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Don Wallace

Georgetown University Law Center

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Private Participation in Infrastructure and the Provision of Public Services—Inevitable and Difficult

*Don Wallace**

I. INTRODUCTION

Dean Parker set the stage very well for my presentation, as yesterday we learned of past events in Russia, Kosovo and Iraq, and hopefully a brighter future.

We also learned that the scale of the countries involved in this process varies considerably with countries such as the People's Republic of China, which contains about a fourth or fifth of the world's population, on the one hand, and Cape Verde, which has a relatively small population, on the other.

The subject that I am going to discuss applies to different levels of government and economic sectors in these countries. Can you really generalize in this way? Maybe one can, maybe one cannot. This is one of the issues in all these areas of law reform, law harmonization and change. This is apart from the question of whether foreigners can impose their vision on a country. Could God impose a single vision on all countries, all sectors, all levels of government?

I have been a delegate to the United Nations Commission for International Trade Law ("UNCITRAL") for many years, and its answer to the above question is yes. We no longer discuss law harmonization or doctrinal unification. We discuss how to find the best practices. In many sectors, these are Anglo-American common law practices.

The theme of this conference relates to the legal, or "soft" infrastructure, as articulated by Professor Buxbaum. My subject is "Private Participation in Infrastructure and the Provision of Public Services—Inevitable and Difficult." There have been discussions relating to hard, physical infrastructure, such as power plants and roads. However, both the soft infrastructure and the physical infrastructure unite in my subject.

II. INEVITABLE BUT DIFFICULT

A. *Why Is It Inevitable?*

When I first discussed this subject with Dean Parker and Professor Michael Malloy, I suggested as the topic "Host Country Framework for Infrastructure and Provision of Public Services—Is There a Need for It?" There clearly is a need for a host country legal framework, including concession laws, regulatory laws, tax laws, and everything else that goes along with it. The reason there is a need for a legal framework is because private sector participation in infrastructure—roads, public

* Professor of Law, Georgetown University Law Center; Chairman, International Trade Law Institute. J.D.; Harvard, 1957; Member, New York and D.C. Bar.

schools, jails, public housing, power plants, telecom, and all the other things that the (International Finance Corporation) “IFC” and “OPIC” (Overseas Private Investment Corporation) work on—is inevitable and difficult. Why is it inevitable? Because of money. Public lenders, such as the World Bank, only have a limited amount of money. The amount of investment needed for infrastructure around the world is enormous. Commercial lending to governments, so-called sovereign debt, is very limited and discouraged due to earlier debt crises. Banks will not lend to governments on the necessary scale. The tax base is very limited in many countries. Indeed, the current orthodoxy is to control your public spending carefully, without exhausting your economy—the goose that lays the golden eggs—with taxes. The only way to commence these projects is with private capital, local if it exists (and it does not always exist), and foreign, which also brings expertise and experience to the projects themselves.

The need for private finance is almost universal. The solution may vary from country to country, depending on the level of development of a country, which can be anything from central government to provincial. For instance, there may be a need for small water projects or a waste treatment project on the one hand, or power projects, like Dabhol, and others, on the other hand. The need is also universal because the world is at an age of material development. Actually, the future of the modern world is uncertain. We are very materialistic at this period in time, especially the United States. The current time is an example of a great social experiment and a great collection of consumers in history. Consumers want goods and services. This leads to the two-fold pressure for infrastructure, whether it is roads, power or telecom. Individuals want electricity. Travelers visit other countries and do not understand that although some countries are more economical than others (in regards to the efficiency of electricity), brown-outs are very common. Actually, brown-outs are endemic. In addition, roads are not well-maintained in many parts of the world. Populations are growing. People want clean drinking water, etc. There is an individual desire and need for improved infrastructure. Of course, factories and service providers need infrastructure as well. Countries require working telephone systems, lights, power, and so forth. There is an inevitable, inexorable Malthusian pressure (though we are able to solve the food problem).

What is the exact subject I am addressing? There are so many words that are discussed and a great deal of acronyms. I was in Montenegro about two months ago. There, they refer to this as private sector participation in infrastructure and the provision of services. The British have given us a great deal of this because the British first nationalized everything, and now they have denationalized, i.e., privatized, everything. They have the greatest number of consultants and many bank lawyers. Britain used to call it the “PFI” (Private Finance Initiative) and now they call it Public/Private Partnerships. In the United Nations, we refer to it as privately financed infrastructure projects. Many of us have also heard the term “BOT” (Build Operate and Transfer), “BOO,” (Build Operate Own), or “BOOT” (Build Operate Own and Transfer), or “ROT” (Rehabilitate Own and Transfer). In the United Nations, we also refer to it as concessions. This is a term Americans resisted, but the

French taught us about their concession system. The French system is a little different and the deals that derive from their arrangements are called Concession Agreements. We discuss Project Finance, which is a financing technique. There are other ways of inserting private finance into these projects, for example, through bond issues, and Moody's now assesses these projects. This is a fascinating field. In many ways you could call it a microcosm of, or even a metaphor for, what we discussed yesterday. While it is too big to be a microcosm, it embraces almost everything that we discussed yesterday. And it is disturbing and sad to hear how little private financing is occurring in Iraq because this is the only way to proceed in post-conflict situations.

It is important to mobilize the necessary resources, which are often thought of as foreign capital, but it can also be local capital. Local developers, sponsors, project companies, experience, and networks are vital phenomena, especially since domestic infrastructure typically does not produce foreign exchange for the foreign investor.

B. The Many Difficulties

Privately financed infrastructure is objectively difficult; it is not just ignorance in the West about host countries that makes it difficult. In theory, bright investors and developers will be diligent, but it is difficult anyway. Eight factors illustrate this. The first is lack of sufficient policy and negotiating experience, as well as capacity, in many host countries. It is a vicious circle because when governments are unable to coordinate their efforts, the risks for investors and lenders increase, causing the investors to become nervous and demanding. When investors become more nervous and demanding, governments have a harder time coordinating their efforts, thus creating a vicious circle. Many countries lack experience because provision of infrastructure is the government's primary role. For example, during an oil crisis in Argentina, President Frondizi stated, "oil is Argentina's sovereign 'mission.'" So the government's mission is to provide roads, and public services. Governments in many developing countries cannot turn these services over to foreign businesses. It is the sacred public duty of the government itself to perform the services. If a country would discharge its sacred duty, the country would not need foreign and private investors. Populations are growing and the pressures are mounting—there is demand for higher standards. Consumers across the globe desire cellular phones and other products and services. It is difficult for the "PTTs" (Ministries of Post, Telephone and Telegraph) to provide these types of services when they cannot even provide the landline telephones.

In many countries, there is no ability to cope. They do not have the legal structure, framework, regulations, the platform, the documentation, or properly organized ministries. The countries also lack experience and training. What exacerbates these deficiencies? Is it turning over the family patrimony of provision of service to foreigners? This question brings me to my second point, which relates to nationalist, etatist, ideological resistance. Many countries, such as France, China, and previously

Turkey, have a statist tradition-etatism, which is not communism. It means that the people will collectively provide for itself whether in a monarchy, a democracy, or the Governing Council of Iraq.

Ideological resistance is a kind of post-socialist, Marxist idea. In the 1980s, Lady Margaret Thatcher and Ronald Reagan changed the world. The past orthodoxy of elites, professors, and in the case of the French, the top civil servants who are called the *Ecoliens*, guided the fate of countries (in a very interventionist, from the top down, way). The Stalinist experience in Russia has completely discredited that practice. However, the intelligentsia, in developing countries and elsewhere, has not yet grasped that concept. So a resistance persists in terms of going to the market. "Marketism" like Marxism will create problems, if it is seen as an absolute answer that can solve everything. Some of the resistance is visceral or innate in the person resisting the change. It is simply irrational.

The government and the people need to come to a realization. Abraham Lincoln stated, "we have to disenthral ourselves of the dogmas of the past." One way to begin this re-infrastructure is to have the people decide via the legislatures to enact a general concession law, and possibly sector specific laws. Enacting an enabling law (a framework) is a means to overcome public resistance and signal a movement into a new era. Of course, there will be resistance from trade unions because they fear loss of public sector jobs. In addition, there are ideological flavors, such as the romantic successor to Marxism, which is the position that the people must be involved in the decisions. Examples of various ideas exist in Argentina with Peronism, and also in Venezuela with Populism. While people should be involved in the decision-making, problems continue to obstruct the movement forward.

A subsequent problem comes from the French, one of the highest civilizations of all time, which has given us administrative law as part of its version of the civil law system, as opposed to the common law system. The French system has the *conseil d'etat*—the council of state at the top of a body of administrative tribunals, which applies the administrative law. Unfortunately, that interventionist law survives with BOT in Argentina, Latin America, Turkey, and parts of Africa. This law gives the government unilateral powers, including the right to order changes to projects. The French removed some of its features and rigidities, but some Latins have not. These unilateral powers include giving governments the right to change a contract for a two-lane road into an agreement for a four-lane road, and make a project unbankable. There is real tension because administrative law gives the government this right—it varies from country-to-country, and it may be in a statute or an agreement. Governments in these countries really have extraordinary powers. The expression that is used is "extraordinary clauses." This tension is an obstacle to moving projects forward. Turkey changed its constitution to conquer this problem. On the other hand, the French may say, "you Anglo-Saxon pragmatic, insufficiently principled, individualistic people." In the past, many developing country elites have felt that way about the United States. French public servants say, "our job is to provide

high level public service—high quality, continuous, universal service, which is adaptable as the economy evolves. How can we bargain with developers and lenders represented by, for example, Kenneth Hansen and others who basically want to make the best possible deal they can?” Professor Francis Wang said that for one thing, one must have two things at once. Also, one must be able to have the free-bargaining of the entrepreneurs, sponsors, project developers, and lenders. It is noted that banks are not usually free-bargainers—they simply make demands or will not provide the money. How can one have free-bargaining and also have the government assurance that it can provide all these services? The bargaining types are correct in that everything should be negotiable. However, the government has retained the ultimate power to agree or disagree to the negotiated concession agreement or the project agreement. The government is the sovereign, and it does not have to agree. The tension between developers and lenders, and the government increases the transaction costs because of the negotiation costs. The government is facing a free market negotiator (banks or developers) and their lawyers on the one hand, and this interventionist tradition on the other. This tests a government’s capacity to accomplish its goal.

A third point is structured competitive selection of concessionaires. To illustrate, a friend represented a U.S. airline that was willing to take over an airline in an Asian country on the condition it would be on a sole-source basis, with no competition. The government said no because advisors and the World Bank state countries must have competition. However, the airline will walk away. The great project, Dabhol, that several of the conference participants were involved in, was not subject to competition. I assume that this gigantic project in India was honestly negotiated, but newly elected politicians said it was corrupt, such as pay-offs, etc. Lack of competition makes such projects vulnerable. Countries must have a structured variety of competitive selection. However, the French have occasionally said no, the state can do this project. So, why can we not delegate it to whom we want? This is the French position—delegation. Why is that not corrupt? Indeed, it could be very corrupt. Admittedly, in a country such as France that is very rich and able—corruption is one thing—but corruption in Mauritania and Mali might be disastrously worse. Thus, competitive selection must be open and transparent.

Traditional public procurement has risks, but often they are out of sight. Privately financed projects are also vulnerable to risks, but these are usually in the open. A shibboleth in this field is *allocation of risk*. As a lawyer, it may be more accurate to say *allocation or assignment of the duty to discharge the risks*. In the construction phase, these might include cost overruns, delays, force majeure, and contingencies. Some may say, “look at all these things, what is wrong with these private sector investors?” These risks all exist when the state performs a project. When you have a state provision of electricity, for example in California, TVA, or in developing countries (where typically the government obtained a loan from the World Bank or the Asian Development Bank), a contractor came in and built the road, or a power plant. The risk and the force

majeure are borne by the government. The cost overruns are paid for by the government via the World Bank loan, and then repaid by the government. The risks always existed and BOT/PFI reveals them. The idea that private sector participation in the provision of infrastructure and these services somehow creates risks is implausible (although a risk of expropriation may be added). To the contrary, the argument is to allocate the risks to the entity best able to handle them. Competition and proper incentives will usually address some of the infirmities and temptations inherent in sometimes enormous projects.

A fourth point entails the needed legislative framework. What exactly is the needed legislative framework? It can be everything. Once, an officer from the governing council of Madagascar (now called Malagache) said, “we want to privatize our economy.” The officer wanted to know what this meant for law. What did it involve? Actually, instead of wanting privatization, the officer wanted everything—private law, tax law, company’s law, securities law, investment law, agency law, property law, etc.

Some countries need all types of law. More immediately and specifically, these countries need a general concession law, they need to deal with sector policy, regulation and competition policy. A World Bank employee once said, “we do not want to replace one public monopoly with several private monopolies.” That is a risk here. Another risk is that private investors will present low offers initially and just one year later, try to renegotiate the rates. An example of this risk is the Manila water works, which was an IFC project.

A fifth point is in regards to the structuring of sectors—how much public, how much private? Governments unbundled electricity into generation and into transmission and distribution. How many power projects will exist in the country? Are you going to use hydropower or coal? How much will be private sector? Is there local capital? With legislation comes regulation, which is very important. Proper regulatory regimes are one of the big issues. A power company states that it will sell electricity to the public in return for a price. The power company computes its internal rates of return and then demands more money. There is a lot of subsidized electricity in many parts of the world to the private sector, for example, agriculture in India.

A government says to a would be road concessionaire, “you want to charge too much,” or even “the roads are free.” The concessionaire replies, “we are going to run it as a toll road and we are going to charge a great deal.” There are tremendous issues in making it work. The concessionaire may receive some subsidies and capacity payments, but this is one of the main reasons why these projects do not work well. In addition, a year later there is renegotiation. If the government wants to regulate, this is a difficult subject to address. There are other issues: does electricity have one regulator, telephone another, and so forth, or are they all under one regulator?

The government needs other types of law. For instance, security interest law is very important. Laws are needed that allow one to give security in anything, including intangibles, office equipment, etc. This touches on the problems exposed by Hernando De Soto.

In some countries in Latin America when a business owner wants to borrow money for a little business, as Hernando De Soto might suggest, money might be needed for a few computers, office furniture, equipment, carpets, etc. A business owner obtains money from the bank if he or she is wealthy, or the business owner can mortgage his or her house. If the business owner is unable to select one of these options, he or she might be able to borrow the money, but the business owner must pledge to return the computers or other goods to the bank in the event of default. The banks will not take a lien if they do not have possession, which is a profound problem in many countries. That is one of the basic law reforms needed in these countries, and particularly in BOT, because when the banks lend for these projects, they need the right kind of security. Yes, banks may be able (in a few cases) to take an unsecured mortgage and threaten the government owner, but lenders prefer the income stream, such as the tolls being generated by the financed bridge. This lender expectation requires that the borrower obtain a security interest, a “lien” or “charge” in those tolls, so they cannot be released to another creditor. This requires conformation with Article 9 of the Uniform Commercial Code or the model Charge Law of the EBRD. Many countries and advisers are working on this subject.

A sixth point is that in theory, project finance is non-recourse. In other words, lenders lend to the project without recourse to the credit of private investors or government. There may be a need for some government subsidies, and indeed, some government guarantees create contingent liabilities, which tend to be forgotten. There were debt crisis in the early 1980s in Mexico, later in Russia and Asia, and most recently, in Argentina, where such contingent liabilities were not always quantified.

Seventh, dispute settlement is a major issue. An example is the Dabhol power project in India. India has commissioners that regulate utilities, and others settle disputes. So do other countries; but these systems may not work..

An eighth point relates to capacity. Several host countries were discussed yesterday. During that time, we discussed the differences in whether countries—large or small, with centralized governments, provinces, municipalities or independent agencies—may have the legal and regulatory frameworks needed, and whether some will have more negotiating experience than others. However, gaining experience is difficult and takes time. This is an area where training can make a contribution, but it is training of a rather elaborate variety. One must be sensitive that accepting private and foreign participation in infrastructure may impinge on national history and self-image.

II. CONCLUSION

Private participation in public infrastructure will continue to be difficult, despite its necessity. This is an extremely challenging area, and I admire Ken Hansen and others who give advice in this area for their careers.

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