

# A High-handed Approach to National Highways

RAM SINGH

The B K Chaturvedi Committee, set up to recommend ways to expedite the National Highways Development Project, seems to have been guided by the misconception that infrastructure can be built by simply doling out additional concessions to the investors. The new rules make inadequate capacity highly rewarding for investors, and offer the entire viability gap-funding grant during the construction phase itself. The question, however, is whether these concessions are necessary and justifiable, given the huge costs they impose on the road user and the taxpayer at large.

The acceptance of the recommendations of the B K Chaturvedi Committee Report (2009) is the most recent example of the government bending over backwards to attract private investment in infrastructure. The Committee has suggested ways for expeditious financing and implementation of the National Highways Development Project (NHDP). It has granted several additional concessions to investors in the highway projects, which will make them more lucrative. The question, however, is whether these concessions are necessary and justifiable, given the huge costs they will impose on the road user and the taxpayer.

## Change for the Worse?

To put the argument in perspective, the build-operate-transfer (BOT) toll contracts are governed by the rules specified in the model concession agreement (MCA) for these contracts. Under BOT toll contracts, the developer of a highway project is granted the right to charge toll fee from road users. There are two main justifications for this concession. One, the developer provides upfront funding for the project, alleviating the taxpayers' burden. Two, he bears the construction and the maintenance costs along with the traffic risks associated with the project. The concession period – the period for which the developer is allowed to charge toll – is about 20 years. In order to spread the project development costs across the concession period, the MCA provides for multi-phase expansion in the capacity of the project, depending on traffic requirements. Under Clause 29, if actual traffic turns out to be less (greater) than the predictions, the concession period is increased (reduced) proportionately. If traffic exceeds the designed capacity and continues to do so for three years, to avoid congestion the concessionaire is required to widen the road at his cost. These rules imply that road users get satisfactory

service, and the investors and taxpayers share the unanticipated losses (gains) arising from traffic-risk.

The Committee has changed these rules. Under the new rules, in contrast, if the government asks for capacity expansion on account of high traffic, it will have to compensate the investor by increasing the concession period. Moreover, even if the actual traffic turns out to be excessively large, the contract period cannot be reduced. So, the event of traffic exceeding the designed capacity has been made very lucrative for investors. Simply put, it would ensure them unexpectedly high profit. But the taxpayers will foot the bill of capacity expansion! Moreover, for obvious reasons, now the investors would like to increase the likelihood of the highly rewarding event of inadequate capacity. So, under the changed rules, there will be a tendency to under-provide the initial capacity. But were these changes needed at all?

The Committee has justified these changes by arguing that the MCA rules make the investor bear the cost of capacity enhancement required by an unanticipated large traffic. And, by doing so, the extant rules take away the upside of the project risks from the investor. But, the Committee has missed out on one crucial consequence of the event in which the actual traffic exceeds the designed capacity. It entails not only the cost of capacity enhancement but also an unexpectedly high profit to the investor.

Moreover, the changed rules may enable the investors to dilute their obligations under other MCA clauses. To see how, consider Clause 12.5 under which the concessionaire is required to upgrade a four-lane highway to six-lane and at his cost. But he has to do so by the end of the 12th year after the contract has been signed. Now, suppose the traffic exceeds the designed capacity much before, say in the seventh year or so. Under the changed rules, the concessionaire can refuse to immediately upgrade the highway to six-lane unless he is compensated for the cost of upgradation. It appears that the Committee has not seriously thought through the implications of the changed rules.

The changes made in the viability gap funding (VGF) grant rules are equally

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Ram Singh ([ramsingh@econodse.org](mailto:ramsingh@econodse.org)) is at the Delhi School of Economics.

problematic. The grant is provided to make socially-desirable but unprofitable projects attractive for the investors. Otherwise, these projects will not attract private investment. The underlying objective of this grant is not, and *should not* be, to provide the upfront financing – that is the responsibility of the private sector. The MCA rules allow VGF up to 40% of the project cost; 20% during the construction phase and the rest during maintenance phase. In contrast, the Committee has offered the entire grant during the construction phase itself, and has reduced it to a mere cost-sharing device. Besides this grant, investors can borrow 20% of the project cost at concessional rates from India Infrastructure Finance Company Limited (IIFCL), a public sector company. Indeed, excluding the profit margins, investors can meet up to 70% of cost just using grants and other funds raised by public sector entities.

Simply put, the above changes in the MCA rules have undermined the very rationale behind the toll projects and the VGF. Indeed, what was the responsibility of the investors has largely been passed onto the taxpayers.

The changed rules have other adverse consequences too. On the one hand, the VGF grant payment has been preponed and on the other, only limited funds are available for the purpose. Consequently, compared to what would have been possible under the earlier rules, now the grant requirements of fewer projects will be met. This means that at least in the short run, fewer grant dependent projects will take off. In addition, the new rules are likely to create moral hazards during the construction phase and later on, especially in view of the fact that the investor is paid 90% of due debt, if the contract gets terminated.

### Wooing Private Investment

One wonders what made the Committee to opt for the above discussed policy changes. It appears that the decline in private investment in highways during the last two fiscal years has made the government desperate for private investment. Even a cursory look at the Chaturvedi Committee report makes this conclusion inevitable. However, the Committee has confused symptoms with the causes. It is wrong to

attribute the decline in private investment during 2008-09 to the unprofitability of the road projects or to the extant rules regarding the VGF and the above-discussed Clause 29. To be sure, recall the pre-August 2008 scenario: a 9% plus growth rate, upbeat credit and financial markets, and bullish investors scrambling for projects to invest in. During 2006-07, as many as 60 highway projects attracted private investment. In fact, there was a shortage of well-structured projects on offer. The extant VGF rules and Clause 29 posed no threat to the attractiveness of highway projects.

The decline was largely due to two reasons: the midway policy changes and the economic downturn. Projects worth at least Rs 70,000 crore fell prey to the detrimental and mid-course changes made in the request-for-qualifications and the request-for-proposal rules in 2008 and early 2009. Besides, due to the economic downturn there was a decline in private investment across sectors. Moreover, a technical application of rules has also increased the interest costs for highway projects. Highways are public assets and therefore cannot be used by private developers as loan security. In the absence of any “tangible” security, as per the Reserve Bank of India norms, loans to these projects have been classified as unsecured. It means that the lenders have been subjected to stricter capital-adequacy norms as well as quantitative restrictions. This, in turn, has increased the lending rates for highway projects.

By now, however, the investment climate has improved significantly. Along

with the economic recovery, investors have revived their interest in road projects. Moreover, the Chaturvedi Committee has correctly rectified problematic features of the request-for-qualifications and the request-for-proposal rules and of those concerning the exit policy, bid security, and security to lenders. These belated measures will further increase the attractiveness of highway projects.

### No Lessons Learnt

Nonetheless, in its fixation with private investment the Committee has sacrificed the valid interests of the taxpayers in order to implement the wish-list of the investors. On the other hand, it has ignored several issues that are crucial for the success of the highways development project. Even the lessons that can be learnt from the experience with the NHDP, so far, have been ignored.

For instance, during the first two phases of the NHDP, as many as 90% of the item-rate contract-based projects have experienced delays and/or cost overruns. Under an item-rate contract, neither the contractor nor the authorities have incentives to prepare the initial cost and time estimates carefully. Consequently, there are large variations in the scope of the project as well as the quantities used, leading to frequent delays and cost overruns. Indeed, to a significant extent, the slow progress on the NHDP so far is attributable to the use of these contracts. Serious rethinking is required on this issue. An appropriate version of what are called the engineering procurement and construction (EPC) contracts can

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Also, road projects encounter many problems during the implementation phase; and thus, suffer from long delays and cost overruns. To illustrate, the contracting process for Phase I had got over by 2003. The execution of the contracts was targeted to be complete by November 2004. However, the implementation is not complete yet. Similarly, 90% contracts for Phase II had been awarded by 2007 but the execution is still below the halfway mark, though it was targeted to be over by December 2009. During the last four fiscals – between March 2005 and February 2009 – only a little over 5,000 kms of highways have been upgraded. Most of the ongoing projects are also experiencing delays. Without resolution of the implementation problems, the official target of building 6,000 kms per year appears unrealistic.

Regrettably, the Committee has totally neglected the implementation problems. It has exclusively focused on making the BOT toll contracts attractive for investors. True, under toll contracts the contractors

have stronger incentive to complete projects in time. But due to the red-tapism, these contracts are not immune to delays. Out of the 39 BOT projects completed so far, as many as 28 have experienced delays. Indeed, it is the “official holdups” faced by toll contracts during the implementation phase – and not the extant VGF rules and Clause 29 – that is a major irritant for the investors. Moreover, if these problems are not addressed, then even if there is desired response from the investors, it can only go so far in achieving the ambitious target of building 20 km of highways per day. The Committee seems to have been guided by the misconception that infrastructure can be built by simply doling out additional concessions to the investors.

Moreover, private investment does not come for free. It has several direct and indirect associated costs. For one, the interest costs are higher for private firms than for the government borrowings; therefore, the direct costs of financing projects are higher under private investment. Two, the government is required to make annuity payments to investors or

forgo the right to charge toll fee from the users. Therefore, the government should seriously explore other sources of funds, especially those that are not distortionary in nature. The revenue that can come from the tolling of publicly-funded highways is one such source. It has not been utilised properly but its potential is vast. Many segments which can be tolled are not being exploited. At the same time, it is important to note that the toll revenue depends, among other things, on the quality of the road service and the efforts put into toll collection. The currently used commission-based toll contracts as well as operation-and-maintenance contracts are deficient on both the counts. It may be worth combining the responsibility of maintenance with that of toll collection.

#### REFERENCES

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