

Corporate Governance

The fourth *TICCS*[®] pillar classifies the corporate-governance structure of infrastructure companies into two classes and two subclasses. The behaviour of a firm and its managers differs depending on if whether it was created to develop a single project or multiple ones. A firm's level of external debt financing also impacts its behaviour. External debt financing creates a demand for monitoring on the part of creditors, especially with single-project firms. External monitoring alters the behaviour you would expect to see in a firm and its managers.

Academic Insights

Infrastructure companies typically take one of two corporate forms: 'projects' or 'corporates.' Infrastructure project companies are single-project firms or project-financed. Infrastructure corporates are multi-project companies more akin to corporate-governance structures found in other industrial sectors. These two types of firms can be expected to exhibit fundamentally different behaviours.

Infrastructure project companies are created in the context of a long-term contract between an investor (the owner of the project company) and a public- or private-sector client. Project companies are created for the sole purpose of delivering a new tangible infrastructure asset and operating it for the length of the contractual period. Infrastructure project companies are also referred to as special-purpose vehicles (SPVs) or special-purpose entities (SPEs). They typically serve as the focal point of a nexus of contracts between investors, builders, operators, a client, and providers of long-term finance, usually in the form of long-term senior debt. The formal definition of project financing put forward in the Basel-II Accord is reproduced in the appendix.

Debt plays a significant role in project finance because it tends to be the main source of capital. The theoretical literature on project finance and corporate governance (see for example Shah 1987^[1]) highlights the role of leverage as one of the most counter-intuitive dimensions of project financing. Project financing reduces the net financing costs associated with large capital projects (Esty 2004^[2]) because external debt plays an important disciplinary role by preventing managers from wasting or misallocating free cash flows and deterring related parties, including the public sector, from trying to appropriate them (Jensen 1976^[3], Hart 1995^[4]).

Because leverage mitigates these costly incentive conflicts among capital providers, managers, and investors, it increases expected cash flows available to capital providers, thereby establishing a link between financing structure and asset values. In this context, the presence of significant loan financing is a signal of creditworthiness (Fama and French 1997^[5]).

Indeed, infrastructure assets have few growth options, which hinders over investing in negative-NPV projects and makes investment decisions more easily monitored by external claim holders. When raising financing, infrastructure project companies typically commit to a given capital program and are not able to seek other sources of financing without the explicit involvement of their original creditors. In the event of various credit events, senior creditors have control rights akin to those of majority shareholders and can require a financial restructuring or even take over the company from its original owners.

The empirical literature on infrastructure project finance (Brealey 1996^[6], Esty 2002^[7], Blanc-Brude 2007^[8], 2018^[9]) , shows that project financing typically relies on high levels of non-recourse external debt financing (typically between 60 and 90%) and concludes repeatedly that project finance loans have different characteristics from corporate debt. In corporate finance, debt can be used to increase returns on equity, creating incentives to take risks. In project finance, because the financial viability of a single project has to be demonstrable ex ante with a high probability, debt is used to minimise the cost of capital and creates incentives to minimise risk.

By contrast, infrastructure 'corporates' or multi-project companies have all the usual characteristics of the firm: managers have more freedom to make various investment decisions and can change course both strategically and financially over time. They can take on new projects, including those in sectors that are not directly related to infrastructure (e.g., utilities investing in media companies) or invest internationally in other infrastructure firms (e.g. European utilities invested in Asian utilities in the mid-1990s), thereby changing their business-risk profile.

Likewise, infrastructure corporates are free to change their financial structures and can use multiple sources of private and public financing. Creditors play a much more limited monitoring role and do not have different control rights in the event of default than with other corporate borrowers. Nor do they play a leading role in the financial structuring of the firm either before or after credit events.

As a result, high or increasing levels of indebtedness in infrastructure corporates is typically interpreted as signalling higher credit and equity risk. UK water utilities are a case in point (Helm 2009^[10]).

The *TICCS*[®] Corporate-Governance Classification

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Single-project infrastructure companies can be found in any of the industrial classifications identified in the *TICCS*[®] second pillar, in particular social infrastructure, road, and conventional or renewable power generation projects. Infrastructure corporates or multi-project companies tend to be found in the utilities sector and in some transportation sectors (ports and airports), where they have often existed for several decades. Regulated infrastructure companies defined in the first *TICCS*[®] pillar also tend to be infrastructure corporates. In principle however, the *TICCS*[®] corporate-governance classifications are not exclusive of any of the other classes defined in the other three pillars.

References

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As noted above, external debt financing creates monitoring mechanisms that can be expected to have a significant impact on the behaviour of managers and the predictability of the firm's activities and risk profile.

As asset owners and managers become the new owners of infrastructure project companies, they sometimes reimburse senior creditors early (prepayment) and replace external senior debt instruments with shareholder-provided debt or refinance project debt at the portfolio or group level (e.g. *HoldCo*).

Such decisions can lower the cost of external financing, but they also remove the project-level monitoring function of external creditors that is so characteristic of single-project infrastructure companies and has contributed to its historic performance track record.

Using these insights, the TICCS® fourth pillar includes two classes of corporate governance and four subclasses. We differentiate between subclasses of 'monitored' and 'unmonitored' project companies as shown.

- CG1: Infrastructure projects
 - CG10: Monitored infrastructure project companies with substantial external senior debt
 - CG11: Unmonitored infrastructure project companies without substantial external debt
- CG2: Infrastructure corporates

The table below describes the TICCS® corporate-governance classification.

Code and Definition	Code and Definition	Synonyms
CG1 - Infrastructure project companies: Companies according to the Basel-II definition of project finance created for the sole purpose of building and operating a well-defined tangible infrastructure asset limited in time and space.	CG10 - With creditor oversight project companies: Infrastructure project companies with presence of external senior debt.	- Special-purpose vehicle - Special-purpose entity - Single-project company
	CG11 - Without creditor oversight project companies: Infrastructure project companies without presence of external senior debt.	
CG2 - Infrastructure corporates		