Public-Private Partnerships To Upgrade Argentina's Infrastructure: Risky Business?

May 31, 2018

According to the Argentine government, public-private partnerships (PPPs) represent a win-win arrangement: They will allow for the completion of long-needed infrastructure upgrades, thanks to the help of private investors. However, challenges remain. Economic instability could potentially weaken domestic and foreign investor interest and even lead to project delays.

Overview

- Inspired by its application in other countries, the Argentine government established a PPP framework last year, which will bring about much-needed infrastructure development and improvements through efficient competition among contractors.
- Macroeconomic factors could delay the plans, however. Argentina has a swelling budget deficit, while the depreciation of the Argentine peso recently prompted the central bank to raise the country's interest rate.
- Projects will use Títulos de Pagos por Inversion (TPIs) and Títulos de Pagos por Disponibilidad (TPDs) to underwrite and pay for construction, operations, and maintenance.
- S&P Global Ratings believes that potential funding sources to contractors may come from repackaged securitizations backed by TPIs placed in international capital markets, mirroring recent transactions completed in Peru and Panama.
- In our view, the creditworthiness of the certificates will either be equal to, or notched down from, our sovereign rating on Argentina, based on the relative prevalence of positive over negative attributes of the overall PPP framework according to our sovereign criteria.
- In turn, ratings on these securitizations would be a pass-through of the certificates' creditworthiness upon review of key structural factors, including counterparty risks, temporary investments during construction, funding of expenses, and effective mitigation of any potential shortfall on the notes should delays in the certificates' issuance occur due to construction delays or other reasons.
Infrastructure Is A Key Priority For The Macri Administration

Despite the challenges, Argentina looks to carry out its infrastructure objectives. The implementation of a national infrastructure plan has been among the main priorities of the Macri administration since President Macri took office in 2015. It seeks to compensate for two decades of low investment and the subsequent deterioration of core infrastructure assets. The plan’s main pillars are energy and transportation projects. This is largely due to Argentina’s gas and power shortages, its limited or non-existent railway or road connectivity, and high volumes of congestion.

In line with this objective, the Ministry of Transport in 2016 announced a transportation plan worth US$33 billion, which was scheduled for completion by 2019. So far, the transportation plan has followed its expected course: Of the 2,800 kilometers (kms) of planned new roads, 1,400 kms are already under construction, and upgrades are underway on over 10,000 kms of the country’s existing 13,000 kms of roads and highways.

Financing for most of the transportation projects has thus far come through the public sector. But this is changing. In February 2017, the government approved a new PPP law that aims to bolster the framework for investments and to encourage infrastructure development for a wider range of sectors beyond 2019.

In S&P Global Ratings’ view, by diminishing the public resources devoted to infrastructure works, PPPs should improve the country’s financial balance, as well as the efficiency of the planned upgrades. In addition, the use of PPPs, with private contractors competing for projects, should lower costs.

The first round of PPP projects will likely be granted in June 2018

The government, since enacting the law, has also created an under-secretariat responsible for PPPs. The under-secretariat is tasked with designing programs and with fostering PPP proposals. The process has rapidly evolved since: November 2017 saw the launch of a first round of PPPs comprising six highways and safe routes. The required investment for this portfolio of projects is estimated at around US$8 billion.

A total of 32 potential concessionaires and consortiums presented bids on April 20, 2018, while the opening of the economic offers from 10 different concessionaires was held on May 17, 2018. The projects mapped below (see chart 1) are expected to be granted in June 2018 and financed thereafter.
This first round will likely set a precedent as further projects are set to be launched throughout 2018 and beyond. The likely projects under the same PPP regime include railroads, electrical transmission, hospitals, penitentiaries, water, sanitation, public lighting, bridges, and logistics contracts. Overall, the PPP regime is expected to attract estimated investment bids totalling around US$26 billion.

We believe that the new framework includes several positive features that represent significant advances from previous PPP laws enacted in the country. In particular, the new approach will establish clearer guidelines regarding the obligations and rights for private-sector concessionaires. For instance, it will elucidate how projects should be executed and how much
compensation concessionaires can expect. Our view is that the framework should allow sponsors and lenders to design financing structures that support long-term debt repayment. We consider this vital, especially given the long-term nature of the investments. In this context, we anticipate that international market issuances could become a viable alternative for financing these projects because the local capital markets are still underdeveloped.

External conditions may have consequences for Argentina's PPP plans

Recently, changing external conditions have negatively affected Argentina more than most emerging markets, due to its heavy reliance on foreign funding and its large budget deficit. Confronted by a steep depreciation in its currency, Argentina’s central bank reacted swiftly. Over eight days, it increased its policy interest rate to 40% from 27.25%.

Although these developments created uncertainty around the bids, no concessionaire withdrew. In our opinion, the incrementally higher cost of debt as a result of deteriorating macroeconomic factors may negatively affect both the local and international players and their access to financing. Nevertheless, the bidding process itself required a type of performance bond, whereby if the concessionaire withdraws from the project, the bond could be enforced by the government to make itself whole. Additionally, we believe the government’s decision to seek external funding from the International Monetary Fund (IMF) is unlikely to materially weaken its own ability to proceed with the overall PPP framework.

Financial Structure Considerations: Trying To Draw In Bidders

The PPP structure in Argentina has been inspired by other PPP regimes in markets like Peru, Panama, Chile, and Australia. Its principal goal is to attract the highest number of experienced bidders, including both national and international companies, and even promote partnerships between them.

Introducing TPI and TPD certificates

The designated contractor is the bidder that presents the minimum value of public compensation once it is prequalified. Once the concession is granted, the contractor and the Dirección Nacional de Vialidad (DNV), which represents the Argentine government, sign the contract. Among the terms of the agreement, most relevant is the contract structure, which separates the financial compensation between the construction phase and the operation and maintenance of the project. This thereby simplifies and clarifies the financing sources’ structure.

According to the agreement, construction work will be fully compensated on a quarterly basis (provided that construction is completed within the investment period) via Títulos de Pagos por Inversión (TPIs, or investment reimbursement certificates). These U.S. dollar-denominated certificates will be irrevocable, freely transferable, and will provide 20 semiannual payments on May 15 and on Nov. 15 of each year.

TPIs may be fixed- or variable-rate, depending on the type of performance bond. As part of the contractual requirements, the PPP structure implies the submission of certain performance bonds with regard to financial close, as well as primary projects and operations services. As such, if the designated contractor provides first demand guarantees, its reimbursement will be in fixed-rate TPIs and will not be subject to any deductions. On the contrary, when primary projects or operations performance bonds are issued with surety insurance, variable-rate TPIs will represent 15% of the total compensation and will be subject to possible deductions; meanwhile,
fixed-rate TPIs will still pay out the remaining 85%. Furthermore, variable-rate TPIs could receive penalties during the life of the PPP contract; therefore, they are subject to penalties and sanctions for noncompliance with quality standards.

In regard to the project’s operation and maintenance, payments will be made by freely transferable and irrevocable Títulos de Pagos por Disponibilidad (TPDs; availability reimbursement certificates) that are issued on a monthly basis in Argentine pesos. Unlike TPIs, there may be projects, such as toll roads, where historical traffic levels are sufficiently strong to ensure enough reimbursement. Therefore, no compensation would be granted; otherwise, the payment may be subject to a cap or provided in full as part of its economic bid offer. The certificates would be subject to discount penalties before they are issued and, with respect to payments, they would be available after 15 business days from the date of issuance for an amount equal to one-twelfth of the annual amount proposed in the bid documentation.

In general terms, both types of compensation share certain structural characteristics regarding additional interest for delays in payments and the PPP vehicle as the issuer and obligor for every TPI and TPD, subject to Argentine law. In addition, the compensation types are global and freely transferable without the DNV's consent.

The credit risk of TPIs from the sovereign view

S&P Global Ratings' sovereign ratings criteria ("Sovereign Rating Methodology," Dec. 18, 2017), when determining the likelihood of payment of sovereign obligations such as infrastructure-related debentures, give the flexibility to equalize the rating or notch down, generally one to three notches from the sovereign issuer credit rating, based on our analysis of these strengths and weaknesses, among others:

- The overall political importance of the project the obligation is funding;
- The government party responsible to make payments on these certificates (i.e. central bank, finance ministry, or other agencies);
- How the liability is reported (if at all) in government statistics;
- Political or community resistance to the project itself;
- Whether or not there is cross-default with other sovereign debt; and
- Enforcement mechanisms.

The decision of whether to equalize the rating on the TPIs to the rating on the sovereign or to notch (and if so, the number of notches) would be based on the relative preponderance of positive versus negative attributes identified above, plus any other factors considered in the overall analysis. Moreover, our credit opinion of the TPIs would be replicable to all infrastructure projects that use these certificates as the main source of funding, as we do not expect their key characteristics to vary from one corridor to another.

The PPP Trust

Availability payments would be made through a PPP trust created by the Argentine State, which will operate as a single special purpose vehicle (SPV) for the whole transportation program. Yet each project will have an individual account waterfall, which is separate from others'. We would expect to see an additional offshore SPV in case the securitization is placed in foreign capital markets. The PPP trust is responsible for overseeing the cash flow allocated and executing the
payments of TPIs and TPDs to all financing projects. The funds held inside the PPP trust will come from two primary sources: (1) taxes on diesel gathered by Sistema Vial Integrado (SISVIAL) and (2) toll contributions.

Additionally, the government must make annual contingent cash contributions to fund the PPP trust at an amount sufficient to fulfill each project’s reserve account and cover any shortfall on the volume necessary to release TPI and TPD payments during that calendar year. In other words, the government will be responsible for any deficiencies in the PPP trust accounts used to cover every project reimbursement. The so-called “contingent contribution” will be included in the national budget bill every December of the previous year in order to have approval and delivery no later than March 31. (See chart 2 for a diagram of the PPP scheme.)

**Chart 2**

### PPP Scheme

- **EXPENDITURES**
  - Main Works
  - Maintenance
  - Operation
  - Complementary Works
  - Re-pavings

- **PPP CONTRACTOR**
  - Funding entities
  - Public Compensation
  - Compensation for use

- **REVENUES**

- **REPAYMENT**
  - TPI Investments: After 2 year grace, each 6 months during 10 years
  - TPD Availability: Every month from year 0

- **Every month DNV & PPP contractor joint confection of**
  - AR-PI
  - AR-PO

- **National Highway Administration (‘Vialidad Nacional’) CONTRACTING PARTY**
  - C-O (Qtrly)
  - C-I (Qtrly)

- **Payment and guarantee PPP TRUST**
  - TPU (85%) (Quarterly)
  - TPIV (15%) (Quarterly)
  - TPD (Every month)
  - Tolls
  - Excess load
  - Service areas
  - Services for third parties

- **Other resources and/or guarantees**
  - Gas Oil Tax

<table>
<thead>
<tr>
<th>AR-PI: Recognition of investment act</th>
<th>TPI: Payment investment title</th>
</tr>
</thead>
<tbody>
<tr>
<td>AR-PO: Recognition of availability act</td>
<td>TPIF: Fixed payment investment title</td>
</tr>
<tr>
<td>C-O: Communication of availability</td>
<td>TPIV: Variable payment investment title</td>
</tr>
<tr>
<td>C-IR: Communication of investment</td>
<td>TPD: Payment availability title (in some PPP contracts, depending if tolls are enough to operate and maintain)</td>
</tr>
</tbody>
</table>

Source: Ministry of Transportation, Dirección Nacional de Vialidad (DNV).
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**Payments upon termination are a key structural element**

Each project will also have its own 12-month reserve account that must be fulfilled in U.S. dollars before March 31 each calendar year—in an amount equal to the total TPIs due in the same year.
Moreover, the PPP contract includes a termination payment associated with possible early termination. The amount would be equal to the value of the investments acknowledged by an investment progress act granted by the state, but not yet issued as TPI, and subject to pending penalties. The agreement specifies possible trigger events or commitment termination events (CTEs) under which a termination payment is attributable. Fixed TPIs will never be affected by early termination; meanwhile, variable TPIs may be subject to deductions.

**Peru And Panama PPP Frameworks: Setting The Precedent**

S&P Global Ratings identifies three key alternatives for the funding of PPP contracts:

- Project finance transactions, which rely on the cash flows generated by their assets as the main repayment source;

- Structured finance repackaged securities, in which the underlying assets are infrastructure-related certificates to be issued by a branch of the government only upon completion of construction milestones, thereby eliminating operational and construction risk; and

- Repackaged securities in line with the above; however, the debt has an explicit and irrevocable guarantee from the government, which recognizes it as sovereign debt.

We have rated a wide array of transactions like these. In particular, we've seen several transactions originating in Peru and Panama (see table below) that are as described in the second and third bullet points above. We believe Argentina's PPP framework will most resemble structured finance repackaged securities. As such, the overall analysis of the structure would rely on our credit opinion of the underlying asset (i.e., the TPIs), which, in turn, would rely fully on the "contingent contribution" of the government as last resource of payment, and not on the taxes and toll contributions. Otherwise, the credit risk analysis would fall under project finance (first bullet above).
Specifically in the case of Peru, the government has used U.S. dollar-denominated certificates to periodically reimburse the concessionaire for the construction costs of Lima Metro Line 2 or the rehabilitation of certain toll roads, which are unconditional and irrevocable obligations of the Peruvian government (GoP). The concessionaires in these projects have financed a significant portion of the projects' development by securitizing these certificates through an offshore SPV. In doing so, they issue repack securities in the foreign capital markets. These certificates (RPI-CAOs or CR-PAOs, as defined in the table above) are denominated in U.S. dollars, and the amounts will be paid out on a fixed schedule over the course of a predefined number of years (typically more than 20). The overall transaction structure—through which investors will receive the quarterly payments derived from these GoP payments—serves to pass along the credit risk associated with the certificates until full amortization.

The security ratings on these repack transactions reflect our credit opinion of the underlying asset (i.e., the infrastructure-related certificates), plus other structural features, including credit default swaps, temporary investments, reserve accounts, letters of credit, et al. In the case of IIRSA and Metro de Lima, the rating on the repack securities is one notch below the foreign currency rating on Peru, reflecting that (1) the certificates are subject to budgetary allocation; (2) they specifically belong to the Ministry of Transport and Communication's (MTC) budget; and (3) they do not constitute sovereign indebtedness. The certificates' governing documents do not show cross-default clauses with other sovereign debt, and are not recognized by the sovereign as public external debt in its budget. If this were the case, S&P Global Ratings would potentially consider

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Outstanding Structured Finance Repackaged Securities Related To Infrastructure

<table>
<thead>
<tr>
<th>Issuer Name</th>
<th>Structure Type</th>
<th>Location of Assets</th>
<th>Security Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>CRPAO PEN Trust #1, Series 2008-100</td>
<td>Repack securitization backed by construction payment obligations denominated certificados de reconocimiento de derechos del pago anual por obras (CRPAOs) issued by the Peruvian government, acting through the Ministry of Transport and Communications, to finance the construction of toll roads Interoceanica Sur and Interoceanica Norte as part of the initiative 'Integracion de la Infraestructura Regional Sudamericana' (IIRSA).</td>
<td>Peru FC: BBB+/Stable/A-2 LC: A-/Stable/A-2</td>
<td>BBB</td>
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<tr>
<td>CRPAO VAC Trust, Series 2009-100</td>
<td></td>
<td></td>
<td>BBB</td>
</tr>
<tr>
<td>Interoceanica IV Finance Limited</td>
<td></td>
<td></td>
<td>BBB</td>
</tr>
<tr>
<td>Peru Enhanced Pass Through Finance Limited</td>
<td>Repack securitization backed by construction payment obligations denominated in Retribucion por Inversiones segun Certificados de Avance de Obra (RPI-CAOs) issued by the Peruvian government, acting through the Ministry of Transport and Communications, to finance the construction of Lima's Metro Line 2.</td>
<td>Peru FC: BBB+/Stable/A-2 LC: A-/Stable/A-2</td>
<td>BBB</td>
</tr>
<tr>
<td>Lima Metro Line 2 Finance Limited</td>
<td></td>
<td></td>
<td>BBB</td>
</tr>
<tr>
<td>SPARC EM SPC (Panama Metro Line 2)</td>
<td>Repack securitization backed by construction payment obligations (CDNOs) issued by Metro de Panama S.A., to finance the design and construction of Panama's Metro Line 2, guaranteed by the Ministry of Economy and Finance, acting on behalf of the Republic of Panama.</td>
<td>Republic of Panama FC: BBB/Stable/A-2 LC: BBB/Stable/A-2</td>
<td>BBB</td>
</tr>
</tbody>
</table>
equalizing the project rating with the sovereign rating.

In other cases, such as the Panama Metro Line 2 transaction, we see a similar framework to that of RPI-CAOs and CR-PAOs in Peru. There is one important distinction, however. The Panamanian government explicitly guarantees the payment of the certificates through a legal document issued by the Ministry of Economy and Finance (Ministerio de Economía y Finanzas) of Panama, acting on its behalf. In this case, the transaction's structure is also intended as a pass-through for the certificates' credit risk, as investors will receive payments derived from the underlying securities on an annual basis. This transaction benefits from an explicit, full, and irrevocable guarantee from the Panamanian state as guarantor over the payment of the Certificados de no Objection. Therefore, the rating on the notes is weak-linked to the rating on the Republic of Panama, and there is no need to analyze the creditworthiness of the underlying certificates themselves. The guarantee will cover any nonpayment over the issued certificates, and we analyze this through our guarantee criteria ("Guarantee Criteria," Oct. 21, 2016).

In our view, the key risk factor for transactions of this type is the potential for delays in the issuance of certificates (should construction fail to advance or not be completed within the scheduled time frame). Certificates would not be available for purchase and the transaction would not be fully backed up by the expected receivables. As such, we've seen that the risk of a shortfall on the notes is mitigated by the structural features in the transaction. These include trigger events that early terminate the transaction and thus lead to the payment of a redemption protection amount to noteholders, which, in turn, is covered by the available assets of the SPV, such as cash held in reserve accounts plus letters of credit, among others. This is the key differentiating factor, in our view, from project finance transactions exposed to construction risk, which, under a securitization, is mitigated/replaced by a counterparty providing a letter of credit.

Additional risk factors to be considered are the temporary investments during construction, as we typically see note proceeds (minus closing expenses) being held in reserve accounts such that funds are available to pay interest and ongoing expenses, and purchase certificates as these become available. We analyze these investments under "Global Investment Criteria For Temporary Investments In Transaction Accounts," May 31, 2012.

Repackaged Securities: What Are The Key Risks?

Our analysis of the above transactions focuses on the below key risks outlined in our repack criteria ("Global Methodology For Rating Repackaged Securities," Oct. 16, 2012), which would apply in the case of Argentine PPPs, if these end up resembling the precedent transactions from Peru or Panama.

**Risks associated with the underlying security**

**Payment default risk:** The rating on a repack will be no higher than the lowest rating on any underlying security where a payment default on the underlying security would likely result in a payment shortfall on the repack. If an underlying security is not rated, but its issuer has an issuer credit rating from S&P Global Ratings, and we have a credit opinion on the underlying security, then we would use that credit opinion when applying these criteria (which is currently the case for the Peruvian deals).

When the default risk associated with the underlying security is, in our view, sufficiently mitigated by a counterparty (guarantor), we consider the counterparty's rating in place of the rating on the underlying security to determine the lowest-rated cash flow source (which is currently the case for
Prepayment risk: When the underlying security can prepay for any reason (including via acceleration, redemption, or mandatory tender), we analyze the impact of the prepayment on the issuer's ability to make payments according to the terms of the repack. In all the above transactions, we see that certificates cannot be prepaid, thereby avoiding continuing interest accruals on the repacks and the potential for interest shortfalls (negative carry). However, if there is an early termination event, such as a commitment termination event where the issuer is no longer required to purchase certificates, the transactions can unwind and the notes will be partially or fully redeemed, depending on the purchased certificates. There is typically a redemption payment, which will be covered by a letter of credit from a rated financial institution. Moreover, we see that any payments due on the certificates that were, in fact, issued and purchased by the issuer will remain as scheduled.

Deferral risk: We typically see that the certificates' payments cannot be deferred. If, however, there is a deferral mechanism under the certificates, we analyze that it matches the deferral period under the notes.

Withholding tax risk: Generally, we have seen that there are no withholding taxes on the certificates' payments. As a result, all of the payments are made free and clear of any taxes.

Structural risks

Asset and liability accrual and repayment terms: Overall, our key analysis focuses on verifying that the repack issuer's liabilities are always match-funded with the issuer's assets. Likewise, we typically see that if there is an acceleration event, there's an established repaying mechanism that assures that investors will receive the net present value of their investment plus the corresponding accrued yield.

Expenses and indemnities: As a typical repack issuer has limited ability to support transaction costs given that these generate minimal excess cash flows (if any), we see in all transactions that capped expenses are either prefunded at issuance with notes' proceeds or paid outside the transaction by a third party (i.e., the concessionaire) and, if any extraordinary expenses occur, these would be subordinated in the waterfall after payment of principal and interest on the notes. As such, the certificates' payments are not contingent on being used to cover ongoing expenses.

Market risk and wind-up events: We've seen that the underlying security's maturity date is the same as the repack notes' maturity date. No assets need to be sold in the market in order for the noteholders to be paid, thus there is no market risk within the repack structure.

Investor optionality: We see that the transactions do not present an investor optionality risk because portions of the notes may not be voluntarily prepaid without redeeming all.