Annexure –B

RBI ANNUAL REPORT 2013-14

I. Assessment and Prospects

For the Year July 1, 2013 to June 30, 2014

Excerpts pertaining to Infrastructure Sector:

Strengthening infrastructure by improving contractual arrangements for private sector

Despite concerted efforts by the government, the revival of interest in infrastructure investment has been rather modest. Therefore, further initiatives have been taken in the Union Budget 2014-15 in consultation with the Reserve Bank. The Reserve Bank has followed up on the budgetary announcements and, as stated earlier, allowed banks to raise funds for lending to infrastructure sector without regulatory requirements such as CRR, SLR and priority sector lending targets. The Union Budget has also sought to improve infrastructure through measures related to public private partnership (PPP) and setting up of a National Industrial Corridor Authority in order to coordinate the development of industrial corridors with smart cities linked to transport connectivity. The Budget aims at providing incentives for Real Estate Investment Trusts (REITs) as well as announced the setting up of Infrastructure Investment Trust (a modified REITs type structure) in order to attract long term finance from foreign and domestic sources for PPP and infrastructure projects. The budgetary provision for the Pooled Municipal Debt Obligation (PMDO) was enhanced from `50 billion to `500 billion with the extension of the facility by five years to March 31, 2019.

However, the PPP model in India has come under strain during the cyclical downturn, partly due to aggressive bidding by private sector firms facing competitive pressures. Their unrealistic assumptions that the economy will keep growing at a high rate have been belied. Cyclical downturns had not been adequately built in the project mathematics. At the same time, contractual arrangements with the private sector provided little flexibility and have worked to dampen private sector interest in infrastructure investments during difficult macroeconomic conditions. Some firms have also exacerbated the problems of liquidity and leverage by showing inflexibility in asset sales by sitting on large land banks or other assets. These problems need to be quickly resolved by a flexible approach, both from the government and the private sector. In this context, a more focussed initiative to revive the infrastructure sector, inter alia, by improving contractual arrangements with private sector is needed.

Given the infrastructure deficit, a large opportunity awaits the private sector for participation in the growth of the infrastructure sector. These opportunities exist in road, railways, ports and power sectors. Improved contractual arrangements can rekindle interest in this space and help the investment cycle to turn around soon.

Rethinking Contractual Arrangements with Private Sector in Infrastructure

While infrastructure expenditure is vital for growth, it is a challenge to balance it with fiscal restraint, which remains a policy imperative. This could be partly addressed by the private sector, but many such existing investments are facing problems.

The banking system, which has largely financed private involvement in infrastructure, is showing the resultant strain. While stressed advances of the scheduled commercial banks (SCBs) have declined marginally to 10.0 per cent of the total advances in March 2014 from 10.2 per cent in September 2013, they remain high. Five sub-sectors, viz., infrastructure, iron and steel, textiles, mining (including coal) and aviation services, that account for about 24 per cent of total advances, comprise over half of stressed assets. Of these, asset quality in iron & steel and infrastructure has worsened most sharply. While share of advances to infrastructure continued growing, albeit slowly (the share of the other four sub-sectors have declined), from 13.5 per cent in March 2011 to 14.4 per cent, in March 2014; infrastructure as a share of stressed assets, has risen sharply, from 8.4 per cent to 29.2 per cent. This implies that the stress rate of infrastructure, which was much less than the average, is now over twice that of the overall portfolio. Over a fifth of all infrastructure advances are stressed and in stress tests of credit risk exposure to sectors, infrastructure impacts banks most severely on account of potential losses on future assumed impairments.

It is important to avoid a repeat of the past, where a push for infrastructure projects, many of which later stalled, resulted in accelerated growth in gross NPAs. Furthermore, while early detection and prompt corrective action (PCA), concerted recovery efforts, and a more supportive legal infrastructure, etc. can help to address issues of asset quality, it is necessary to also revamp the contractual relationship between private firms and the government in the infrastructure sector.

The nature of contracts with the government determines the risk allocation to the private sector in infrastructure. The broad principle is to allocate such risks as can be controlled or managed by the private sector to them, but many current contracts do not fully reflect this principle. In power generation, the bids allowed bidders to assume exchange rate and fuel cost risks, without enforcing suitable hedging. This led to large scale renegotiation. In roads, the transfer of traffic risk, known as unpredictable, highly variable and outside the control of the private sector, could have been avoided. Given that the high leverage of construction firms in the road sector amid environmental and land acquisition issues has tempered the private sector's interest in PPP bidding, measures such as premium rescheduling, cancelling and rebidding of contracts and recourse to engineering, procurement and construction (EPC) contracting has become necessary. The perception is that Port concessions are designed to charge users more than needed; a number of them have been challenged in courts. Similarly structured airport concessions have had to be renegotiated.

Pension and insurance companies have consequently been reluctant to lend to infrastructure projects, which their regulators, prudently, given the experience so far, perceive as excessively risky. Total lending by them is thus limited, even as there is substantial growth in assets under management (AUM). A better distribution of risk will allow them to increase their participation and could bring in substantial additional funding into the sector.

A wholesale reversion to works contracts may be undesirable, not only fiscally, but because infrastructure PPPs are needed to increase accountability and leverage private management and implementation capacity. Based on learning from existing projects, revamped contract arrangements that limit risk transfer to project costs and controllable revenue items and use of innovations like Least Present Value of Revenue (LPVR) bids, e.g. for electronically tolled roads, may be examined.

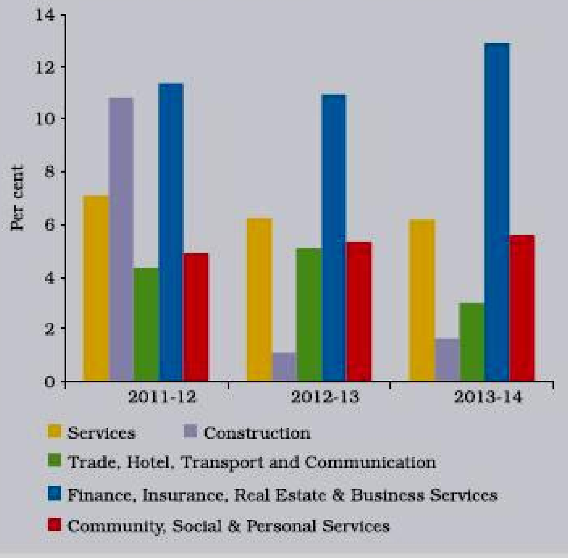
Revamped infrastructure contracts also need to factor in the possibility of renegotiation and include mechanisms that clearly lay out the process to be followed in such an event. This will reduce the advantages of those who bid unreasonably in the expectation of being able to renegotiate better terms subsequently. Also, a more level playing field will help to attract foreign direct investment (FDI) into the sector.

Economic Review

Services sector stayed weak in 2013-14

Growth of services sector during 2013-14 was mainly driven by the sub-sector 'financing, insurance, real estate & business services' which grew in double digits followed by 'community, social & personal services' **However, the construction sector suffered a major setback in the last 2 years on account of the economic slowdown.**

Chart II.7: Growth in Services Sector GDP

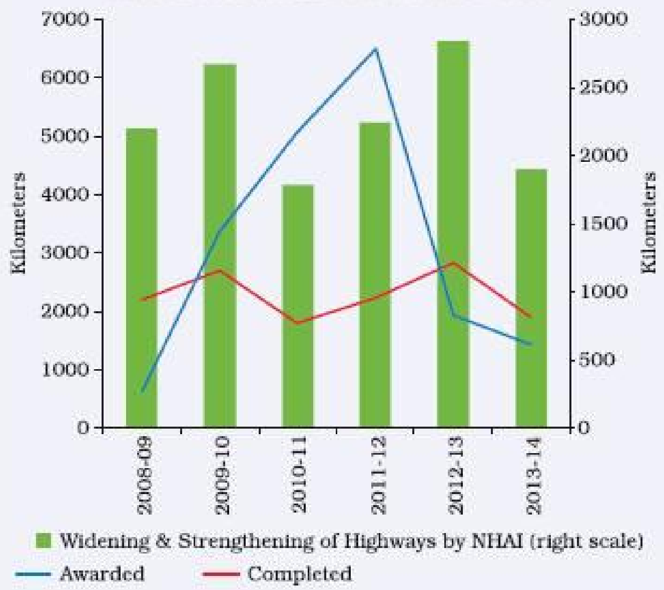


In the last few years, infrastructure sector has been experiencing sluggish growth mainly due to macro economic factors and policy gridlock coupled with sector specific bottlenecks. However, over the last one year, the government attempted several reforms aimed at reviving the sector viz., streamlining approvals through the Cabinet Committee on Investments (CCI), increasing domestic availability of coal supply through fuel supply agreements and coal imports at a cost-plus basis, streamlining coal block auctioning, financial restructuring of state electricity distribution companies and gas pricing guidelines. These supply-side measures have yielded some benefits, though more efforts will be needed to turnaround the investment in the sector. Along with supply side constraints, of late, the power sector is also facing demand side pressures, associated with both slow growth as well as the financial weaknesses of most of the state and privately owned electricity distribution companies, which has made them reluctant to buy power. This has led to many power producers operating at sub-optimal capacities. Plant load factor (PLF) of thermal power plants declined to 65.6 per cent during 2013-14 from 70.3 per cent recorded in the previous year, putting pressure on the profitability of power producers. In addition, several power projects have been stuck due to issues such as environment clearances and land acquisition.

For the last 2 years, the road sector seems to be experiencing stagnancy. Notwithstanding several sector-specific measures, the road subsector failed to attract private investment during 2013-14, partly due to increased leverage of many construction firms operating in this area and partly due to difficulties in land acquisition, obtaining environmental clearances and concerns about the financial viability of the projects. There were only few takers for public private partnership (PPP) projects for roads in 2013-14; less than 1,500 km was awarded under the engineering, procurement and construction (EPC) mode. During 2013-14, the National Highways Authority of India (NHAI) recorded a growth that was 33.2 per cent lower than that during the same period in the previous year with regard to the strengthening/widening of national highways (Chart II.8). During the current financial year, the new government has set a target of 8,500 km of national highway construction; with the majority to be awarded through the EPC route.

A series of governmental initiatives were taken in 2013-14 to boost infrastructure investment. These included establishment of the CCI and the Project Monitoring Group (PMG) to expedite the clearance of key mega infra projects, enactment of new legislation for land acquisition, rehabilitation and resettlement, treating debts due to the lenders as 'secured' loan in the case of PPP projects, relaxation of external commercial borrowing (ECB) norms for infrastructure finance companies and facilitation of infrastructure debt funds (IDFs). However, these initiatives yielded limited benefits. Since its inception PMG has undertaken the resolution of issues pertaining to projects worth `5.8 trillion. A majority of the projects resolved by PMG were in the power sector followed by coal projects and related mainly to fuel supply agreements. However, as on May 1, 2014, of the 727 central sector infrastructure projects (worth `1.5 billion and above) monitored by the Ministry of Statistics and Programme Implementation (MoSPI), about 39 per cent of the projects were reported to be delayed and 41 per cent were without any specific date of commissioning. The cost overruns of these projects continue to remain high at 20 per cent.

Chart II.8: Performance of Road Sector



Source: National Highway Authority of India, Government of India.