippines: Infrastructure Development is a Priority

President Rodrigo Duterte's administration has made tackling the country's infrastructure deficit a major priority. The fourth item on the President's 10-point Socio-Economic Agenda calls for boosting annual infrastructure spending to account for 5% of GDP, "with Public-Private Partnerships (PPPs) playing a key role". In addition to this explicit support of PPPs, several of the Agenda's other objectives – increasing competitiveness and the ease of doing business, supporting rural development, investing in health and education, and promoting science and technology to enhance innovation – require infrastructure improvements in order to be realized. Overall, government spending on infrastructure is estimated to be USD 163 billion through 2022, with PPPs playing a key role. This planned spending is in addition to the USD 6.24 billion worth of PPP projects already awarded.

## Public-Private Partnership Center Supports Sustainable Financing Sources for Bankable PPPs

In addition to sponsor equity, privately financed infrastructure in the Philippines has typically relied on banks to fund construction and operations. High levels of liquidity and a preference for bank financing, as well as certain taxes that disfavor bonds, help to explain the relatively limited use of the domestic capital markets for infrastructure. However, the focus by policymakers to address the national infrastructure deficit has highlighted the need to develop a wider range of financing options. Working with other Philippine government bodies and the private sector, the Public-Private Partnership Center (PPPC) has led the discussion and actively supported reforms that will enable greater use of capital markets for infrastructure finance. With support from the Asian Development Bank and the US Treasury Office of Technical Assistance, the PPPC's efforts have been wide-ranging and include the following: providing significant technical input that enabled the Philippines Stock Exchange (PSE) to develop specific listing rules for PPP companies; supporting legislative changes that facilitate expeditious acquisition of – and just compensation for – the required right of way (ROW) for national infrastructure projects as well as limiting the ability to needlessly delay projects through the courts; updating legislation (the PPP Act) that institutionalizes best practices and proper incentives; hosting large conferences that attract domestic and international capital market professionals, as well as "knowledge-sharing seminars" targeting government agencies.

These direct and indirect efforts in support of capital market development for infrastructure finance are in addition to the PPPC's primary role, which is to support the development of well-structured, bankable projects that attract private developers and operators. It serves as the hub of PPP expertise within the Philippine government, and acts as the central coordinating and monitoring agency for PPP projects in the Philippines. Crucially, the projects remain "housed" within the implementing agencies, which retain technical responsibility and oversight of projects. It champions the country's PPP Program by enabling implementing agencies in all aspects of project preparation, providing project advisory and facilitation services, and monitoring and empowering agencies through various capacity-building activities.

## Characteristics of Infrastructure Assets

Large up-front cash outlays are required in the construction phase. Once operational, costs decrease substantially, although periodic capital expenditures associated with deferred maintenance and rehabilitation are common. On the revenue side, there is no income during the construction stage for greenfield projects (i.e., those assets built from scratch). When existing assets are expanded or renovated, revenue may continue to flow during the course of the new construction, although it is unlikely that such revenue will be sufficient to meet the operating and financing costs of the entire (existing and expanded) asset. Once construction is complete, cash flows are expected to increase during the ramp up period of the new/expanded asset and then reach a steady state, with revenues driven by a combination of usage and tariff increases, and sometimes pre-agreed ("availability") payments from the government. Infrastructure investors are attracted by the expectation of consistent, long-term returns that are often viewed as a natural hedge against inflation, assuming tariffs are increased in accordance with rising input costs.

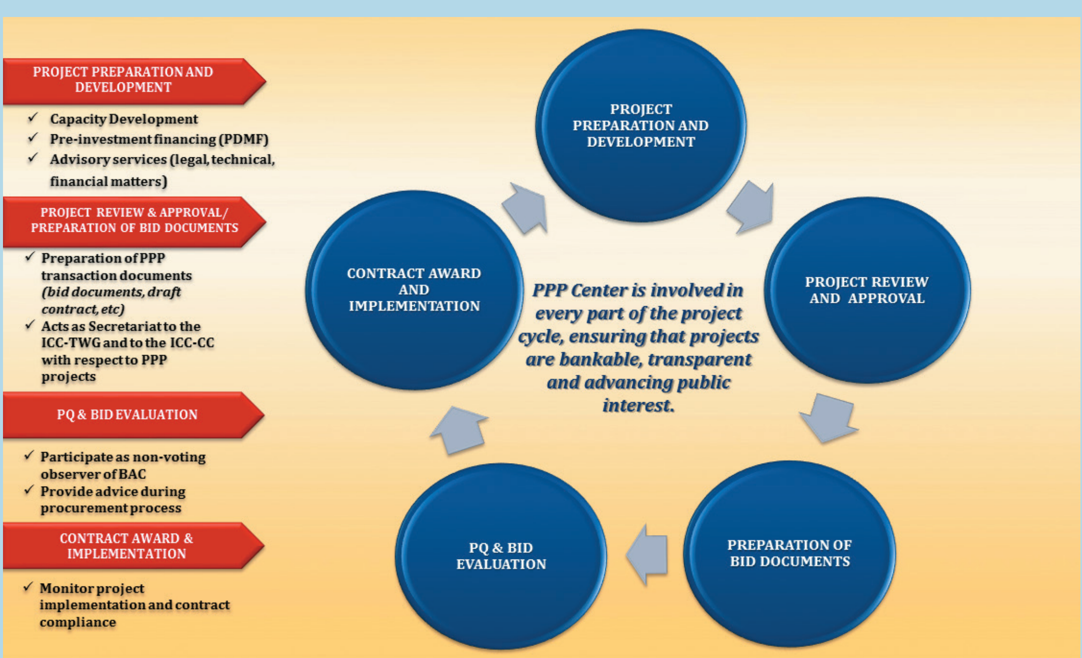
There are of course many challenges associated with infrastructure finance. Probably the biggest are in the construction stage, when the developer must secure financing for the significant up-front costs in the absence of revenues, and then complete the construction on time and within budget. Once operational, the viability of forecasts is tested – are enough users willing to pay the regulated prices to realize the project revenue? Can the asset be operated at the planned cost levels? A final challenge is the willingness of both private and public partners to respect the roles and responsibilities assigned to them under the agreement. Is the developer/operator providing all services at the expected levels as required under the contract? Are the implementing agency and other public sector stakeholders (e.g., the regulatory authorities and the executive branch) able and willing to deliver right of way, enact pre-agreed tariff increases, etc., in a predictable and timely manner? None of these and other potential risks can be entirely eliminated for any one project. Thoughtful and comprehensive preparation and monitoring of projects can, however, substantially mitigate them.

## Private Sector Engagement in Philippine Infrastructure

The Philippines has a fairly long history of engaging the private sector in infrastructure development and operations. A Build-Operate-Transfer (BOT) law was passed in 1990 – the first one in Asia – and was then amended in 1994. That law, Republic Act (RA) 6957 as amended by RA 7718, provides the legal framework for Philippines PPPs and is implemented under rules and regulations that were revised in 2012. The Coordinating Council of the Philippine Assistance Program (CCPAP), attached to the Office of President, was created under Administrative Order No. 105, s. 1989 for the overall implementation of the Philippine Assistance Program and then later on, the BOT Program under Memorandum Order No. 166, s. 1993.

In the 1990s, the policy makers relied heavily on the BOT model to address the nation's crippling energy shortages. This approach succeeded in developing over USD 8 billion worth of power generation assets providing in excess of 8,000 megawatts. Given the challenging economic environment, government absorbed demand and foreign exchange risks. The currency depreciation and economic stagnation caused by the Asian Financial Crisis of the late 1990s required government to absorb costs associated with these risks. In the early 2000s, BOTs were again utilized, this time often for unsolicited projects in the transportation sector. The key takeaway from the first two decades of private sector engagement in public infrastructure was the need for careful due diligence and project preparation, in order to better identify the risks and then assign them to the partner (public or private) best able to manage them. These experiences led to the current

**Figure 1: Roles of the PPP Center**




Source: The PPP Center

operating framework in which the PPP Center acts as the technical hub for PPPs, advising implementing agencies on their projects. In 2010, the BOT Center was renamed the PPP Center.

Philippine legislators have acted to improve the enabling environment for PPPs. The Right of Way Acquisition Act (RA 10752) provides the procedures for the easier acquisition of right of way for government infrastructure projects. Another law, RA 8975, prohibits the issuance of temporary restraining orders by lower courts on national projects implemented under the BOT Law to ensure expeditious implementation and completion. At the moment, a draft bill – the PPP Act – is under consideration which would enhance the existing BOT Law. This is critical legislation that aims to institutionalize PPP policies, regulatory frameworks, and process improvements, cementing the sustainability of the gains that have been achieved thus far. The proposed Act has several objectives, such as institutionalizing best practices like the Project Development and Monitoring Facility (PDMF), which finances the development and structuring of viable projects; allowing for alternative dispute resolution provisions in contracts; and modernizing procedures related to the Swiss Challenge period to unsolicited proposals. Longer term, provisions that limit foreign participation to a 40% share for PPP projects that require a public utility franchise hope to be addressed in order to facilitate greater competition and innovation.

Since 2010, fifteen PPP contracts have been awarded for a total of approximately USD 6.4 billion.*[1] These include completed projects, such as the NAIA Expressway, a 7.75 km elevated expressway that improves access to the country's gateway airport in Manila, and 12,202 classrooms that were built in various regions throughout the country. Other projects that are under construction include the Mactan-Cebu International Airport New Passenger Terminal Building and the Bulacan Bulk Water Supply Project, both currently identified as good deals in the international PPP space.

## PPP Project Development and Approval Process

The PPP Center, led by an Executive Director (equivalent to Undersecretary) appointed by the President, is attached to the National Economic and Development Authority (NEDA). A PPP Governing Board (PPPGB) sets the strategic direction as well as creating an enabling policy and institutional environment for PPPs. Chaired by the Socioeconomic Planning Secretary from NEDA, the PPPGB includes representatives from the Department of Finance (DOF), Department of Budget and Management (DBM), Department of Trade and Industry (DTI), Department of Justice (DOJ), Office of the President (OP) and a private sector representative from the National Competitiveness Council (NCC).

As one of its key decisions, the PPPGB approved and adopted the new appraisal process for PPP projects. Pursuant to this policy, the Investment Coordination Committee – Technical Working Group (ICC-TWG) composed of NEDA for socio-economic appraisal, the DOF for financial appraisal, the Department of Environment and Natural Resources – Environmental Management Bureau (DENR-EMB) for environmental impact analysis, and the PPP Center for value for money analysis.

PPPs in the Philippines undergo an extensive development and review process, ensuring that viable, and bankable projects attractive to a wide range of sponsors will be put up for bid. The first step is to identify and allocate risks to the partners best able to manage them. The framework is the Generic Preferred Risk Allocation Matrix (GPRAM). The GPRAM enables the Investment Coordination Committee (ICC), which is responsible for green-lighting PPPs, to review how the risks were identified, shared and/or mitigated.

In keeping with the theme of technical "ownership", projects are developed within the implementing agencies (IA), which are encouraged to create internal PPP units to take the project from development, approval, to bidding completion, and operations. The IA completes a full feasibility study of a project, identifying and structuring the project as a PPP and thereafter submits a complete project proposal to the ICC-TWG. The ICC-TWG then evaluates the project and endorses such to the Investment Coordination Committee (ICC), which considers the fiscal, monetary and balance of payments implications of major national projects. With a positive ICC recommendation, the project goes to the NEDA Board, chaired by the President of the Philippines, for final approval.

This process is extensive for good reason. The Philippine government has learned from its long history of engaging the private sector in infrastructure development, that a comprehensive process is necessary for large and complicated projects to be properly vetted.

**Figure 2: Number of Ongoing PPP Projects**


*Projects started from 2010 onwards (excluding MRT 7 and MMS 3, which were developed before 2010, and the terminated MPOC)
**Amount does not include 28 other projects with no estimated costs yet

Source: The PPP Center

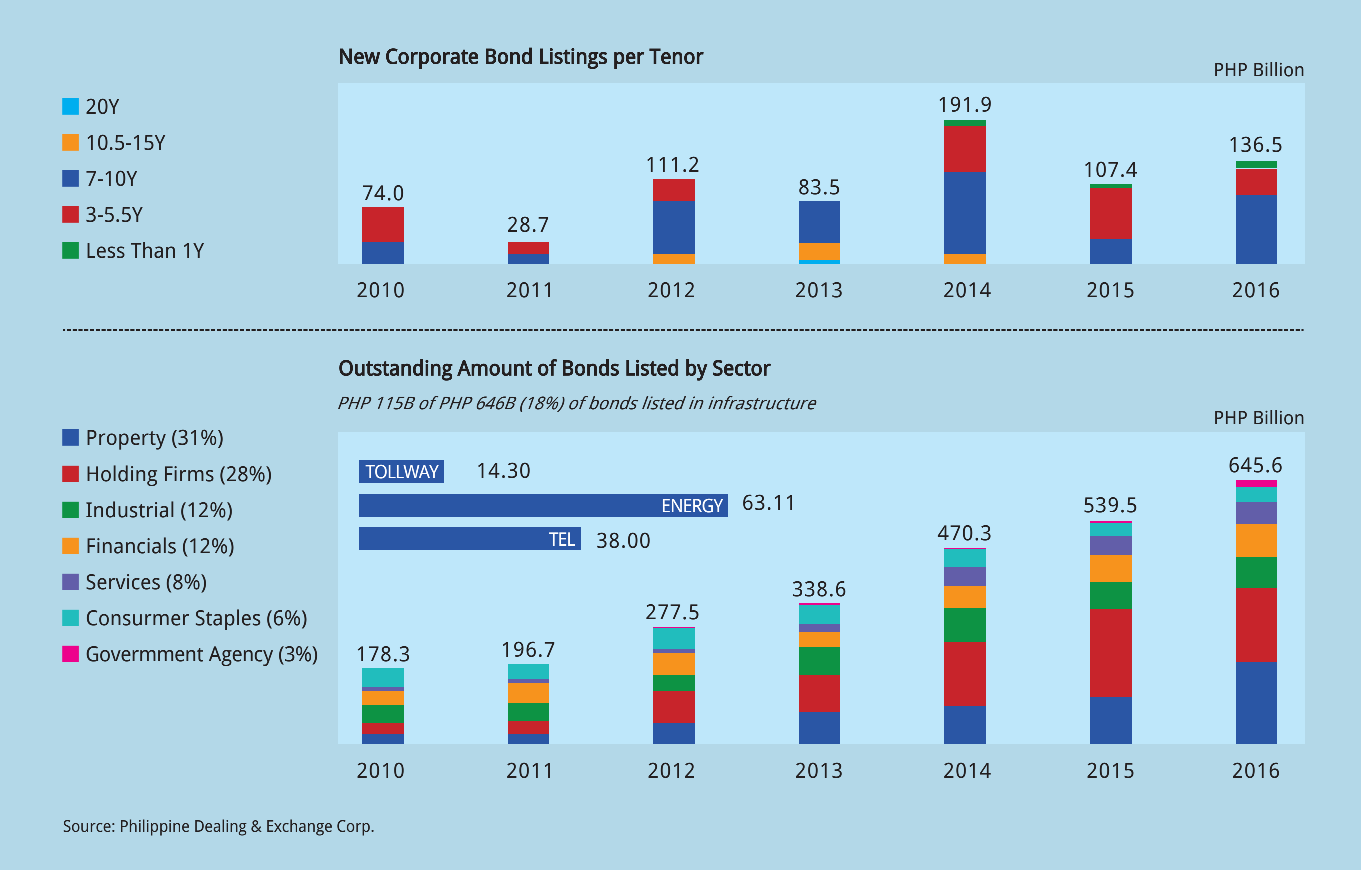
# Financing PPPs in the Philippines

While there is no requirement, Philippine PPP capital structures have tended to be about 80% debt and 20% equity. The debt component has generally been financed by domestic banks. There are several reasons for this. First, banks tend to be the primary source of project finance debt throughout the world, especially during the construction stage. Larger banks, including those in the Philippines, often have the in-house capacity to structure and monitor projects. Second, consistently strong domestic economic growth in the Philippines (GDP increased 6.8% in 2016, above the 5.9% achieved in 2015 and in line with 7% projected for this year), enhanced by increasing remittance flows and investment in the business process outsourcing sector, have led to high liquidity levels. Well prepared PPPs that provide essential services are therefore attractive investments for these healthy banks. Third, companies engaged in PPPs have a large local component, given the constitutional requirement that facility operators of "public utilities", which includes most public services, be majority (60%) Filipino-owned. Many of the largest Filipino conglomerates that have pursued PPPs have relied on existing relationships with – and in some cases, ownership shares in – domestic banks. A liquid banking sector and local corporate involvement have minimized currency risk which large infrastructure PPPs often face.

And fourth, bank capacity to finance PPPs and other infrastructure projects was enhanced between 2010 and 2016 through regulation. The central bank (Bangko Sentral ng Pilipinas, or BSP) waived the Single Borrower's Limit (SBL) for banks in the case of loans extended to projects falling under the government's PPP Program. Under this waiver, existing limits that capped a lender's exposure to a single borrower at 25% of the lender's net worth were increased by an additional 25% for "national PPPs". Extended for an additional three years in 2013, the waiver expired in December 2016.

Largely for the reasons outlined above, domestic capital markets have to date played a smaller role in PPP infrastructure finance. However, both peso-denominated bonds and equities have been issued for infrastructure projects, including PPPs. Of the almost PHP 488 billion raised on the local stock exchange between 2013 and 2016, about PHP 67 billion (14%) was for infrastructure purposes (based on use of proceeds). Preferred shares have been the instrument of choice, with notable issuances including Megawide Construction Corporation's raising PHP 4 billion to develop and implement PPPs and San Miguel Corporation's PHP 30 billion issuance last year that included funding for mass transit, airport, toll road and water infrastructure purposes. On the bonds side, PHP 115 billion, or 18% of the outstanding PHP 646 billion of outstanding non-government bonds at year-end 2016, were energy, telecommunications and toll roads.

**Figure 3: Annual Corporate Bond Statistics**




Source: Philippine Dealing & Exchange Corp.

## Specific Efforts Aimed at Financing Infrastructure through the Capital Markets

The PPPC has long appreciated the importance of capital markets to sustainably finance infrastructure investments. Over the last several years, the Center hosted several round table discussions that involved both domestic and international financiers, regulators, issuers, and ratings agencies. These discussions led to real change in the domestic market. The Center has engaged regulators and investors directly, hosting "knowledge-sharing seminars" on the Philippine PPP process and projects with the SEC, market exchanges and the Insurance Commission. The PPPC has also provided targeted sessions, such as a recent workshop on project finance credit factors for the national pension system.

In 2016, after extensive consultations with the market and PPPC, the PSE developed listing rules that recognize the unique factors associated with PPP companies. Subsequently approved by the SEC, the new requirements permit firms that have completed certain phases of a PPP project to list equity shares even if the project has not yet demonstrated a three-year operating history. Similar requirements are expected to be developed in 2017 that will facilitate the listing of non-recourse, infrastructure or PPP project bonds.

Broader use of project bonds will address several issues. The deleveraging and shrinking of many international banks' balance sheets – together with changes in banks' lending policies as a result of regulations (including the Basel III requirements for increased bank capital and liquidity) – have led some global and regional banks to reduce project finance lending commitments. At the same time, with the declining and even negative yield trend, capital market investors such as insurers, specialist fund managers, pension funds, and sovereign wealth funds are searching for higher yields and have increased their capacity to invest in project bonds and equity.

While both these supply and demand trends are not yet acute in the Philippines, the domestic project bond initiative is proactive, aimed at supporting the current administration's goal of ramping up infrastructure spending. The end of the SBL waiver coincided with other regulatory changes on bank loans to subsidiaries and related parties that encourage ring-fenced, non-recourse special purpose entities (SPEs) for PPP-related project financings. Properly structured, each SPE will be treated as an independent entity subject to its own borrowing limits.

Indeed, two domestic transactions in 2016 made use of SPEs. AP Renewables, a project company whose sponsor is Aboitiz Power Corporation, placed PHP 10.7 billion of notes with domestic "qualified buyers" a first debt financing (the 2009 acquisition was 100% equity financed) associated with its operating (or brownfield) geothermal assets, respectively the seventh and fourth largest in the world, called Tiwi-Makban. Later in the year, Hedcor Sibulan, another project company associated with Aboitiz Power Corporation, issued PHP 4.2 billion in notes. Similar to Tiwi-MakBan, Hedcor Sibulan had an established operating history, in this case several run-of-the-river hydroelectric power plants. While the Tiwi notes were unrated, due to an ADB partial credit wrap, the Hedcor notes were assigned Aa by PhilRatings and reportedly placed with non-bank as well as bank investors.

Two aspects of these transactions bode well for the future. First, the use of non-recourse project companies allows experienced sponsors to take on large and potentially risky infrastructure projects but keep them off of their corporate balance sheets. This preserves the corporation's borrowing capacity and more importantly, isolates both the project and the corporation's assets from risks posed by the other. This is a positive development for PPPs, enabling project-specific risks to be allocated among the partners, particularly at the construction (greenfield) stage when they are greatest. Secondly, both of these more complicated transactions were brownfield, enabling lenders to include historical performance in their investment decision. While capital markets broaden the investor base for infrastructure they create a challenge for institutional investors who have little knowledge or experience with the infrastructure sector. Assets with an operating history, although potentially quite complicated credits, are an easier access point for investors new to the sector than during the construction stage.

## Domestic Capital Market Initiatives that Support Infrastructure Finance

The Philippines bond market still remains smaller than most other ASEAN markets but it has experienced rapid growth over the last 10 years. Government securities dominate, with corporate bonds representing only 18% of the total outstanding at the end of 2016. Several years of low rates have challenged the growing institutional investors to realize greater returns in their fixed income portfolios. There are a number of on-going efforts aimed at deepening the Philippine financial markets by promoting transparency and stability, as well as efficient and effective market-based pricing. Four initiatives spearheaded by the interagency Financial Stability Coordinating Council (FSCC), which includes the BSP, DOF, Insurance Commission, and SEC, are good examples.

### Philippine Peso Overnight Index Swap (PHP OIS)

Strongly supported by the Bankers Association of the Philippines (BAP), the PHP OIS is an interbank, over-the-counter organized market that will allow institutions to manage interest rate risk. The fixed-floating interest rate swap market can also serve as a basis of a new PHP interest rate curve, linked to changes in monetary policy. The PHP OIS can be used as an alternative interest rate benchmark for funding or hedging short-term peso transactions and pricing peso-denominated loans. The PHP OIS is expected to launch in 2017, once a self-regulatory organization has been formed and approved by the SEC.

### Philippine Interbank Repurchase Agreements (Repo) Program

The enhanced Repo program will provide greater liquidity and depth to the primary and secondary debt markets. This will enable market participants to better manage their risks, as well as broaden investor appeal and facilitate price discovery. The SEC, BSP and Bureau of the Treasury (BTr) are currently reviewing a proposal submitted by BAP and expect to launch the enhanced program this year.

### Benchmark Reform

The BSP and BTr are reviewing the existing benchmark guidelines as well as recommendations to enhance the stability and integrity of reference rates, such as the Philippine Interbank Reference Rate (PHIREF) and the Dealing System Treasury Rate (PDST). A "Benchmark Framework" is envisioned that will contain the principles and guidelines in benchmark setting for the reference rates. Other initiatives include the review of PDST Calculation Guidelines and the proposed Corporate Yield Curves across credit ratings of corporate securities. The benchmark reforms are targeted to be implemented this year.

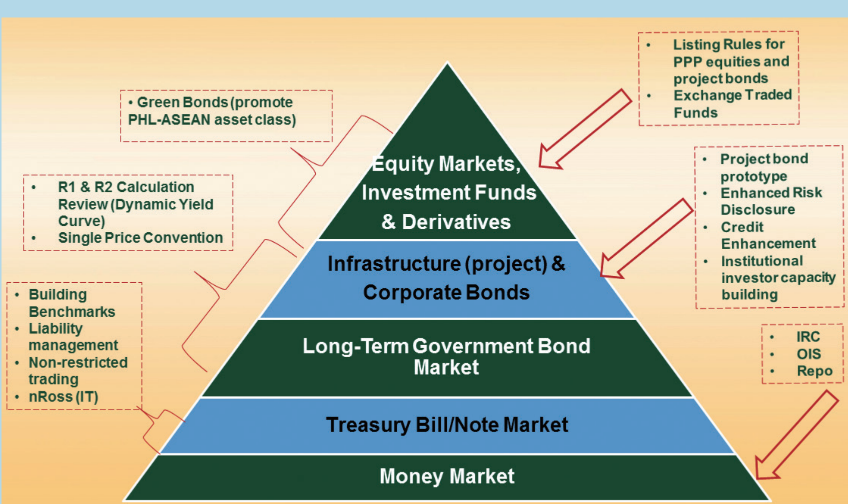
### Single Price and Other Efforts towards Regional Market Integration

Adoption of the single price convention would facilitate regional market integration and the establishment of a tax-unified local debt market. The Treasury is working on instituting a single-price auction system for government securities.

In addition to the efforts outlined above, other policies have already been implemented by the SEC to improve time to market, reduce unnecessary costs, and remove barriers towards regional integration. For instance, shelf registration, which was enhanced in 2015, enables corporate issuers to manage their costs by matching capital-raising efforts with projected cash flows. Securities that are credit-enhanced by multilateral organizations are now exempt from registration, allowing for faster market access and a broader investor base. New best-effort underwriting rules allow for different distribution plans (subject to SEC approval) and reduce capital charges associated with firm underwriting. Constraints on selling time and financial statement validity have also been liberalized. In order to attract regional liquidity, the SEC is involved in integrating the ASEAN capital markets. The ASEAN+3 Multicurrency Bond Issuance Framework simplifies the process for foreign players to raise capital domestically, reducing their forex risk and incentivizing their entry into the Philippines (and vice versa). There is also a regional effort to create cross-border dispute resolution mechanisms and develop a Corporate Governance Scorecard, which will raise standards of publicly listed companies and increase their visibility to investors. Finally, the SEC is advocating the adoption of widely accepted Green Bond principles, in an effort to attract global fund managers who are responsible for over USD 11 trillion of assets and are committed to pursuing investments in this rapidly growing sector.

These various capital market efforts are supported by BSP's recently revised framework for monetary operations under the interest rate corridor (IRC) system. The BSP explains the IRC is "intended to help ensure that money market interest rates move within a reasonably close range around the BSP's policy rate…providing the fundamental basis for monetary policy transmission." Accordingly, the BSP has replaced its Special Deposit Account with an auction-based 7- and 28-day term deposit facility and a standing overnight deposit facility (the IRC's "floor", currently at 2.5%). The repurchase facility (the corridor's "ceiling") was replaced by an overnight lending one (the IRC's "ceiling", currently at 3.5%) and the reverse repurchase facility (RRP) is now an overnight RRP offering the policy rate (3%). Since June of last year, as the BSP has steadily increased the amount of pesos Philippine banks could compete to deposit in the term facilities, the rates have gradually moved towards the 3% policy rate. Liquidity however, remains quite strong, with bid-to-cover ratios of 1.4-1.7x on the PHP 180 billion on offer during the first two weeks of February 2017. These moves by the BSP enhance the foundation supporting the Philippines capital market by providing greater market input into monetary policy.

**Figure 4: A Broad Effort on Capital Market Development**




Source: Philippines Securities and Exchange Commission

# Conclusion

The PPP Center has served a critical role in promoting private sector engagement in the Philippines infrastructure. First, it has developed expertise in the identification, development, bidding and monitoring of bankable PPPs. Second, working with agencies across government, the PPPC has promoted policy improvements that recognize both government and private sector risks and objectives, including the institutionalization of its capital markets development initiatives through the proposed PPP Act and its eventual Implementing Rules and Regulations. Third, the PPPC appreciated early on the importance of assuring sustainable sources of financing to infrastructure projects by attracting institutional investors as well as banks to the sector. Over the next several years, working with its partners in government, such as the Department of Finance and the SEC, as well as the private sector, the PPPC will continue to address obstacles and promote opportunities for insurance companies, pension funds and asset managers to support infrastructure development that is critical to the Philippines' future.

## Notes

*1 Amount based on January 2017 average daily pesos per US dollar rate (1 USD=PHP 49.736)

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### PUBLIC-PRIVATE PARTNERSHIP CENTER

By virtue of the Executive Order No. 8/2010, as amended by Executive Order No. 136/2013, the PPP Center is mandated to facilitate the implementation of the country's PPP Program and Projects.

The PPP Center is the main driver of the PPP Program. It serves as the central coordinating and monitoring agency for all PPP projects in the Philippines. It champions the country's PPP Program by enabling implementing agencies in all aspects of project preparation, managing of the Project Development and Monitoring Facility (PDMF), providing projects advisory and facilitation services, monitoring and empowering agencies through various capacity building activities.

The PPP Center provides technical assistance to national government agencies, government-owned-and controlled corporations, government financial institutions, state universities and colleges, and local government units as well as the private sector to help develop and implement critical infrastructure and other development projects.

The Center also advocates policy reforms to improve the legal and regulatory frameworks governing PPPs in order to maximize the great potentials of these infrastructure and development projects in the country. It also acts as the Secretariat of the PPP Governing Board, which is the overall policy-making body for all PPP-related matters, including the PDMF.