India
Special Report

India's Public Finance Outlook: Toward an Emerging Market Model

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- "*International Rating Methodology for Regional and Local Governments*", 4 April 2002
- "*Public-Private Partnerships: The Next Generation of Infrastructure Finance*", 6 August 2004
- "*The 12 Habits of Highly Successful Finance Officers*", 21 November 2002
- "*Water & Sewer Revenue Bond Rating Guidelines*", 13 April 2004
- "*Rating Rationale – Water & Sanitation Pooled Fund, Public Finance, India*", June 2003.
- "*State Revolving Fund and Municipal Loan Pool Rating Guidelines*", 5 November 2004
- "*Indian Public Finances: Do they matter?*", 16 January 2006

Summary

Hopeful signs are emerging that India will become an emerging market model for both the decentralization of governmental responsibility and the creation of sustainable financing for infrastructure projects. The central government's infrastructure development plans and local government reforms provide a very supportive platform for these efforts, sometimes including financial incentives to local governments for their participation in reforms. Nevertheless, the acceptance and implementation of these reforms by state and local governments has been mixed.

Recent financing experiments in the Indian domestic bond market by several key states, using a variety of pooled and conduit financing techniques through state-owned corporations, serve as promising prototypes for the sustainable financing of infrastructure in India. In some cases, these debt issuances provide useful precedents for creating and marketing bonds, illuminating the role of escrow funds for debt service, the mechanics necessary for full and timely debt service payment – as well as for the full utilization of bond trustee services – and the debt service reserves and other investor protections. In others, they illustrate how to lower default risk through the pooled financing of municipal loans without a state guarantee. Finally, they demonstrate that various types of public-public and public-private partnerships can be used to attract private capital for infrastructure projects. If more states were to adopt similar structures, that would certainly promote the further development and diversification of India's domestic bond market.

India's rapid urbanization has led to an ever-increasing need to provide basic infrastructure – particularly water, sanitation, solid waste management, roads and urban transport. The financial resources required to expand these basic amenities are enormous, resulting in a significant resource gap that cannot be met from traditional central and state government grants and loans. Recognition of this funding gap has resulted in a near-universal acceptance that the private sector can and should play a larger role in the financing of infrastructure in partnership with the public sector – whether actively as a project sponsor or passively as an institutional bond investor.

However, fundamental changes are needed in the governance and financial position of states and urban local bodies ("ULBs") if they are to access domestic capital markets for their infrastructure projects. These include improvements in local budgeting, revenue collection and accounting methods, voter participation in project planning and approval, policy coordination between the different levels of government, and increased financial transparency to regulators, rating agencies, investors and the public. Reliable revenue streams will not only include general local taxes, but also service-linked user charges and other dedicated revenue sources that reduce or eliminate over-reliance on governmental guarantees or subsidies.

The Urban Infrastructure Gap

Growth in India's urban population is outstripping the ability of the country's municipalities to meet demand for basic urban services such as water, sanitation, roads and urban transport. Efforts to better meet infrastructure needs are hampered by a chronic lack of resources, inadequate management capabilities at the state and ULB level, and the inability to develop sustainable financing for infrastructure projects. Over the long term, this problem will weaken the country's prospects for sustainable economic growth, which is why the policy pronouncements of the Ministry of Urban Development ("MoUD") now stress the need to enhance the economic productivity of urban areas.

The table below illustrates the very low investments that urban water supply and sanitation has attracted, although there was a significant jump in the 9th Plan.

Plan Expenditure (Central & State) on Urban Water Supply & Sanitation

(INRbn)

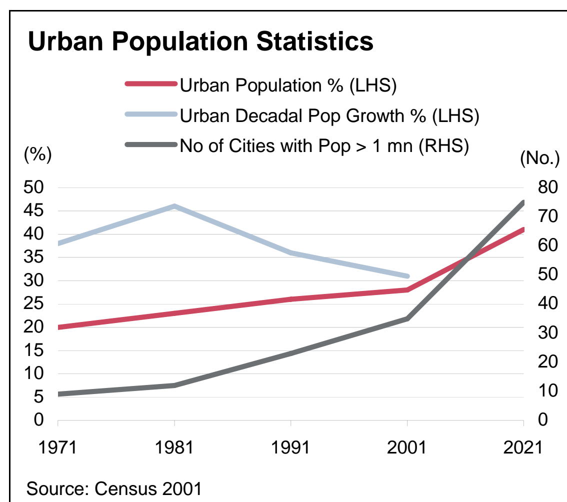
Plan	INRbn
1st Plan 1951-56	0.1
2nd Plan 1956-61	0.4
3rd Plan 1961-66	0.9
Annual Plan 1966-69	0.7
4th Plan 1969-74	2.5
5th Plan 1974-79	5.4
Annual Plan 1979-80	1.5
6th Plan 1980-85	23.4
7th Plan 1985-90	25.6
Annual Plan 1990-92	17.3
8th Plan 1992-97	73.2
9th Plan 1997-2002	186.2

Source: PK Pradhan, Ministry of Urban Development, GoI, at Global Convention on Agenda for Urban Infrastructure Reforms.

India's Urban Population Trends

According to India's 2001 census, its urban population totalled 285 million people out of a total national population of 1.03 billion. Three of the 10 largest cities in the world (Mumbai, Kolkata and Delhi) are located in India, and the country's urban population increased as a percentage of the total from 1% in 1901 to 18% in 1951 and 28% in 2001. This rise has led to the emergence of many "metro cities" – i.e. those with a population of more than one million. Urbanization trends indicate that the urban population will continue to grow at the rate of about 3% per year in the next few decades, as illustrated in the graph below, Urban Population Statistics.

Urban Population Statistics



Source: Census 2001

State of Urban Infrastructure in India

Despite the higher incomes of urban populations, the quantity and quality of basic infrastructure and urban services remain inadequate in many respects. The urban poor often have inadequate access to services such as water supply, sewerage and transportation, for example. Thus, the general urban population, and the population living in the slum settlements in particular, have been most adversely affected by deficiencies in urban services.

Various public and non-profit entities have produced an array of studies that document India's enormous infrastructure investment needs. The studies vary as to how they measure and prioritize these needs – from establishing a base level of service for India's urban population, to developing a world-class level of such urban services. Irrespective of the figures examined, however, all the studies suggest that the funding needs far outstrip current rates of investment by the central and state governments. In fact, financial reports for the state governments suggest that levels of infrastructure investment are declining relative to their budgets and to growth in state gross domestic product ("GDP"). This is the central reason why private sector participation is needed to supplement publicly financed efforts.

The Central Public Health and Environmental Engineering Organisation ("CPHEEO") has estimated the following service funding requirements for the 10th Five-Year Plan (2002-07). We note that it does not stipulate whether this outlay corresponds solely to the capital component or whether it also includes operating investment requirements.

- Water Supply: INR282 billion (USD6.3bn)
- Sanitation: INR232bn (USD5.2bn)
- Solid waste management: INR23bn (USD511 million)

In the next 10 years, some USD90bn is needed to fund key urban infrastructure such as water supply, sewerage, solid waste management and urban roads; available funds, however, total about USD10bn. Over the next five years alone the projected gap merely for the operation and maintenance of basic services in cities has been estimated at USD17bn. If urban mass rapid transit systems were also included, the gap would be much wider[1].

Water Supply

Traditionally, the state governments have played a dominant role in the planning and financing of government services and infrastructure, but have left service delivery, and operating and maintenance functions to the ULBs. About 85% of all urban households and 65% of urban slum households have access to piped water supply. Nevertheless, the level of service is often poor due to low pressure, supply interruptions caused by the need to manage demand, an *ad-hoc* approach to water pricing, and a generally high percentage (between 30%-50%) of unaccounted water in the form of system losses through faulty distribution networks[2].

Sewerage and Drainage

Old networks, faulty pipe alignment and the laying of water and sewer lines in the same trench are the prime causes of poor sanitary conditions in urban India. The institutional arrangements are similar to those for water supply and lack a managerial and organizational structure. While about 70% of the urban population have access to excreta disposal and 48% to a sewerage system, only about 26% of wastewater undergoes treatment before disposal, which results in serious environmental degradation. The situation is grimmer in slums, where only 46% have access to shared toilet facilities[2].

Solid Waste Management

Urban India generates about 0.1 million metric tons of waste every day (according to the 10th Plan document on Civic Amenities, 42 million tons of urban solid waste are generated annually). Collection efficiency ranges from 50% to 90%, while an average of about 65% of collected waste is dumped untreated[2]. Collection and transportation systems are primitive and much waste is disposed without proper treatment. Recycling and composting are used to reduce the volume of waste disposed, as a means of lengthening the lifespan of disposal sites. Municipal solid waste is one of the most neglected services, beset as it is by a lack of financial resources or proper equipment, inadequate manpower, the fragmentation of responsibilities and the non-involvement of the community.

Roads and Urban Transport

Urban roads are inadequate to meet growing traffic requirements. The number of vehicles in India has increased 80-fold over the last 40 years but road length has increased by only 5%[1]. Efficient roadway and urban transit networks are integral to the country's continued economic development. Traffic congestion costs the economy by delaying the delivery of workers, goods and services, and contributing to increased noise and air pollution levels, as well as heightening traffic safety risks. Only 17 of the 23 metropolitan cities have organised bus services, while urban rail service is limited to just four cities – Mumbai, Kolkata, Delhi and Chennai. Except for mega cities (those with a population exceeding four million), the modal split in favour of public transport is generally less than 20%[3].

■ Traditional Methods of Infrastructure Financing

Historically, the majority of Indian urban infrastructure projects undertaken by ULBs have been financed via subsidies from the central and state governments, direct debt issuance by the states, or borrowings by state corporations that are dependent on state government budgetary appropriations or guarantees. This reliance on external government funding for local infrastructure projects has done little to promote fiscal and administrative responsibility among the ULBs, but has, instead, contributed to the fiscal ills of the central and state governments. Many states have structural budget deficits and issue debt to cover both capital needs and operating deficits.

State market loans rose from INR156bn in 1991 to INR868bn in 2001 to INR2296bn in the 2006 budget estimates. These figures are equivalent to 12.2%, 14.6% and 19.9%, respectively, of the total outstanding liabilities of the state governments. Total state liabilities – which include loans from the central government and state small savings and provident fund borrowings – are much larger, having grown from 22.5% of GDP in 1991 to 33.5% of GDP in 2005.

[1] According to Mr M Rajamani, Joint Secretary to the government of India, Ministry of Urban Development, at the 2nd Conference on financing municipalities and sub-national governments, Washington DC, September 2004.

[2] USAID Report on Status of Urban Service Delivery and Urban Infrastructure Sector Reform in India, November 2001.

[3] 10th Plan Document on Civic Amenities.

Finally, state government guarantees to ULBs and other entities, and subsidies that cover the deficits of state public enterprises further expose the states to budgetary pressures. Increasing operating budget deficits (revenue deficits) have contributed to the growth of debt issuance, absorbing resources that would otherwise have been available for capital expenditure (see the table below, Select State Financial Trends, for an illustration of these trade-offs). An alignment of interest rates on state borrowing to domestic market rates in the mid-1990s exacerbated this debt service problem.

Select State Financial Trends

Year	Revenue Deficit as a % of GDP	Capital Outlay as a % of GDP
1990-95 Avg	0.7	1.6
1995-00 Avg	1.6	1.4
2000-03 Avg	2.5	1.5
2003-04	2.2	1.9

Source: RBI Study of State Budgets 2005-06

State investment in infrastructure is failing to keep pace with economic growth and the rise in the urban population. At the same time, the capacity of states to invest in infrastructure has been weakened. Concerns about mounting state debt, persistent if improving state budget deficits and substandard municipal finances resulted in the State Finance Commission ("SFC") and Reserve Bank of India ("RBI") reforms of state and municipal finances. These reforms are discussed in Appendices I and II of this report.

Multilateral institutions, such as the World Bank, JBIC and USAID, also play an important supplementary role in the financing of infrastructure, and in the promotion of domestic bond market participation. USAID's FIRE-D program sought to link project assistance to the implementation of certain fiscal reforms. Major institutions, such as the Life Insurance Corporation of India ("LIC") and the Housing and Urban Development Corporation of India ("HUDCO") are providing supplementary funding for infrastructure. Some domestic bonds have been sold by larger and more creditworthy states, larger cities and municipal corporations; however, they are still limited in number.

Several of India's larger cities and local government corporations have also begun to enter the bond market on a stand-alone basis, although few local government entities have both a steady supply of projects to be financed and strong underlying credit quality.

■ New Central Initiatives for Urban Infrastructure

Over the years, the central government has sponsored several infrastructure and urban investment schemes. Increasingly, grant funding has become conditional on the acceptance of certain reforms by the participating states and local governments. However, the effectiveness of past programs has been somewhat hampered by the relatively small size of the funding commitments in relation to the needs, a reluctance or slowness on the part of state and local governments to submit to reforms (even those mandated by constitutional amendments), and the unintended administrative entanglements that result from having so many active programs competing with one another for the same local government audience. Other impediments include the fact that states have only recently begun to develop viable debt structures for the domestic bond market, while public partners have yet to establish how to use funding commitments as a means of leveraging matching private capital.

In spite of these limitations, the direction of recent infrastructure and urban development initiatives holds much promise, in that central government grants are tied to managerial and fiscal reforms at the state and local government level. Perhaps the boldest of these "conditional infrastructure investment programs" is the National Urban Renewal Mission ("NURM"), which was announced by central government toward the end of 2005.

NURM

The NURM is a five-year, INR1,000bn (USD22.2bn) conditional infrastructure investment program for select Indian cities. Eligible project areas include urban renewal, water, sewerage, solid waste, environmental improvement, street lighting, roads, urban transport and civic amenities.

The conditionality of the program is reflected in a series of mandatory reforms by the participating cities and states, as well as matching funding requirements from participating states.

One submission of the NURM is to promote urban infrastructure and governance through the Ministry of Urban Development ("MoUD"). The other is to provide basic services to the urban poor through the Ministry of Urban Employment and Poverty Alleviation ("MoUEPA"). Mega cities, state capitals and cities that are important in terms of culture and tourism are eligible for assistance under the program. The modalities and eligibility criteria under the NURM are discussed in Appendix III of this report.

The Draft State Pooled Finance Scheme

The MoUD has drafted and approved a set of guidelines to promote ULBs' access to the domestic debt capital markets through a state pooled financing vehicle. These are currently being reviewed by the Planning Commission and the Ministry of Finance. If the central government adopts these guidelines, this will open up the capital markets to a wide range of ULBs that would not otherwise have independent market access, either because of their low credit quality or small project size.

Fitch currently rates the debt of India's first state-owned infrastructure bank (see section below on *Tamil Nadu's Water and Sanitation Pooled Fund*). It also rates the debt of many infrastructure banks and state revolving funds in the US, which were the initial inspiration for this type of infrastructure finance model (see "*State Revolving Fund and Municipal Loan Pool Rating Guidelines*", dated 5 November 2004 and available at www.fitchratings.com).

If the guidelines are adopted by the government of India ("GoI"), it would then be the states' responsibility to implement the program by either designating an existing state pooled finance entity ("SPFE") or creating a new entity of this type to carry out the pooled finance development scheme. Under the proposed guidelines, SPFEs would have the following roles:

- Issuance of debt securities on behalf of ULBs without state guarantees (states may provide credit enhancement to SPFEs, but should be precluded from supporting SPFEs via direct state guarantees);
- working with the ULBs to select projects for financing based on viability and priority;
- facilitating the reform process for the ULBs in the areas of accounting and financial management reforms, efficient service delivery, pricing and tariff reforms, and governance reforms;
- obtaining credit ratings for the issuance of debt on behalf of the ULBs.

The proposal also suggests that bonds issued by the SPFE would be eligible for tax-free status under the government's existing guidelines for tax-free municipal bonds. Interest or dividend income earned on the investments made using the debt service reserve fund ("DSRF") corpus will be exempt from income tax provided that it is reinvested in building the DSRF corpus and used to further leverage infrastructure investments.

Contribution from GOI to the SPFE's DSRF would be 50% of the DSRF requirement as determined by a credit rating agency for a suitable rating which can help raise the funds cost effectively or 10 percent of the amount of the proposed bond issue, whichever is less. Each respective state government will contribute the balance of the DSRF. The GoI has set aside INR4bn for the 10th Plan and INR800m for 2003-04 (Source: MoUD).

■ The Emergence of Innovative Public Finance Structures

Recent debt issuances by a few Indian states are of great importance to the development and diversification of India's domestic capital markets. In some cases, they serve as useful precedents for creating and marketing bonds, illuminating the role of escrow funds for debt service, the mechanics necessary for full and timely debt service payment – as well as for the full utilization of bond trustee services – and the use of debt service reserves and other investor protections. In others, these debt issuances illustrate how to lower default risk by the pooled financing of municipal loans without a state guarantee. Finally, they demonstrate that various types of public-public and public-private partnerships can be used to attract private capital for infrastructure projects.

As prototypes for future state debt structures, they hold out the promise of sustainable infrastructure financing in India. The case studies in Appendix IV illustrate the important evolutionary steps that Indian state corporation debt is taking as it migrates toward the domestic bond market.

■ Where Next for India's Emerging Public Finance Market?

Growth in India's urban population and economic development goals has increased the need for the rapid provision of urban infrastructure. The concept that governmental financing can be supplemented with private sector funds to increase the total money available for local infrastructure development is validated by recent experience with several state corporation bond issues.

If ULBs can access domestic bond markets with a credit rating, this will allow them to actively support decentralization by bringing increased efficiency to their debt market transactions, while improving their accountability and transparency to the market, to taxpayers and to voters. Credit ratings, in tandem with ongoing government-sponsored reforms and the continued introduction of innovative debt structures, will lead to a gradual improvement in the number and quality of investment-grade state and ULB debt issuers. Ratings will also allow the introduction of

progressively longer debt maturities, correcting the long-standing mismatch between the term of debt and the useful life of many infrastructure assets. All of this could lead to gradual improvements in the financial performance of state and local governments, thereby reducing the current over-reliance on state-level guarantees and subsidies.

Fitch believes India could easily become an emerging market model for public finance. The present environment creates an opportunity to improve the state of public finances and to engage the domestic capital market in the sustainable financing of urban infrastructure requirements. Much depends upon the political will at all levels of government to implement the initiatives that have now been introduced. The macroeconomic outlook, which is expected to remain stable, is also a vital factor.

The relatively few and relatively small recent state corporation bond issues for infrastructure projects have been unimpressive in the terms of the way they addressed the country's immediate and immense infrastructure needs. Nevertheless, if public sector reforms are encouraged to progress, and if a public finance credit culture is able to develop in India, these small beginnings could easily prove to have a lasting impact on infrastructure finance.

Appendix I: Central Reforms in the State Government Sector

The RBI, the Finance Commissions and the Ministry of Finance have been at the forefront of recommending state fiscal reforms: the 11th Finance Commission recommended a package of state fiscal reforms for the period 2000-01 to 2004-05 and central government created a fiscal reform facility incentive fund to encourage state participation in the deficit reduction program. While there was some progress toward reducing state budgetary deficits, most of it came in the last year of the plan, and the average level of deficits was still comparatively high.

The 12th Finance Commission recommended the discontinuation of the incentive fund. Emphasis at the Commission shifted instead to state enactment of fiscal responsibility legislation. In 2003, the Conference of State Finance Secretaries decided that the RBI would provide technical assistance to help states prepare fiscal responsibility legislation. The RBI circulated a model fiscal responsibility bill to the states. To date, the states of Karnataka, Punjab, Kerala, Tamil Nadu, Uttar Pradesh, Maharashtra, Orissa, Rajasthan, Assam, Gujarat, Himachal Pradesh, Haryana, Chhattisgarh, Madhya Pradesh Tripura and Andhra Pradesh have all enacted the fiscal responsibility and budget management act. Fitch views this as a credit positive for the states concerned.

The central government's key goals under the state fiscal responsibility legislation were as follows:

- to eliminate the revenue deficit by 2008-09;
- to reduce the overall fiscal deficit to 3% of state GDP over that same period;
- to produce annual targets for revenues and fiscal deficits;
- to produce an annual statement on the state's economy and fiscal strategy;
- to provide details on the number of government employees and personnel costs.

In consideration for the state's adoption of this legislation, the central government provided a debt consolidation and relief program that allowed states to consolidate all loans from central government and reschedule their amortization over a new 20-year period, at a new and lower interest rate of 7.5%. Thus the program offered lower interest costs and lower annual debt-servicing costs, further enhancing participatory state fiscal performance.

The RBI also conducted an internal study on the sustainability of state debt in 2005. The states were ranked by selected indicators of debt load, financial performance, local tax generation and growth in operating expenditure. The RBI made some important observations and recommendations on state fiscal reforms in that study. First, it noted that state budget documents do not give a full picture of state liabilities, including contingent liabilities. It recommended that, as states adopt fiscal responsibility legislation, they include a goal of eliminating budgetary subsidies for loss-making public enterprises. It also advised improving the transparency of state finances as a means of enhancing their credibility with the capital markets. It further recommended that some form of debt cap be considered. Finally, the study proposed a shift in capital expenditure that would aid economic growth and allow states to become increasingly self-financing – such as through dedicated taxes and user charges.

Impact: Fitch notes that improvements in state budgetary performance emerged in the fiscal year ended March 2005. This can be attributed to the enactment of fiscal restructuring plans by many states, debt relief on certain loans owed to the central government and increased central government transfers to the states, as well as the accrual to the states of all small savings collection payments. However, since not all of these events are recurring, it will be largely up to the states to sustain progress in their fiscal performance and begin a debt retirement plan for outstanding long-term liabilities. Rising global interest rates, political resistance to civil service cuts, and continued susceptibility to economic cycles will make sustainable progress at the state level challenging.

Appendix II: Central Reforms to the ULB Sector

The economic reforms of the early 1990s and the passing of the 73rd and 74th Constitutional Amendments in 1992 (collectively "the amendments") decentralized considerable functional and financial authority for the provision of social and economic services and the provision of infrastructure to sub-national governments. These amendments, which promote a comprehensive process of urban sector reform, include:

i. introducing legislation to facilitate decentralization;
ii. improving the financial and administrative management of ULBs;
iii. increasing the urban resource base through improved taxation, user-charge collection and a rules-based system of resource transfers.

The 74th Constitutional Amendment Act recognises the principles of local self-government and empowers ULBs by providing them with financial resources through the Central Finance Commission ("CFC") and State Finance Commissions ("SFCs"). The SFC review is an important step toward improving financial accountability at the municipal level. As ULBs' accountability increases, the commissions may evolve bodies that coordinate policy and resources between the different levels of government. For now, a more aggressive state oversight role, as mandated by the constitution, seems necessary.

Since the SFC makes recommendations on local and shared taxes as well as state devolutions, an externally driven review period occurring every five years becomes the trigger for municipal rating reviews. Internally driven reviews can be tied to the issuance of municipal debt, or to the release of an audit or budget, for example.

One clear vulnerability of state oversight is the likelihood that conflicting agenda or "regulatory tripwires" could interfere with an otherwise adequately functioning municipal authority. This is of particular concern where municipal debt service payments are at stake. Central and state governments need to develop a way of reconciling their government orders and regulations so as to avoid any interference or perception of interference with municipal finance activities.

An Urban Reform Incentive Fund ("URIF") was set up by the Government of India (GOI) in the Union Budget for 2002-03 to provide reform-linked assistance to the states, by amending the rent control act, repealing the urban land ceiling act, introducing duty reductions for land and property transactions, and improving the accounting systems and computerising land records. A City Challenge Fund ("CCF") has been proposed to facilitate city-level reforms by funding the transition costs of developing municipal management and service delivery systems.

Key Provisions of the 74th Constitutional Amendment

The 74th Constitutional Amendment provides a positive framework for the empowerment of ULBs. Some of its main provisions are detailed below.

- It requires each state to revise its own municipal law to promote greater decentralization, resource mobilization, accounting reforms and the entry into private sector partnerships.
- It authorizes state legislatures to grant municipalities the authority to levy, collect and appropriate certain taxes and duties.
- It includes provisions related to shared tax collection by the state and state grants.
- It provides for the establishment of funds at the ULB level to handle receipts and disbursements.
- It has resulted in the development of a model municipal law that governs municipal corporations, municipalities and panchayats.

The Model Municipal Law

The model municipal law serves as a template for states to revise their municipal legal framework. Its key provisions include:

- a definition of core municipal functions, including water supply and sewerage;
- state oversight of municipal finances through SFC recommendations;
- a form of administrative receivership for cities that default in the performance of their duties or that abuse their powers;
- a requirement that each state frame a ULB debt limitation policy;

- encouragement for ULBs to generate internal sources of revenue;
- establishment of a state municipal accounting manual, and state appointment of a municipal auditor;
- a requirement that ULBs prepare an annual balance sheet and appoint a municipal accounts committee;
- a requirement that ULBs prepare an inventory of properties and facilities;
- encouragement for ULBs to implement their own development plans ;
- authorization for private sector participation in the construction, financing and delivery of services (including revenue billing and collection).

Other Notable Developments:

A National Workshop on Municipal Accounting Reforms organized by the MoUD, the National Institute of Urban Affairs and state government representatives, with the cooperation of USAID, took place in New Delhi on 26 September 2003. It made the following recommendations:

- the adoption of an accruals based accounting system for ULBs;
- the development a model municipal accounting manual.

With USAID support, the MoUD agreed to develop an accounting training module and workshops for ULBs. It would also develop uniform software for the computerization of budget and financial accounts.

Appendix III: National Urban Renewal Mission – Eligibility Criteria & Modalities

NURM: Eligible Funding and Matching Funding Requirements

Type of City or Project (%)	Eligible Central Government Grant	State Government Matching Grant	Financial Institution Loan Requirement
Population of 4m or More	35	15	50
Population of Less than 4m and More than 1m	50	20	30
Other Cities	80	10	10
Desalination Projects	80	10	10

Source: MOUD, GOI

The release of central assistance is linked to the implementation of certain reforms by the participating municipalities and their respective states, as detailed below.

i. Mandatory ULB reforms include the adoption of an accruals-based, double-entry accounting system, the introduction of various e-governance and technological applications, the reform of the property tax system, the implementation of systems to recover utility costs through user fees, and budgetary provisions for basic urban services for the poor.

ii. State mandatory reforms include decentralization measures mandated under the 74th Constitutional Amendment Act, the repeal and reform of certain laws and duties (such as urban land, rent control and stamp duties), the introduction of independent regulators for urban services, the implementation of a public disclosure law and community participation law, and the institution of a city planning function at the ULB level.

iii. Optional reforms for both ULBs and their respective states include various streamlining, automating and process-simplification measures, certain water preservation measures, the implementation of voluntary retirement schemes and the encouragement of public-private partnerships.

Modalities: Preparation of a city development plan (“CDP”) is a pre-requisite for accessing funds under the NURM. A CDP is envisaged as a document that would provide a an overview of a city and proposals for its future development. It should present the current status of city’s development; set out the directions of change; identify the thrust areas; and suggest alternative routes, strategies and interventions for bringing about the change. It should also establish a logical and consistent framework for the evaluation of investment decisions. An elaborate toolkit provided by MOUD, GOI outlines the framework and methodology for preparing the CDP and the City Investment Plan (“CIP”).

Along with the CDP and a detailed project report (“DPR”), an application for the investment support component details the status of and commitment to reforms and the steps to financial closure. This last point will be supported by commitment letters from the state government/financial institutions/other parties detailing the balance funding required to undertake the project.

The NURM will be steered by the National Steering Group (“NSG”), which will provide policy oversight, and will be assisted by two central sanctioning & monitoring committees (“CSMCs”, which will sanction and monitor projects and associated reforms, for the two submissions at the national level. There will also be a state-level steering committee (“SLSC”) to screen and prioritise identified projects and a state-level nodal agency (“SLNA”) to appraise projects identified by the ULBs and oversee their implementation at the state level.

On approval and sanction of CSMC assistance, the MoUD and MoUEPA will release the funds to the state government or its designated state-level agencies – in four instalments, where possible – as additional central assistance (a 100% grant in respect of the central share). The first instalment of 25% will be released once the state government, ULB or parastatal agency has signed a memorandum of agreement (“MoA”). The balance of the assistance will be released – where possible, in three instalments – upon receipt of utilisation certificates to the extent of 70% of the central fund and also that of the share of the state/ULB/parastatal agency. This payment will also be subject to the achievement of agreed milestones for the implementation of mandatory and optional reforms at the state and ULB/parastatal agency level, as envisaged in the MoA.

Appendix IV: Case Studies

Case Study #1: How to Make a Debt Guarantee Credible
Maharashtra Patbandhare Vittiya Company ("MPVC") Limited

(Long-term debt rated 'BBB+(ind)(SO)' by Fitch, with a Stable Outlook; see Fitch report dated 20 March 2004)

There are many examples throughout Asia of state-created and -owned agencies or corporations that issue debt which is guaranteed by a parent government. It is important, however, to understand that differences in a local government's public accountability, budgetary process, administrative controls, and statutory or contractual debt arrangements can result in rating distinctions between straight government debt and government-guaranteed debt. Fitch has seen some transactions in India where the nuances of the government guarantee are brought into sharp relief.

In the case of MPVC's bonds, the guarantee from the government of Maharashtra is further supported by a tripartite agreement between the government, the trustees and MPVC, in which the government has a contractual obligation to provide annual budgetary provision for all the debt service payments of MPVC. MPVC itself is a special-purpose vehicle with no operational role other than raising funds and equitably distributing them to various entities executing irrigation projects throughout the state. This avoids the risk that funds provided for debt service could be diverted to another end-use. It also eliminates commingling risk, which was a problem for some earlier irrigation company bond issues, resulting in delays in payments to bondholders. Note that the existing arrangements are contractual and that a stronger security could be made with statutory authorization.

Case Study #2: Securing Debt for a State Corporation With Operational Responsibility
Maharashtra Jeevan Pradhikaran ("MJP")

(Series XI debt rated 'BBB(ind)(SO)' by Fitch, with a Stable Outlook; see Fitch report dated 9 August 2004)

(Series XII bonds of 2005 rated 'BBB+(ind)(SO)' by Fitch, with a Stable Outlook; see Fitch report dated 24 January 2005)

Like MPVC, MJP has a tripartite agreement. Its initial series of debt was rated one notch below the debt of MPVC, owing to MJP's operational role, which created a slightly higher risk that funds meant for debt service payments could be diverted. MJP is responsible for conceiving, preparing and implementing water supply and sewerage schemes in urban and rural areas throughout the State of Maharashtra, with the exception of Greater Mumbai. As a statutory body of the government of Maharashtra ("GoM"), it also acts as advisor to the state and to local urban entities on water and sewerage planning, operations and training matters. MJP receives budgetary support from GoM, which it leverages in the form of bond issues to accelerate the construction of local government water and sewerage projects.

In January 2005, MJP further tightened the structure for its upcoming Series XII bonds, opening a designated escrow account for the new series with a bank mutually agreed upon by both MJP and the trustee. This structural enhancement did not affect previously outstanding debt series. In terms of the cash flow management for the full and timely payment of MJP's debt service, a contractual process has been established whereby MJP notifies the appropriate state government departments of an upcoming payment requirement three months in advance of the actual payment date. MJP credits payments received from GoM to the designated escrow account.

Case Study #3: Using Trustee Relationships to Maximize Full and Timely Payment
Karnataka State Financial Corporation ("KSFC")

(Taxable Redeemable Bonds 2005 rated 'AA-(AA minus)(ind)(SO)' by Fitch, with a Stable Outlook)

KSFC was established under the State Financial Corporation Act of 1951. It manages loans to small and medium enterprises ("SMEs") in the State of Karnataka. KSFC is an arm of the government of Karnataka ("GoK") and its board, mostly comprising GoK officials, has approved the bond issue, which has been guaranteed by GoK under a government order. KSFC established a designated, trustee-held account for the repayment of its debt service under the terms of its financing agreement.

The trustee is required to monitor the balance in the designated account and notify KSFC of any shortfall in funds at least 15 days prior to a debt service payment date. KSFC must ensure that the designated account

contains the scheduled debt service amount at least seven days prior to the payment date. The agent bank confirms the adequacy of funds in this account by sending notice to the trustee.

In the event of a continuing shortfall seven days prior to the payment date, the trustee notifies the finance department of the State of Karnataka to transfer the required funds into the designated account. The state is required to make this transfer at least five days prior to the payment date. The trustee confirms receipt of this payment and makes debt service payments to the investors three days prior to the payment date.

Special Note on Bond Trustees

The trustee's role is of great importance as it oversees adherence to the segregation of accounts, the flow of receipts into these accounts, the actual debt service repayment and notification mechanisms, and the procedures for investor remedies in the event of default. Trustees in India have evolved into effective organizations in the past few years and a few of them have become specialists in this field. Typically, a large financial institution/bank sets up a trustee arm that caters to the demand for trustee services, although in some cases the banks themselves may provide such a service.

Case Study #4 Maximizing Public-Public and Public-Private Partnerships

The Tamil Nadu Urban Development Fund ("TNUDF") was established as a trust in 1996under the Indian Trusts Act, 1882. The state's Municipal Urban Development Fund ("MUDF") was converted into the TNUDF with the participation of the government of Tamil Nadu ("GoTN"), the Industrial Credit and Investment Corporation of India Limited ("ICICI"), Housing Development Finance Corporation ("HDFC") and the Infrastructure Leasing and Financial Services Limited ("IL&FS").

TNUDF is a public-private partnership providing long-term debt for civic infrastructure without a government guarantee. This arrangement brings private sector management expertise to the selection and financing of local public infrastructure projects, and gives creditworthy ULBs access to the private capital market. TNUDF is managed by a corporate trustee (Tamil Nadu Urban Infrastructure Trustee Company Ltd.) and uses a dedicated fund manager (Tamil Nadu Urban Infrastructure Financial Services Limited).

TNUDF uses shareholder capital, investment income, ULB loan repayments and multilateral agency loans for its programs. Its important achievements include the issuance of India's first true toll road bond (the Madurai Inner Ring Road Project), and the creation of the Water and Sanitation Pooled Fund ("WSPF"), India's first state infrastructure bank for ULB water and sewerage projects. The importance of WSPF is discussed below.

Case Study #5: Enhancing Credit Quality by Pooling Project Risk
Water & Sanitation Pooled Fund ("WSPF")

(INR304m bond issue rated 'AA(ind)(SO)' by Fitch, with a Stable Outlook; see Fitch report dated June 2003)

As the first rated pooled finance issue in India, WSPF's 15-year domestic bond issue in late 2002 represents a major breakthrough in Indian public finance. This pooled finance vehicle is important because it provides an attractive means for small and medium-sized ULBs to access the capital markets.

The proceeds from the issue were lent to 13 ULBs in Tamil Nadu so that they could either refinance existing higher-coupon loans or finance water supply and sanitation projects. In aggregate, the loan agreements with the ULBs mirror the repayment obligation on WSPF's bonds. Monthly loan repayments are credited to a separate fixed deposit account by participating ULBs, a schedule designed to ensure that the funds needed for upcoming loan payments to WSPF are segregated in advance.

These funds are transferred to the WSPF trustee-held account in advance of WSPF's bond payment date. In the event of any shortfall in the ULB loan contributions, the financing agreement contains provisions to tap SFC devolution payments to the ULBs. This state aid intercept feature is a major credit enhancement for the bonds. In practice, some ULBs make their loan payments using their own budgetary revenues, while others elect to allocate their state aid allotments to their loan contributions. Participating ULB revenues include property tax, user charges and SFC devolutions.

The second credit enhancement under the program is that that WSPF's bonds have a fully funded debt service reserve fund. If the fund is drawn, it must be replenished using the same state aid intercept mechanism as for the ULB loans. The final credit enhancement for WSPF's bonds is a USAID guarantee in an amount equal to 50% of the principal amount of the bond issuance. Future bond issuances may or may not include this security feature.

The basic premise of the pooled finance structure is that it reduces the risk that a single borrower loan default could cause a bond default. The greater the size and diversity of a pool – even with the inclusion of small and less creditworthy borrowers – and the more the concentration of the largest participants is decreased, the more the default risk is spread, improving the creditworthiness of the pool and lowering the cost of funds. Additional benefits of this structure are as detailed below.

- Each individual borrower has access to the capital markets at a much lower interest rate than it would otherwise obtain if it borrowed on its own.
- Transaction costs are spread among the participants, providing further efficiency.
- Resources once used to fund grants can instead be used to make subsidized loans, spreading the resources to a larger group of beneficiaries.
- Bonds used to finance loans can receive higher ratings than those assigned to the underlying borrowers owing to the diversity of the pool and other structural credit enhancements.

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