

## Record caFE VB GADGIL

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# The concession document needs a re-look

The Hyderabad metro rail, among the largest elevated tracks in the world, is on course to be commissioned in 2017. The creation of Telangana state has posed some problems especially with regard to passenger estimates for the city of Hyderabad. However, VB Gadgil, chief executive & MD, L&T Metro Rail (Hyderabad), is confident the metro will be up and running on time. In a conversation with Shobhana Subramanian, Gadgil expresses concerns about the structure of concession agreements that are drawn up between governments and developers, pointing out that a renegotiation clause must be built in. Excerpts:

## What are your thoughts on the PPP model?

The model is viable, provided some corrective measures are built in. For instance, there should be preparedness on both sides and the project should not be started in a hurry. There needs to be a reasonable time given for the land to be acquired and the detailed project report should be as current as possible. If the project is implemented after a gap, the plan becomes old, not having taken into account certain new developments and the developer is in trouble. In an urban environment there are several agencies working with one another—water, electricity, sewerage—we need one agency to coordinate.

We also need to accept that there is a basic difference in the way the government and the private sector think for historical reasons—one is driven by commercial considerations, the other is not. The spirit of partnership needs to be stronger. For instance, even today, the concession agreement that is drawn up is more in the nature of a contract rather than a partnership agreement. Many of the older clauses are somewhat one-sided. Further, concessions these days are very long—25-30 years. So, if you want someone to take a gamble over such a long period, there must be some flexibility built in to address unforeseeable developments that are beyond the con-

trol of the concessionaire and the government and which could affect the fundamentals of the project. Today, there is only a dispute resolution mechanism, there is no renegotiation clause if the fundamentals change and this needs to be adequately addressed.

## So, a renegotiation clause is needed...

If we are to look ahead for 30 years, we need some protection, otherwise developers will shy away from projects. What we need is not just a dispute resolution mechanism, we need to pencil in solutions for any changes in fundamentals—these cannot be left to subjectivity. The ownership of risk and delivery of the project should rest with one person on either side. Although we talk of one-window clearance, that doesn't seem to be happening. There are also clauses that simply commit to "assisting", there is no commitment to delivering, and it is hard for a partnership to function that way. We need to spell out the remedies for any abnormal changes. India is going through a difficult time and decisions are being delayed, which affects the project. The concession document needs a re-look.

## If this is fixed, the PPP model should work...

PPPs work better when the concession periods are shorter and in less dense urban areas. But it becomes difficult for a concessionaire if he is held to a strict timeline when there are cases to be resolved in court. The agreement is not always equitable and there are instances when the government gets away by doing something whereas the private developer doesn't.

Also, due to changes in the law, there are some mid-term course corrections that make the situation complicated. In Mumbai, for instance, there is a problem and the matter is in court. In fact, the substratum of the agreement itself is changing due to changes in the law.



If the existing conditions prevail, the cost of Hyderabad metro rail project will be ₹2,000 crore higher than the original estimate of ₹14,000 crore. We will not be compensated with any additional Viability Gap Funding from the central government

In such a situation, how do you expect us to perform?

## Is there a problem because of the two Acts—the Metro Act and the Tramways Act?

Both the Acts have their pluses and minuses. The Tramways Act is

under the jurisdiction of the state government while the Metro Act is a central Act, so the controlling authorities are different. The basic problem is that the Metro Act doesn't recognise the PPP model at all possibly because they thought the projects would be implemented by the gov-

ernment. As far as fares are concerned, we are given to understand the first fare will be fixed by the concessionaire. Two Acts cannot coexist, there is ambiguity and it is not healthy in a partnership to resort to litigation—the project is bound to suffer. Officially, we are governed by the Tramways Act, we haven't shifted to the other Act.

## How do developers deal with cost escalations as has happened in the Mumbai Metro?

There should be a dispassionate scrutiny of any event. The dispute resolution clauses are fine on paper but our experience is that it takes years before you get a final result. If we can't solve it at the local level, we resort to arbitration, then approach the lower court, thereafter multiple courts. Finally, even if one of the parties gets a result, it is probably too late. There is a formula to deal with inflation—even if the fare structure is decided beforehand—there is a formula related to WPI. But if there are some abnormal events that result in a cost increase, then how do we address that? We may make some assumptions but the state of the economy is beyond our control. The more these cases become public, the more developers will shy away from projects. If we want the PPP model to succeed, all stakeholders need to discuss these issues and come up with an equitable and viable solution.

## What would you like to see incorporated into the agreement?

We need to factor in changes in the rupee-dollar parity, interest rates, general trend of inflation. Our assumptions are based on past data but when something goes wrong—the sharp depreciation of the rupee in the last three years, for instance—we need to be compensated. It may be difficult to insert some renegotiation clauses now into the contract; the contract conditions cannot be changed because someone may contest that.

## Should there be a regulator for metros?

I am not sure how effective a regulator can be given that there are multiple agencies scrutinising technical specifications and there are conflicts and contradictions. We need system-specific guidelines so that no disputes arise.

## What is the update on the Hyderabad Metro?

In terms of costs, if the existing conditions prevail, the cost will be ₹2,000 crore higher than the original estimate of ₹14,000 crore. We will not be compensated with any additional Viability Gap Funding (VGF) from the central government; the maximum amount is ₹1,458 crore, the basis on which we won the contract. We are 100% owners of the project, the government has a golden share which gives them one director on the board.

Since 50% of our revenues are to be earned from fares, we are hoping our estimates will turn out to be correct in Hyderabad, now that there are two states. If growth is sluggish, we will need to worry about that. When we did the ridership analysis, our estimate was that there would be 1.6 million passengers initially on three lines and two million in 10 years. However, for a metro project to become successful, the last-mile connectivity—travel to and from the station—needs to be in place.

## You are also allowed to develop land and earn revenues from that, isn't it?

Yes, that is true. Around 40-45% of our revenues are to come from real estate. But although we have the rights to develop land and rent it out—we can construct approximately 18.5 million sq ft of area—the revenues from this stream too will depend on the growth of the city. There are hundreds of developers and the appetite for real estate needs to keep pace with the supply. Also, 5% of our revenues will come from advertising.

## FINANCIAL REGULATORY REFORM

# The emerging market perspective

Regulatory reforms in advanced economies hold little relevance for emerging economies at this stage because their financial systems are fundamentally different. Financial systems in both need reform, but the challenges differ



ALOK SHEEL & MEETA GANGULY

The ongoing G20 and Financial Stability Board (FSB) debates on reforming global finance have so far involved advanced economies (AEs). Emerging market economies (EMEs) have nevertheless willingly signed on to the reforms for three possible reasons.

First, the G20 co-opted them into the global high table of financial regulation through the restructured Financial Stability Forum (FSF), hitherto a preserve of AEs.

Second, most of these reforms would not be implemented immediately in EME financial systems that are still fundamentally different from those in AEs.

Third, EMEs stand to gain from a 'safer' financial system in AEs because as net savers much of their own financial intermediation is routed through it. A shock in AE financial systems automatically transmits to EMEs through sudden stops and attendant currency crises that can derail their economies as happened recently.

Financial panics are often preceded by escalating leverage with maturity mismatches. Drivers of leverage in AEs and EMEs are, however, different. In AEs, the primary driver for leverage was consumption and to increase the return on capital through increased trading of claims and re-claims on real assets in an environment of low returns. This led to rapid expansion of financial assets as a proportion to GDP through the shadow banking system. High credit growth in EMEs, like China and India, was linked to high rates of investment and growth through commercial banking. EMEs are far less leveraged and financialised and their banking systems remain mostly deposit based.

Deposit insurance and central bank discount windows make EME financial systems less susceptible to financial

panics and bank runs. Their central banks also deploy macro-prudential tools to ensure that financial bubbles are contained. Unsurprisingly, therefore, while EMEs were affected by sudden stops from abroad, their financial intermediation held up, even as it froze in AEs with their growing reliance on shadow banking.

The impact of the ongoing financial regulatory reforms on EMEs has been relatively benign so far. Despite the general decline in cross-border claims on financial assets amongst AEs, capital flows to EMEs are back to pre-crisis highs. This is perhaps aided by the long phase-in period for Basel III, and the preponderance of FDI in these flows. TNCs, which drive these flows, never lost access to capital markets during the global financial crisis (GFC). Capital flows to EMEs have been more impacted by monetary policies in AEs than their regulatory reforms.

Unlike in AEs, EME concerns are more developmental than regulatory: increasing savings to accelerate growth; deepening the financial system to develop long-term funding instruments for infrastructure financing; absorbing large inflows of capital to counter the backwash from EMEs to AEs; and reducing the cost of capital and leads and lags in monetary policy transmission. AEs, on the other hand, need to roll back extreme forms of financialisation that expose them to greater financial risks without commensurate gains in economic growth.

Basel III is one area where the new regulatory norms will impact AEs and EMEs almost equally at the same time. Indeed, EMEs are actually ahead of AEs in implementation. However, while banking capital needs to be strengthened in both AEs and EMEs, the rationale for tightening capital norms in EMEs is not self-evident. Capital norms in AEs need strengthening as financialisation of their economies has heightened systemic risks. In EMEs, on the other hand, additional banking capital was needed even under Basel II norms to address issues of rapid credit and economic growth. There is now a probability that migration to Basel III may divert scarce savings in EMEs away from critical investment needs to cover

risks benchmarked to AE financial systems, keeping the cost of capital high in the foreseeable future.

**Shadow banking:** Both AEs and EMEs have flourishing shadow banking systems. In China, it accounts for a little over 40% of total financial intermediation, as against about 25% in the US, UK and the euro area. Despite superficial similarities, however, the driving force, structure and relationship with commercial banks are different in AEs and EMEs. This reflects the fundamental underlying difference that while shadow banking in AEs is a measure of their financial depth, in EMEs it is a measure of their financial repression, as they try to channelise household savings into providing low-cost funds for investment and government developmental programmes.

The similarities are no doubt striking. First, there are strong linkages between commercial and shadow banking. Second, authorities have avoided regulating shadow banks to promote financial inclusion, including home own-

ership. Third, the growth of shadow banking stems from a demand for higher returns, in AE because of easy monetary policy and a global savings glut, and in EMEs because of low real returns on account of financial repression.

The differences, however, are stark. First, the exposure of commercial banks to shadow banking was mostly off-balance sheet in AEs, whereas in EMEs it was direct because it was permitted, even encouraged, by regulators to promote financial inclusion. While sub-prime borrowers in the US may not have been credit worthy for housing finance, they were never excluded from the banking system as in EMEs.

Second, while shadow banking in EMEs channelised savings to risky borrowers at high rates of interest, in AEs shadow banking created money through a sharp increase in its velocity through repeatedly leveraging—"rehypothecating"—the same pool of underlying assets. In other words, while shadow banking in EMEs was through vanilla credit instruments that con-

verted savings into investment, in AEs it created money through innovative money market instruments.

Third, shadow banking loans and mortgages in EMEs are refinanced by commercial banks, much like Fannie Mae and Freddie Mac in the US. However, they are not securitised and taken off the balance sheets of both the loan originator and refinancing bodies through market sales. In India, the loan originator retains the loan on its balance sheet, thereby ensuring credit quality. Since these loans are backed by real assets, the threat of dispossession keeps loan delinquency low. Delinquency is also low also because the borrower tends to declare a lower value for the asset to dodge taxes. This, ironically, makes the loan safer, as the borrower is constrained to bring in more equity from the shadow economy.

In view of these differences, neither the FSB initiative on shadow banking nor the 'ring-fencing' of the Volcker, Vickers and Liikanen kind is very relevant for EMEs at this stage. Shadow banking is an extension of regulated deposit-based commercial banking to remote areas and to address the credit needs of those at the lowest end of the socio-economic spectrum where productivity levels are low, and who lack collateral to make them creditworthy. Shadow banking thus fulfils the role of traditional moneylending. In China, it currently also fulfils the role of development finance, as the government strains to keep banking credit in check without affecting growth.

Shadow banking in EMEs is closely monitored by regulators, something that is only now being attempted in AEs. Placing emphasis on opaque money markets, repo and securitisation markets—at the core of FSB's efforts to rein in shadow banking—will not get such lending out of the shadows in EMEs, where productivity levels and property right frameworks need redressal.

Systemically important financial institutions (SIFIs) and resolution mechanisms. EMEs have very few global SIFIs, except China which hosts Bank of China (BOC) and Industrial & Commercial Bank of China (ICBC). There are concerns regarding their health due to rapid credit off-take since the GFC, be-

cause financial results are largely camouflaged and state controlled, and because of ICBC's growing presence abroad and links with global markets.

EMEs have a number of domestic SIFIs, such as the State Bank of India and BNDES in Brazil, but these are mostly state-owned. Financial intermediation is regarded as a public utility committed to universal service through cross subsidies. Less attention is consequently given to putting in place mechanisms for orderly liquidation to avoid taxpayer bail-outs, as equity holders and taxpayers are mostly the same. Hence, it is difficult to envisage the need for any financial sector tax when the cost of intermediation is already high due to the public utility nature of financial intermediation.

EMEs have now realised that their exposure to global SIFIs means that capital may flow out in the event of a crisis in their parent countries or banks. The GFC led to a sudden stop of capital, with foreign banks in India exiting certain areas under stress, although global SIFIs like Citigroup, Deutsche and HSBC never "pulled the plug" on their emerging market operations as such, and even provided some support and resilience during the crisis. Several EMEs are never the less considering 'ring-fencing' mechanisms to ensure that problems with the parent does not lead to withdrawal of capital from overseas branches, by incentivising wholly-owned subsidiaries over overseas branches.

To summarise, regulatory reforms in AEs hold little relevance for EMEs at this stage because their financial systems are fundamentally different. Financial systems in both need reform, but the challenges differ. EMEs have not actively engaged in the global debate on financial reform, but they now need to step up to the plate, after assessing its relevance and impact, instead of blindly assuming that their economies too should be financialised on the lines of the 'gold standard' of AEs.

(Concluded)

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