

Bridging the funding gap

Financing Infrastructure

Wednesday morning, 4 June 2008

Moderator: **Michael Osborne**, Director, Advisory Unit on Multidisciplinary Issues, OECD
Agustín Carstens, Secretary of Public Finance and Credit, Mexico
Andrew Hunter, Head, Macquarie, Europe
Richard Lavergne, Secretary-General, Observatoire de l'énergie, France
Pierre Lortie, Senior Business Advisor, Fraser Milner Casgrain LLP (Montreal), Canada
Hamish McRae, Associate Editor, *The Independent*, United Kingdom

Opening the discussion, moderator **Michael Osborne** underlined the essential role that infrastructure plays in promoting economic growth and prosperity and its capacity to “mobilise resources that enable us to innovate”. But Mr Osborne also drew attention to a recent OECD report, *Infrastructure to 2030: Telecom, Land Transport, Water and Electricity*, that highlights the growing gap between projected worldwide infrastructure requirements and public funding capacities. This gap, suggests Mr Osborne, can be largely attributed to rising social expenditure associated with public healthcare and pension costs. But other factors, such as climate change, population growth, economic expansion and globalisation, are also relevant and will be “an aggravation to infrastructure capacity.” This is true of both developing countries, which will generate 60% of additional infrastructure needs, but also of developed economies. How can governments bridge this burgeoning financing gap? For Mr Osborne, the main options are to increase government revenues by diversifying public revenue sources (such as increased road tolls), create more and better public-private partnerships, and introduce better demand management.

For **Andrew Hunter**, who brought the perspective of a private sector firm to the debate, infrastructure fosters growth by providing services such as water and electricity, access to schools and markets, and facilitating trade. But public funds, the main source of infrastructure investments, are dwindling due to aging populations, while the private sector, which views infrastructure as an opportunity to secure long term investment assets, is becoming increasingly enthusiastic: “the growing stock of pension savings needs to find a home” and infrastructure investment provides an opportunity to match long-term liabilities with long-term assets. Partnerships between the public and private sectors are therefore logically gaining momentum. In order to be ensure profitability and assuage understandable public concerns about private sector involvement in key infrastructures, the partnerships need to be “strong, transparent and comply with consistent regulation.” In response to a question from the floor, Mr Hunter mentioned that although debt levels might be high at the initial stages of a project, thanks to the prospect of stable cash flows, the ratio tends to drop over time and is not of concern. As for the best financing structure practice, he suggested that there was no one ideal method but it depended on the project: PPPs or PFIs are suitable for projects that are not economically feasible, concession mechanisms for those that are economically feasible, and more regulation is required for projects of a monopolistic nature,.

Agustín Carstens echoed the importance of infrastructure in developing countries such as his own, and provided a brief explanation of how Mexico was addressing infrastructure investment after years of neglect as result of financial hardship in previous decades. In order to be able to

effectively deliver social services and promote investment, the current Mexican government recognised that traditional financing methods were limited. The government thus pledged, at the time of its fiscal reform of 2007, that “half of all additional tax revenues will be invested in infrastructure”. Moreover, the reform of the public pension system, and the creation of individual pension accounts, has helped create a large and stable capital pool that is necessary for large and stable investments. In order to entice more private sector involvement, the government also established a National Infrastructure Fund, charged with the financing and management of public infrastructure, and freed from the constraints of general budget management – in the words of Mr Carstens “a real catalyser to engage private sector engagement”. Mr Carstens also stressed the importance that this fund has been mandated to “become a centre of excellence of project evaluation”, something that is lacking in many countries. Under a mandate “to provide direct financing and guarantees to the private sector”, the fund can re-concession and securitise assets, and provide private construction firms with the necessary information and stability to estimate future capacity needs and facilitate planning.

A member of the audience asked Mr Carstens whether the government should not use more funding opportunities from banks such as the World Bank to avoid bottlenecks in infrastructure investment. Mr Carstens replied that such money was not free, but that it required creating “a lot of fiscal breathing space.” Another question from a student from Queens University, Canada, suggested that infrastructure investment was focused too much on highways and ports and perhaps sustainable investments such as alternative energy was being neglected. Mr Carstens replied that the “focus in investment is diverse” and “alternative energy is just as important in developing countries.”

Richard Lavergne talked of the huge investments required in future energy provision and the consequent need for a “cultural revolution” in our approach to climate change and sustainable development. For this, five key stakeholders must be brought together to articulate a policy response: government, business, local authorities, consumers and environmental NGOs: “there needs to be a national consensus on long-term goals”. One of the main problems identified by Mr Lavergne is the “NIMBY syndrome” – “not in my backyard”, with local opposition to big projects often persisting for decades and disrupting long-term planning. So the government needs to put in place systematic analysis to forecast market risk and prepare solutions.

According to **Pierre Lortie**, there are four driving forces in the sudden increase in demand for infrastructure: the rapid growth of large economies (China, India, Brazil, Indonesia), the need to improve dilapidated infrastructure (Eastern Europe), the need to maintain competitiveness in a context of rapid globalisation (the Panama Canal), and the urgent need to renew or replace old infrastructure (the West). In the opinion of Mr Lortie, there are two main public policy issues: “how to invest efficiently without undermining public funds, and how to ensure the upkeep and consistent maintenance of infrastructure”. Indeed, constraints in public finance have exasperated the problem of construction delays, cost overruns and maintenance deferrals. Recent studies in the UK, for example, showed that 73% of infrastructure projects ran over budget or were completed later than anticipated; while in Australia cost overruns averaged 40% and 24% of projects were late. According to Mr Lortie, the advantage of public private partnerships is that these risks are transferred to the private sector from the outset, and this explains why they have grown so rapidly in countries like the UK. “These partnerships bring synergies, more innovative designs, better service for the public, more effective use of capital and more on-time, within-budget projects”.

Hamish McRae commented on the similarities between the infrastructure construction boom being enjoyed by many developing countries today and Europe at the end of the nineteenth century, but the challenge seems to be to do it better: higher standards, lower carbon footprint, and not repeating the error of “deserting densification”. Large quantities of savings are also available, but there are still question marks over how these savings can be mobilised: for unlike in the 19th century, today inflation is rampant, which may undermine the use of traditional techniques to tap the savings of the new middle classes and open the door to the use on innovative financing methods. For low saving countries, they need to be even more innovative and diversify their financing resources. Concerning the relationship between markets and regulation, Mr McRae insisted that regulations are necessary but are often a blunt instrument and tend to obey “the law of unexpected responses” –“when my back is against the wall, I prefer markets... regulators have their political careers to think about”.

In response to questions from the floor, Mr Lortie and Mr Hunter both agreed that private shareholders in a PPP should not be bailed out by their public partners in case of a PPP project goes sour. Finally, Mr McRae said that large, long-term projects are prone to changes in the electoral cycle–“the only discipline on politicians is their long-term reputations”.

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