Déjà vu on the highways

The recent show of aggression by road developers revives memories of what happened six to eight years ago, when wanton bidding had brought the sector to its knees. This time around, it's happening just as the sector is clawing back after years of funk, thanks to the government's ambitious road construction targets and plans to increase allocation for the development of highways. That being the case, are we staring at another potential cul-de-sac?

If so, prudence suggests this would be a good time to ring-fence, metaphorically speaking of course, to pave potential potholes with an asphalt pile of proactive steps. So how aggressive have the recent bids been? To wit: A well-established highway developer recently emerged as the lowest bidder for a very challenging project by quoting way below the reserve price. And this isn't a lone instance—several projects have been bid below their reserve price of late.

In engineering, procurement and construction, or EPC, projects, where the government foots the entire project cost, some exuberance is reasonable, even expected. However, even hybrid annuity model (HAM) projects, where the government's exposure is 40% in the first three years, have seen a confounding rush to quote below the reserve price. Indeed, as much as 40% of the HAM projects have been bid below their reserve price in the past 12 months. It is but natural that such aggressive bidding should squeeze the margins of developers. As such, operating profits are under pressure in the sector due to higher provisioning mandated by new Indian accounting standards.

Which begs the question, what are the reasons cited by developers to justify the aggression? Better control over project execution, superior sourcing strategy for raw materials, and better project management. That isn't entirely convincing, especially because HAM bidders are, by and large, medium-sized developers.

The bigger risk, however, is that competitive bidding could spill over to other public-private partnership modes of development such as build-operate-transfer (BOT). That was indeed the case in 2009-11, when developers were caught in a bidding frenzy. Eventually, there came a stage when developers were stuck with unviable projects and virtually abandoned them. The fall guys were the banks that were left holding lemons.

The ripple effects lasted years, with developers remaining extremely overgeared, while banks—mostly in the public sector—virtually shut off the funding tap. Predictably, fewer projects were awarded. This compelled the National Highways Authority of India (NHAI) to bring in a fairly de-risked model. Following this, things have changed for the better in the past three years and there is a revival of interest in this sector. So much so, even some foreign pension funds are looking at bidding for reverse BOT projects, i.e. under the toll-operate-transfer model. Further, significant improvements have been made to boost participation, including easier norms for exit, upfront payment of arbitration claims, harmonious substitution in projects, and roll-out of HAM.

The government has an ambitious road development programme, aimed at doubling the national highways network from the current 100,000km in the next five to seven years. Given this, it is time the developers did their bit too. More importantly, the NHAI should take a cue from its own experience and put in place adequate safeguards to avoid a repeat of the disastrous cycle at the turn of this decade. Specifically, it could look at six mitigating steps:

1. Provide a risk-adjusted floor and cap price for each of the bids, which would prevent sustained aggressive bidding. Even guidance on a project-to-project basis will set the tone at the time of bidding.

2. Set up an internal review committee to ensure that if deviation from the base price is significant, the developer has the wherewithal to complete the project, and that the reasons cited are appropriate.

3. Blacklist rogue developers who have abandoned projects by quoting aggressively. While this is currently in place, developers do team up as consortia and bid for new projects

4. Strengthen the project preparation process and employ technically superior consultants at the stage of preparation of detailed project reports. This becomes a prerequisite for the authority to confidently approach developers when there is a significant deviation from the base price.

5. The ability to execute in a given time frame defines the calibre of a developer. A grading mechanism can be evolved to make this one of the qualification criteria at the time of the RFQ (request for quotation) stage.

6. Track the portfolio on a rolling quarter basis and have continuous stakeholder interaction with regard to the progress of projects, and to prevent errant developers from bidding.

What such a regimen would herald is long-term sustainability and financial viability for highway projects. Indeed, this is the apposite hour to structurally ring-fence the sector. Not doing so now would bring too much risk back to the table. Neither the lenders nor the highway developers—or, crucially, the government, given the prerogatives of the social compact—can afford to err this time around.

More so since development initiatives are being undertaken despite endemic issues of wherewithal and abiding balance-sheet weakness.

Jagannarayan Padmanabhan is practice leader and director, transport and logistics, CRISIL Infrastructure Advisory.

Comments are welcome at theirview@livemint.com

END