OECD-AfDB Seminar on addressing policy impediments to private investment in African infrastructure

Private Investment in Infrastructure

Paul Collier, Jonathan Leape, Richard Manning, Colin Mayer, and Staci Warden

15 July 2014
OECD Conference Centre
Paris, France

This report serves as a background note for the OECD-AfDB Seminar on addressing policy impediments to private investment in African infrastructure taking place in Paris on 15 July 2014. It summarises the Working-Group recommendations and potential next steps decided upon during the *Roundtable on Stimulating Private Investment in Infrastructure in Africa and South Asia*, hosted on 27th February 2014 in London by the International Growth Centre. This Roundtable brought together academic expertise, private-sector representatives and public-sector practitioners to identify the spectrum of risks and the systemic organisational failures that are hampering investment into infrastructure. The following Working-Group recommendations were prepared by Paul Collier, Colin Mayer, Jonathan Leape and Richard Manning of the LSE/Oxford International Growth Centre, and Staci Warden of the Milken Institute.

Private Investment in Infrastructure

Summary of Working-Group Recommendations and Potential Next Steps following the London Roundtable, 27th February, 2014

By Paul Collier, Jonathan Leape, Richard Manning, Colin Mayer, and Staci Warden

Background

The purpose of the February 27th roundtable was to identify some of the "killer risks" that investors (and policymakers) face in building infrastructure in Africa and Southeast Asia, and to think holistically about systemic solutions. Thanks to the depth and breadth of experience represented in the room, we were able to move beyond generalities to begin to map these risks to project type, project phase, investor risk profile, and the actor best placed to mitigate them. As we expected, we came away with a far richer understanding of the problems, thoughtful recommendations, and a number of ideas for moving forward[1].

Encouragingly, one of our most important conclusions was that the inadequate level of infrastructure investment in Africa is probably not explained fundamentally by a dearth of available capital, despite the global pullback in bank lending and a less-than-supportive OECD regulatory environment. As a corollary, we established that in many sectors there is in fact a willingness to pay for infrastructure services, most obviously in the telecommunication sector, but also in the power sector (as evidenced by price per megawatt of diesel power) and perhaps others.

At the same time, we noted that the inherent characteristics of infrastructure projects pose challenges to meaningful foreign direct investment: the investment horizon spans election cycles; complicated project planning is essential; coordination of multiple federal and local stakeholders -- each with distinct objective functions and veto opportunities-- is required; and execution risks in general are both high and uncertain. These challenges are exacerbated by issues inherent in the African context: political instability, lack of institutional capacity for project preparation and planning, weak regulatory regimes, uncertain national reputations, and shallow capital markets.

We were struck, though, by the extent to which the problems of African government officials and the problems of OECD investors seemed to mirror one another. African officials often lack expertise in project planning and execution as well as in the maintenance and regulation of ongoing infrastructure operations. Potential investors often lack local knowledge and make inaccurate assessments of the risk profile of investment opportunities on the continent. This mutual ignorance and misunderstanding, exacerbated in a low-information environment, leads to temporizing by both sides and sub-optimal investment outcomes.

Given that, the recommendations we discussed as a group apply, to a certain degree, to both sides of the table: the need operate up a learning curve, the importance of both political and technical knowledge, the

[1] Participants focused primarily on the infrastructure-development challenges of Africa; therefore, Africa is the focus of this note as well as the suggested focus for future work by this group.

value of a track record and its demonstration effects, the importance of risk planning, and perhaps most importantly, the necessity of taking systematic, proactive measures to demonstrate good will and commitment, and to build trust.

Although it fails to reflect the full range of our discussions, this memo tries to capture some of the recommendations around which we seemed to coalesce -- for African policymakers, for investors, and for the international financial institutions that are trying to help. It then suggests some potential ideas for further work, as well as next steps for this project.

I. Recommendations

Reduce political risk through national planning

Participants agreed that the most significant risk for infrastructure investment is political risk, and that the most important sources of political risk are corruption, regime change, breach of contract, and the inability to enforce policy changes.

To mitigate these risks, several participants advocated for the importance of a national strategic plan around infrastructure priorities. A national infrastructure plan can help align the interests of federal and local officials across administrations, engender the support of local populations, and give comfort to investors that proposed projects are aligned with national priorities. Just as importantly, a national plan can be an important component of establishing national ownership over the infrastructure development *process,* as opposed to national ownership of infrastructure assets themselves[2].

Participants also discussed the importance of government-commitment type measures that demonstrate political will and, in addition, leverage national resources. Recommendations ranged from participation in IFI (e.g. MIGA) political-risk insurance schemes to establishing national vehicles that can take equity stakes in Greenfield projects, for example through Sovereign Wealth Funds.

For their part, it is incumbent upon infrastructure investors and operators to take steps to ensure that infrastructure projects are aligned with national and local economic and political objectives. Coherent alignment reduces political and reputational risk and dramatically increases the chance of project success. Repeatedly, participants emphasized the importance of inclusive project planning up front to establish the broadest possible alignment of project goals and expectations.

Prioritize the creation of an effective regulatory environment to minimize uncertainty

Given the uncertainty of many aspects of long-term infrastructure projects, participants agreed that the quality of the legislative, regulatory, and dispute-resolution environments for resolving unforeseen issues was more important then the capacity of project plans to identify issues up front. The fundamental conundrum for developing countries, however, is that investors look for a regulatory track record before making investments, while it is difficult or impossible to establish a good regulatory track record prior to attracting significant foreign direct investment.

Here, participant experts recommended that countries without a suitable track record model their regulatory framework on that of a country with a longer operational history. While there was recognition that regulatory regimes reflect national ideologies and will therefore be heterogeneous across the

[2] Participants emphasized, however, that a national plan does and should not mean a national mega-project.

continent, participant experts emphasized that “investors are comforted by a regulatory environment that has provisions with which they are familiar; it is very helpful to recognize the framework or at least elements of it.”

The recommended elements of a successful regulatory environment were to:

- establish a long-term commitment to regulatory independence by making regulatory authorities accountable to Parliament and not to an individual ministry;
- make clear the rationale behind regulatory decisions and give investors “insight into the mind of the decision-maker;”
- set up rules quickly and demonstrate that the regulatory process is transparent and not overly complicated;
- staff regulatory agencies with reliable technocrats.

There was general skepticism of the idea that African regulatory agencies might agree to forgo regulatory sovereignty in order to outsource regulatory capacities to an international or regional entity. However, short of that, we discussed the merits of establishing institutional sector-specific "support groups" for regulators at the international or regional level where regulators could compare notes, discuss best practices and establish mutually agreed standards. Even if it did not enjoy formal regulatory authority, the existence of such a group could potentially both strengthen local regulatory capacities as well as lend authority to their regulatory decisions.

Build formal mechanisms that reduce uncertainty and build trust into projects from the beginning

For African officials, lack of human capacity, perceived weak bargaining positions, and lack of trust can lead to temporizing in the project-approval process as well as excessive caution in crafting the regulatory environment. For investors, ignorance of local conditions, fear of obsolescing bargaining, and lack of trust can lead to prohibitively (and erroneously) large risk-adjusted return requirements[3]. This situation is exacerbated by the long time-frame for infrastructure projects, the multiplicity of actors involved, and the weak information environments in most African countries.

As a general observation, roundtable participants repeatedly emphasized that investors need to work actively to acquire or establish local knowledge, either through putting people on the ground or by working with or acquiring local partners. Likewise participants suggested that the relevant African ministries do more to facilitate expertise and specialization, for example through establishing teams by sector. Further, African ministries need to devote more attention to speeding up and standardizing the required procedures, in order to reduce the “hassle factor”. As one participant noted, “PE firms have the risk appetite for infrastructure investment in Africa; they just don’t have the time.”

Against this backdrop, participants argued that both sides of the table need to work actively to build certainty and trust over longer periods. Communication, both formal and informal, is paramount. Constant, active communication with government officials (federal and local), local populations, suppliers,

[3] As one participant noted, “There are no shades of rigor; you are either comfortable or you’re not.”

and off-takers was viewed to be critical to the success of any infrastructure project. More specifically, participants argued for the importance of establishing institutional mechanisms for formal communication and dispute resolution from the beginning of a project. This means, for example, ensuring that lawyers are brought into the process in the very early stages to help identify potential problems and to "help to maintain the contractual agreement as opposed to litigating breaks in the contract after they have developed."

Participants noted further that the problems of uncertainty and low trust levels are exacerbated by the asymmetric utility functions of the principals involved. Trustees of investment funds, for example, are very much exposed to and concerned about downside reputation risk, both institutionally and as individuals. Likewise, for government officials, the political cost of making a mistake often far outweighs the political upside of being associated with a successful project. Given this, several participants suggested the idea of building impartial third-party arbitration mechanisms into the negotiation process from the beginning. These kinds of institutional mechanisms can both a) give confidence to both parties that they have negotiated a fair deal and b) provide important political cover for decisions/agreements.

Last, several participants noted that investments be viewed not just in terms of asset creation, but rather as a service improvement for which the asset is "merely the vehicle." With this mindset, the key to infrastructure investment will be its ongoing legitimacy with the consumer. Hence, foreign investors would do well to improve communication with local communities in order to minimize political risk and secure the stability of tariff revenue over the long term. As one participant noted, "Growth, job creation, and essential service provision is the best political insurance you can purchase."

Tailor investment products to investor risk profiles across the project lifecycle

Participants established first the principle that risks are best borne by the entity that is responsible for and/or best positioned to mitigate those risks. As one participant observed, "Design risks should not be borne by the builders and build risks should not be borne by the operator. Governments should not be asked to provide guarantees for risks they do not control." Second, participants established the importance of unpacking the lifecycle of a project into its planning, construction, and operational stages, and of creating insurance products that isolate and address the risk elements of each stage.

Capital markets play a crucial role in both differentiating investment opportunities and in enabling the re-bundling of them into diversified portfolios and/or structured investments. For infrastructure in general and in Africa in particular, though, the lack of sufficiently deep capital markets makes this kind of risk isolation and allocation difficult. For example, several participants noted that the inability to refinance or sell out of positions after the construction phase is one of the important reasons that greenfield projects are the "the least attractive" investment opportunities for private-sector FDI.

Because early-stage greenfield investments carry the greatest risk, arguably it behooves us to think hard about ways to accommodate investors who are willing to take on this risk, but who do not currently do so because they don't want exposure to the (far more predictable and quantifiable) long-term operational risk. Here, more could be done to explore the potential not only of payment-commitment technologies for off-takers, but also the potential for investment-commitment technologies for operational-stage investors.

Last, the importance of catastrophic risk insurance was mentioned several times. In particular, several participants recommended that catastrophic risk insurance be embedded in a deal from the beginning stages. This is a good example of the way in which a new financial technology can be tailored to the specific needs of infrastructure investors, and further work needs to be done to develop additional kinds of innovative risk mitigation and/or allocation technologies. In particular, participants noted the need for better mechanisms to hedge currency and inflation risk.

Work to develop local capital markets

Participants also noted the importance – and the potential -- of developing local capital markets around an infrastructure agenda. Given that both labor costs and off-taker payments are most often made in local currency, deep capital markets can help infrastructure investors manage balance-sheet risk. Of course, well-functioning capital markets also reduce market risk for investors more generally in that they reduce information asymmetries and improve price signaling mechanisms.

Just as importantly, well-developed capital markets support a nation's infrastructure agenda more broadly by enabling institutionally managed pools of domestic savings to find remunerative outlets for those savings, to the benefit of project developers and savers alike. And here, gains can be self-reinforcing as local-currency infrastructure bonds both help finance projects as well as support domestic capital-market development and the establishment of a local yield curve. Further, as a collateral benefit, a strong local investor base can do much to establish local identification with, and buy-in for, the infrastructure projects themselves.

Reduce project scale to reduce uncertainty, create winners, and establish a track record

Despite the economies of scale that can come with large projects, many participants recommended that governments prioritize the establishment of smaller, more easily managed infrastructure projects. As one participant noted, "it just makes more sense to do smaller projects in terms of the broader infrastructure picture, as generation, transmission, and distribution can all grow together reasonably and in a mutually supportive way. Instead of building a Three Gorges dam, the best strategy is to systematically add generation capacity each year through 50 MW power plants."

Smaller projects have several advantages. First, they may more easily attract first-time investors who want to gain comfort with a country's political and regulatory environment, because in small projects learning is less costly and failure is less catastrophic. In addition, a pipeline of smaller projects both encourages standardized models and procedures as well as helps establish a government track record through early demonstration effects. In this view, the most efficient way for governments to create the scale required by foreign institutional investors would be to establish a pipeline of smaller, bankable projects, rather than to focus on one mega-project.

Reducing the scale of projects means both developing smaller projects as well as looking for ways to break up larger projects into smaller pieces. Building scale on the back of these measures will require the establishment of a coherent pipeline of project opportunities that can be bundled according to investor risk appetites. Again, deeper capital markets are critical to these efforts.

II. Leveraging the existing infrastructure investments of committed investors

One theme that participants emphasized repeatedly was the importance of finding opportunities to expand the scale and/or scope of existing infrastructure investments. Two specific ideas were discussed, and a third is also presented below. One or more of these could be further explored by the group.

Allow private-sector captive users to sell power back to the grid. In the current environment, captive purchasers build power-generation capabilities sufficient to meet their own needs, but recognize that this operational scale is sub-optimal for keeping overall and marginal-production costs low. Captive users may therefore welcome the opportunity to build larger-capacity generation facilities, if they could then sell the excess power back to the grid. And, while perhaps politically contentious, from a policymaker perspective this kind of "bottoms up" approach could be a way to speed up power provision, finance grid construction, and build systems redundancies.

Create opportunities for shared-use of mining infrastructure. The African Vision Mining report looks to promote open access for the collateral assets associated with delivering mineral assets from mines to markets (roads, rails etc.) across the continent. Mining operators also increasingly recognize the economic and political benefits of allowing shared use of these assets. Participant suggestions included looking at models whereby a special purpose vehicle (SPV) can borrow for the construction of mixed-use assets, with the mining company serving as anchor creditor.

A further idea for leveraging existing investments in African infrastructure is for the African Development Bank and other IFI investors to *securitize and sell down the infrastructure assets on their balance sheets.* This would free up lending capacity for the IFI, as well as enable new first-time investors to get comfortable with African infrastructure assets, given that a sale by the e.g. AfDB would allow for easier due diligence and the potential for a bespoke investment size. Investors would be further comforted by the continuing (smaller) AfDB stake.

III. Possible areas of focus for the IFIs

Throughout the day, we discussed a number ways in which the International Financial Institutions could do more to support infrastructure development in Africa[4].

First, the IFIs could play a unified-voice lobbying role to interface with OECD regulators and ratings agencies to evaluate and improve the investment guidelines that OECD investors face in developing markets, in particular around a) Basel capital charges for infrastructure investments in OECD v. developing countries, and b) the “sovereign ceiling” that limits the upside rating of entities domiciled in a developing country.

Second, the IFIs could continue to support capacity development in a number of priority areas, including: project planning, negotiation, risk assessment and planning, and project management. The IFIs could also support sound regulatory development “in a coordinated manner” as has been achieved in DFiD’s work with health regulators in some countries.

Third, participants recommended that the IFIs continue to develop and subsidize financial technologies such as risk-insurance products, first-loss positions in projects, and other vehicles that leverage private investment. As a corollary, the IFIs could further support the development of local capital markets, both through technical assistance and through their own participation in these markets. This was viewed by several participants as much more important than traditional grant making.

[4] The IFIs currently have programs in several of these areas. This reflects participant observations, not an audit of current IFI practices.

Fourth, the IFIs could play a useful role in improving information environments by brokering information across groups and facilitating such things as project registries. They can also play an important role in developing standardization around key documents and processes, in part by documenting their own requirements and experiences.

Fifth, participants discussed the opportunities for the IFIs to help facilitate demonstration projects, and/or perhaps a “demonstration country” where best practices can be put in place across the board in a coordinated manner, with a further goal of establishing scalable models for the continent.

Last, there may be a useful role for IFIs to play in understanding and co-opting the best elements of the Chinese approach to investment in Africa. Here, the IFIs could perhaps also play a role in encouraging Western and Chinese cooperation around Africa's infrastructure-development priorities.

IV. Possible areas for further policy research and engagement

1. On Substance

- Undertake a more comprehensive understanding of the regulatory and other roadblocks facing institutional investors. Find ways to create “baby steps” for pension funds to get comfortable with investing in Africa. Brainstorm ways in which infrastructure investment in developing countries can help check other boxes for OECD investors. (For example, given the increase in interest in "impact investing," there may be value in establishing ways in which investors could meet impact-investing criteria.)

- Focus efforts on one sector, for example energy, to better understand the particular issues associated that sector.

- Stimulate work on the recommendations in Section 1 of this note with appropriate lead institutions: *Reduce political risk through national planning; Prioritize the creation of an effective regulatory environment to minimize uncertainty; Build formal mechanisms that reduce uncertainty and build trust into projects from the beginning; Tailor investment products to investor risk profiles across the project lifecycle; Work to develop local capital markets; Reduce project scale to reduce uncertainty, create winners, and establish a track record.*

- Research prospects of progress on the three ideas in section II (*Allow private-sector captive users to sell power back to the grid; Create opportunities for shared-use of mining infrastructure; Securitize and sell down the infrastructure assets on their balance sheets*.) with lead institutions.

- Develop research on a few cases where issues of regional integration/cooperation are significant for advancing some of these recommendations.

- Explore scope for an African-owned institution to build economies of scale in negotiation and project preparation capacities.

2. On process

- Engage African Central Bank Governors' roundtable (Oxford, June/July 2014)
- Participate in events at the Bank/Fund Spring meetings in 2014 (in hand), and subsequently
- Set up executive training program at Oxford, bringing together representatives from a small number of African countries, potential investors and intermediaries, including IFIs, to discuss practical issues, perhaps focused on the energy sector
- Develop engagement with Chinese stakeholders around these issues.

www.oecd.org/daf/inv/investment-policy/africa.htm