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

Stimulating private investment in infrastructure in Africa and South Asia

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Stimulating private investment in infrastructure in Africa and South Asia with particular reference to mobilising institutional finance

By Keith Palmer

Context

The crucial importance of State entities

A fundamental characteristic of infrastructure in these countries is the omnipresence of State entities (e.g. government agencies, State-owned utilities). State entities (SEs) are generally monopolies which own and operate directly more than 80% of all infrastructure assets. Typically a combination of weak finances, poor governance and limited implementation capacity result in their investing far too little directly in developing infrastructure networks. Equally important they also exert a dominant (usually negative) influence on the ability of private sector infrastructure investors to finance (or not finance) their businesses. They retain control over their networks by insisting they purchase output from private sector producers on contract, reselling the output to end-customers themselves, rather than permitting the private sector sponsors to contract directly with creditworthy end-customers. Consequently private sector sponsors must negotiate and agree long-term sales-purchase contracts with the SE and this creates a number of serious problems. First, reaching agreement prior to financial close is difficult and at best causes delays and at worst results in complete failure of the financing. Disagreements are inevitable given a bilateral negotiation between private sector sponsors with a high cost of capital (therefore seeking high wholesale tariffs) and SEs that want wholesale tariffs as low as possible. High marginal tariffs for new projects are generally well in excess of the average cost of wholesale supplies to the SE, which puts downward pressure on their internal cash flow and reduces creditworthiness (and therefore the ability to raise external finance), resulting in further underfunding of infrastructure investment. Increases in user tariffs to improve cash flow and increase the SE's investment resources face resistance from politicians and the public.

When private sector sponsors finally succeed in negotiating a satisfactory sales-purchase agreement with the SE, private sector lenders to the project company will often require a host government guarantee of the SE's payment obligations. The guarantee requirement reflects the weak creditworthiness of the SE. The resulting contingent claim on the host government further reduces its access to private finance (and if there is an IMF programme in place the government must negotiate a waiver to the agreed lending/guarantee ceiling). Therefore, not only are the investment resources available to the SE put under pressure by the high marginal cost of private sector output but so are investment resources available to the host government. Whereas a limited number of privately-financed projects can be funded using long term sales-purchase contracts with SEs backed up by host government guarantees, a large increase in the amount of privately-financed investment would not be feasible because the claims on the SE and its host government would be unsupportable without large end-user tariff increases that are politically objectionable.

In a limited number of cases it may be possible to by-pass the SEs. Private sector sponsors can finance "merchant" plant, i.e. without an offtake contract with an SE, by entering into a bundle of smaller sales-purchase contracts with creditworthy "cornerstone" end-customers before the assets are built at (higher) prices that they are willing to pay. If the demand risk is low and the credit quality of end-customers is high, and if the sponsor can directly access end-customers without intermediation by the SE (eg local clusters of customers adjacent to the supplier), then it should be possible to finance the investment without having to contract directly with the SE. However, there are only limited circumstances in which this solution is available without accessing the grid. Large-scale mobilisation of private sector investment on this basis can only be achieved if there are suitable arrangements in place to use transmission networks on fair terms.

Availability of institutional finance

The availability of institutional finance for infrastructure investment in low-income countries is inherently very limited. Institutional investors provide corporate finance (equity and debt) to companies in amounts and on terms that reflect the quality of the companies seeking finance. In the case of bond finance the judgement about quality is heavily influenced by the credit rating of the borrower, liquidity of the relevant bond market and minimum deal size. In the case of public market equity, the judgement about quality is heavily influenced by current profitability, future profit growth and liquidity of the shares. The reality is that almost none of the private sector sponsors seeking to finance infrastructure in low-income countries meet minimum criteria to access institutional bond finance or listed equity. The only available option in these circumstances is for private sector sponsors to raise a combination of project finance debt and private equity. Project finance debt (whether for greenfield or brownfield projects) can only be sourced from commercial banks and DFIs pre-completion. Private equity can be sourced so long as returns are sufficiently high, largely from infrastructure funds. Institutional debt providers will not accept pre-completion project risks even in mature, high quality markets such as the UK; therefore the only available option is to provide debt finance (bonds) post-completion by re-financing commercial bank and DFI debt lent at financial close. Even then, the credit quality of bonds issued post-completion will rarely be higher than the credit rating of the country in which the infrastructure is located.

Can the problems be solved?

There are a number of possible ways of addressing these problems. The first three points below consider ways to help (willing) host governments improve statutory/regulatory arrangements so as to facilitate more open markets and reduce the role of the SEs. The fourth point sets out a simple but practicable solution to mobilise additional institutional finance for private sector infrastructure investment in low-income countries. The fifth point suggests a more radical approach to mobilising public and private capital for infrastructure in these countries.

1. An important initiative to mobilise additional private sector investment would be for host governments to mandate an open access transmission/distribution network with transparent, regulated transmission and distribution tariffs. If private sector producers could negotiate directly with bulk end-customers to anchor revenue streams from creditworthy parties other than the State – wheeling power from where it is produced to where it is needed and can be paid for – there would be an important impetus to invest in both power production and in power-using industries. There would be a more open market, reduced claims on the SE balance sheet and the host government and a consequential substantial increase in private infrastructure investment. State-owned utilities traditionally resist such arrangements fiercely – believing their own interest in controlling the network is also in the public interest – but this is rarely the case. There is real merit in the G20 supporting willing host governments to work out and implement such arrangements. There would need to be political consensus, technical analysis, consultation with many parties and ultimately legislation or new regulations.

2. In some (often middle income) countries statutory arrangements have been put in place to promote renewable power (e.g. FITs, standard renewable contracts etc) that have facilitated rapid growth of renewable energy supply using private sector investment. Acceptable terms and conditions (including pricing that achieves a reasonable return for an efficient investor, stability of terms over the medium term and timely grid access) set out in Statute have resulted in many successful financings of small and medium-size renewable energy projects. Similar arrangements could usefully be extended to more countries and to a wider range of generating technologies so as to begin opening up the market to private investors. To avoid excessive State subsidies, the agreed (usually higher) prices would have to be passed-on to end-customers, perhaps on a phased basis, and there may need to be limits on maximum additions to supply over the medium term. The G20 could elaborate and promote these approaches in low income countries where they have not yet been adopted.

3. Electricity users in rural areas typically rely on small, very expensive diesel generators on-site and the cost of electricity is so high that productive investment is rendered uneconomic. It is very slow, uncertain and expensive to gain access to the national grid, the SE decides whether and when to prioritise the connection and how much to pay for a distribution link. The result in many cases has been that potential investment has ground to a standstill. It would be much preferable to create regulatory arrangements that would permit local investors to develop themselves local mini-grids and/or build distribution links to the national grid. Statutory provisions would require them to meet national standards for grid connection and system management; and could provide that in due course (once fully amortised) the mini-grids or distribution links could be transferred to the SE. The mini-grid/distribution link sponsors would remain responsible for securing the revenue streams and raising the necessary capital (and this may require at least in part some form of patient capital). These arrangements would free up the system to enable willing parties to act on their own initiative, help solve the queueing problem with the SE and boost private investment in agriculture and rural industries. The G20 could elaborate and promote these approaches in low income countries.

4. A straightforward, practicable option for mobilising additional institutional debt for infrastructure in low income countries would be to use the G20 forum to stimulate dialogue with DFI's and their (donor) shareholders in support of (i) bundling and selling DFI infrastructure loans originally made at financial close, once project completion has been achieved, and (ii) using the proceeds of sale of loans post-completion to increase investment of DFIs in more infrastructure investments at financial close. The result would be a 'tilt' by DFIs away from post-completion risk in favour of increased pre-completion exposure and a corresponding increase in exposure of institutional lenders post-completion. The G20 could promote the concept and study the feasibility and cost of increased institutional debt provision post-completion.

5. The more radical concept here is to forge true public-private partnerships between SEs/host governments and private investors to develop core infrastructure PPPs. The partners would share in the costs, risks and benefits of the joint investment. The public sector would bring public sector capital (e.g. World Bank) and government consents and support, the SE would provide access to the existing infrastructure backbone and operational support and the private sector sponsors would bring expertise, commercial credibility and therefore private sector capital to expand and improve infrastructure services. Typically private sector sponsors interface with SEs via supplier-purchaser relationships, where one party's gain is the other party's loss. This is inherently adversarial. By changing the nature of the relationship into a true public-private partnership with

shared objectives and interests it may be possible to bring about an alignment that takes advantage of the respective strengths of the public and private partners. The SE and host government cannot access the funds and expertise required to expand infrastructure networks sufficiently; private investors cannot access and develop core infrastructure assets without the SE/host government acknowledging that there must be a balance of benefits as well as costs and risks for the private partner. New forms of PPP structures could prove to be of mutual benefit. There would be significant changes to the governance, risk and benefit sharing and transparency and new arrangements for mobilisation of public and private sector capital in parallel for the same venture. These new arrangements offer the prospect of better governance and greater economic and financial benefits for the host country. How could the G20 process contribute to bringing about such arrangements? The starting point would be agreement between willing host country governments and donors about the desire to create partnerships arrangements to help unlock much greater amounts of private investment and expertise to develop core infrastructure services. If there is a high level consensus (at least with certain host country governments) it would be possible to develop technical approaches, engage with public and private sector stakeholders to explore the feasibility of these approaches with the aim of establishing practical approaches in ‘leading’ countries.

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