Stimulating Private Investment in Infrastructure in Africa and South Asia

Summary of Main Points of the International Growth Centre Round Table
British Academy, London

27 February 2014

Opening session

- Main premise is that Africa chronically short of infrastructure assets and there is a large pool of global capital earning very low yields.
- Many risks have to be dealt **with simultaneously**:
    1. Gain political buy-in
    2. Standardisation of projects to reduce technical risks
    3. Expansion of insurance availability
    4. Debundling of stages into planning, construction, and operation and then rebundling.
    5. Improving commitment technologies. Many African governments have a poor track record currently
    6. Professional operation of projects after construction
    7. Strong regulation
    8. Changes in OECD Financial Regulation
- Intra-African trade is a strong conceptualization for issues of the public sector coordinating the private sector. **Intra-African trade remains very low**. The barriers are tariffs, but also customs procedures and rules of origin. This leads to long and costly wait times for transit and shipping, especially for smaller firms.
- The **success at the WTO Bali** meeting in passing a multilateral trade facilitation deal may help set the stage to draw the necessary investment for this infrastructure.

Session 1: Killer Risks

- **Reputational risk**: Many trustees and investors are worried about potential risks to their reputations if it turns out that there are skeletons in the closet of these projects.
    - As a result, if similar projects can be replicated elsewhere without these risks, they are often taken. These risks, as well as other,

make the risk-reward very hard to define for these projects, both quantitatively and even qualitatively.

- **Informational Asymmetry**: shallow capital markets provide few signals. Low flow of information increases perceived risk and ability to foresee issues.
    - An offshoot of this is social stability risk – story of Tunisian Airport being named after head of state and then being seriously damaged during the Arab Spring. This led to the point that it is important to embed an investment in a community and gain its acceptance. In the case of the airport, the name did not endear itself to the local communities.
- **Involvement on the ground**: It is critical that investors maintain a presence on the ground with their investments. They need to be there to shape and maintain policies that are conducive to an effective operating environment. Additionally, teams on the ground can act to anticipate coming problems and, if done beforehand, to identify the projects that will be more profitable.
- **Lack of Specialised Expertise**: There is a general lack of specialised expertise on the ground in these countries that can identify these opportunities, identify and mitigate the risks, and then operate the projects effectively.
- **Political Risk**: The political risk is largely different from wars etc. (social stability risk). The main areas are corruption, breach of contract, and unforeseen policy changes. This is especially important given the long time frames and amount of capital involved. There is a danger from large shifts in policy from new administrations based upon the naïve desire to "fix" the power situation.
- **Insufficient term of investments**: Projects can often take 4-5 years of negotiations for only two years of actual construction. The typical tenure for infrastructure investments in Africa is only 5-7 years, which is not enough time, especially for very long-term projects. We need investments that are for significantly longer periods of time.
- **Two Missing Elements in Africa**: What is unfortunately missing in Africa, which is well-managed in the OECD, is both (i) the reliability of tariff measures and (ii) the perceived safety of contracts.
- **Political Risks for Government Officials**: It can be difficult and risky for ministers to move forwards with projects that they do not fully understand.
- **Capital Blazing the Way**: It is possible that certain amounts of private capital can enter the market and be used to lower the barriers to entry for other larger bodies of capital. This can also be done by State-Owned Enterprises.
- **Ability to Pay**: It is critical to look at the demand side for this issue in addition to the supply side. Who will pay for these projects? Who will pay for its maintenance? The costs of these projects are far huger than in

Europe and it is likely that the general African populace will have problems paying for their construction and maintenance.

  - The response to this was that the willingness to pay in Africa does exist. Telecoms is a prime example of this with a very deep market where people can and do pay. Currently, alternatives are paid for at very high prices, so these investments may actually constitute a cost reduction for consumers.

- **Moving Targets**: One main issue as well is the dynamic nature of the markets in Africa currently. As one delegate put it, the problem with projects in these countries is that things move! Reports published in 2011 are now completely outdated. It is therefore very difficult to try sand insulate investors from the risks associated with the poor and very dynamic institutions in these countries.

Session 2: Mitigating Risks within the control of the Host Country

- The benefits of strong regulators are many:
  - A key commitment mechanism for government, especially when regulators are independent of individual ministers or administrations.
  - It allows for the commitment to a regulatory regime for a long period into the future.
  - Critically, regulators allow for the stabilisation of the expected future stream of revenues to investors and operators.
- The critical elements to establishing effective regulators are:
  - Transparency of regulations. The players must understand the game.
  - There must be access to the regulators for private sector actors, who must feel like their concerns are heard.
  - Establishing and developing a proven track record is key. It was noted that where one does not exist, making a framework resemble others that have proven effective can be helpful.
  - They need to be staffed with reliable technocrats. Regulators need to be able to cultivate and maintain trust and relationships with all other actors, including investors. They need to be credible and authoritative.

- **Project Pipelines**: There is a danger of there not being a sufficient build-up of established and bankable projects in these countries. The reality is that governments need help in planning these projects and conducting feasibility studies. National investment authorities could be helpful with this, but many are not currently where we need them to be. More radical approaches may be needed.
- **Consistency**: There is a need for the standardisation of projects. National PPP units will be helpful for this.

- **Long-term Considerations**: It is necessary to plan long-term for this. Prioritising and targeting reforms and commitment technologies for longer-term promises: these are necessary for the sustainability of these projects.
- **Dispute Resolution**: Due to the long-term nature of many of these projects, it is almost guaranteed that there will be strain on these agreements and relationships. Agreements need to build in ways of addressing breaches of contract and real-world changes. Additionally, we need teams (of lawyers) on the ground to head off problems with the agreement and maintain it instead of letting these issues survive, fester, and eventually lay low the whole project.
- **Four Ways to Manage Political Risk**: Minimizing corruption through robust safeguards and legislation. Being mindful of balancing different groups' interest by the location of infrastructure, where possible. Macroeconomic and structural stability. Bringing in technical assistance and training to allow policymaker to sign and negotiate deals in confidence.
- **China's Approach to Political Risk**: China has cheaper finance, faster turnaround times for projects, and a differing risk appetite. The backing of the Chinese government and the fact that Chinese companies can pay through more problems helps to manage these political risks as well. There however signs that China itself is beginning to adapt this model.
- **Governance focus on laws that work**: It was noted that corruption and mismanagement thrives in dysfunction of government. If government can focus on running a tight ship, this will likely be reduced.
- **Tension between private optimisation and development potential**: There is the problem of trying to make these investments achieve their full development potential. An example was trying to get a country to run a railway partially through Malawi where they may prefer to bypass it entirely.
- **Use of International Experts**: It was mentioned that an international group of regulators and city planners/infrastructure experts could be very useful in an advisory role. However, the problem is that many of these individuals are already strapped for time and are generally very expensive.

Session 3: Finance and Unbundling as Risk Management

- **Pension Funds**: These are a very large potential pool of capital. If we can make them comfortable with investing in these projects, perhaps through experience, we can start to draw in these pools. Getting some good prior projects in the country may likely go a long way in this.
- **Most of the capital used for African Infrastructure is nevertheless mobilized from African governments and populaces.**
- **Who Should Bear the Risks?**: Design risks should be borne by designers, not builders. This is similar for other phases of the project. What is necessary is to ensure that risk doesn't pool on one set of

investors/actors, but is instead divided among players accordingly. We should especially be trying to separate the risks associated with building and operation, as these involve differing time frames and require a separate set of skills.

- **Catastrophic Risk Insurance**: This has proven very helpful. Over a period of 30 years, it is not unlikely that you will experience some form of catastrophic risk.
- **What has worked well**: Greenfield PPPs and privatisations of previously public assets have not been popular with potential investors. What has proven successful has been:
    - focusing on quality core assets,
    - the use of insurance,
    - designing a deal for the long-term uses of capital, and
    - "buying a fox to catch a rabbit", which is buying firms with existing operational expertise and then using this expertise to help run other acquired firms.
- **Lessons of Experience**:
    - Catastrophic risk insurance should be built into deals from beginning
    - Governments and donors need to invest in new technologies
    - PPPs and Insurance can help spread around risk
    - International Finance Institutions (IFIs) can be a good source of money
- **Some best practices identified**:
    - Do formal risk assessments
    - Keep strong communications between investors and governments
    - Focus on risk management from the design stage
    - Cultivate strong project teams that are able to identify and mitigate risks
- **Financing and Refinancing**: There is a problem drawing sufficiently long-term capital for the start of the project. Where there is another problem has been historically getting the necessary refinancing. In the absence of refinancing opportunities and/or long-term capital investments, it makes the capital for the projects quite expensive.
- **Regional Projects**: can be quite useful for spreading costs and risks. Where a project is not feasible in a single country, it may be feasible for a cluster of them.
- **Size of Projects**: Mega-projects are inherently very complex. More attention should be given to continuous smaller expansion projects, which may enable more organic growth of an infrastructure system. Instead of a Three-Gorges Dam, we could just systematically add generation capacity every year through 50MW power plants.
- **Scope for more access to Mining Companies' transport infrastructure**: it was suggested that there were some useful opportunities here.

- **Financial Tools**: The amount of capital available to many of the development banks is not sufficient to make full use of some of the very good financial tools outlined in the paper. What may be effective is to use these funds for enablement, i.e. to make the investments that are necessary to draw in the pools of capital that are relatively larger than these.
- **Human Capital**: It is important to establish a local work force that has the necessary skills to effectively run these investments.

Session 4: The Role of Official Actors

- **Loan Guarantees**: The Multilateral Investment Guarantee Authority (MIGA) has been very successful in supporting private finance for these projects. Insurance can significantly increase project ratings. This has been very helpful in overcoming some of the ratings issues and in drawing in more long-term capital more effectively.
- **What is Most Likely to Change?**: General business environment changes can cause ministers to lose face, and are therefore unpopular. Regulatory changes, ring-fencing funds, and promoting project viability is more palatable to local governments and therefore more likely to be adopted and succeed as potential strategies to fix these problems.
- **What is the Asset?**: It is important to remember why we want to invest in these assets when we promote these investments. Infrastructure improvements should be means to an end: better service provision.
- **Three Types of Projects:**
    - Commercially viable projects: These are the easiest to draw capital to and largely stand on their own.
    - Mega-Projects: these are difficult and fraught with risks, including those coming from multiple governments and administrations.
    - Middle projects: this is where we need to focus. These are projects that can be profitable and produce returns, but need help to make them viable. These are the opportunities that need to be encouraged.
- **Size of projects**: Small projects, although most effective, may be too small to be financed individually by outside investors. A trick here may be to bundle them together into packages, which will allow for further diversification of risk and making them larger in size for investors.
- **Asset Sales**: An important problem here is that investors have trouble selling these assets once they are constructed. This means that investors who only wanted to put in capital for the 3-5 years of construction have problems withdrawing it, which acts as a significant disincentive for these investors. There are many funds that help with this investment, but we need to cultivate more to help with the transfer of these assets to investors more interest in longer-term operating of the assets as opposed to shorter-term construction.

- **Rating Restrictions on Investing**: There were two main restrictions which were discussed:

  - The restrictions on ratings for investors such as pension funds.
  - The fact that projects in a country cannot be rated higher than that country's sovereign debt.
- **Shift in Attitude of Multinationals**: Many investors are now investing in development in these local communities, especially education and health. This is seen as an investment in the future workforce on these projects, which is especially true when the timeframe of these projects is decades. This shows that the building of human capital is critical.
- **China**: As Chinese firms have the government behind them and many of these projects are sold as one large comprehensive package, it is very hard for Western private companies to compete with these offers and still maintain profitability.

Conclusion

- Summary conclusion:
  1. Questions had been raised on whether the increase in private flows into Africa would last. The underlying issue is the quality of institutions and governance.
  2. We got a very strong message about the diversity of the countries and therefore the diversity and heterogeneity of the problems.
  3. Costs of doing things in Africa seem extraordinarily high. This creates a good opportunity to drive these down with intelligent investments.
  4. The demand side is also very important. Who will pay for it and how?
  5. It is not clear from the discussion if capital is in short supply for infrastructure investment. It is very possible that it might not be the limiting factor, even though banks remain out of the picture, IFIs are constrained by resources and institutional investors are cautious.
  6. China's substantial role in officially-supported infrastructure investment is an important element to be taken into account because of its scale, even though other countries also provide official support in various ways. There is no substitute for political will by the host country and no substitute for the stability of contracts and reliability around tariff management.
  7. Host governments need to bring in outside experience and expertise where required.
  8. The Round Table showed much agreement on good practices, including:

- Necessity of people on the ground
- Matching capital supply to institutional development
- Importance of risk assessment and assignment of risks to the relevant parties.
- Provide capacity where needed
- Help build Regulation in a more structured way.
- Adopt Defensible and understandable standards.
- Engagement early on with the host government .
- Consider the issue of scale of projects, and avoid being over-focussed on high profile megaprojects
- Improve speed of project implementation and aim for greater simplicity where possible.
- Encourage greater standardisation of contracts

9. More attention was needed to implementing such good practices
10. Potential areas where there was a case for considering policy change included:
    - Regulation of OECD institutional investors
    - Rating agencies' approach to project ratings in Africa.
    - Costs and effectiveness of dispute settlement and arbitration.
    - Making use of foreign exchange reserves as capital.
    - Emphasis on proper project preparation. Should we try and improve it at the margins or try and remake and improve it?
    - Case for developing good practice guidelines on mining-linked transport infrastructure
    - Potential of a better 'platform' for institutional investors (which could include the ideas on un-bundling and re-bundling). Scope for developing a pool of people with high-level experience of successful regulation
11.
    - More use of guarantees for local investors to help build local capital markets and spread risk
    - More finance for IFI products that leverage private investment.
12. More work was needed on many of these points.

- There is now a real will in the African Union to address this infrastructure gap. What we need is:
    - Strong regulatory institutions to set the correct environment to draw in capital.
    - Development finance institutions to be involved to facilitate these transactions.

- An emphasis on many smaller projects, these are easier to implement and get done.
    - Better project planning – this stage is “where the game is won or lost”
    - Local ownership – this is a very effective way for mitigating risks as it aligns the interests of investors and the local populations and governments.
- The final emphasis is on project planning and arbitration:
    - If projects are not well negotiated, it invariably leads to disagreements and arbitration/litigation.
    - Weak planning to prevent this and weak measures in place to resolve issues if it comes to this stage can be disastrous.
    - Networks of PPP officials do exist (e.g. OECD) that can help with this.

March 2014

The International Growth Centre (IGC)

The IGC is directed by the London School of Economics and Political Science and the University of Oxford. It consists of an international network of country offices, policy stakeholders and researchers. Initiated by DFID in 2008, in the last six years the IGC has made a significant contribution to the policy debate. It has completed over 250 research projects, as well building a network of researchers, and staffing in-country offices to sustain relationships with decision makers – both in government and business – in fourteen partner countries. Although the research network is centred on economics, one fifth of the researchers specialise in other disciplines, with the majority of IGC projects including local researchers based in Africa and Asia

www.theigc.org