

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

Infrastructure in Africa: A new agenda

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Context

Africa has no option but to attract private finance if it is to get the infrastructure it needs for development. It does not have sufficient domestic resources and aid is small in comparison to what is required.

The required amount of foreign financing is tiny in the context of global capital markets. However, these markets currently view African infrastructure as highly risky and so require commensurately high returns. The policy challenge is to reduce these perceived risks in ways that are acceptable to African governments and credible to capital markets.

Phases and Horizons

The typical infrastructure project has distinct phases and generates a long horizon. Each of these features has implications for how it can be financed.

The three phases are design, build, and operate. These have specific financing requirements and risks associated with them and consequently require different types of finance to make them viable. For efficiency, the high-cost capital necessary for the high-risk phase should not be tied up beyond the period for which it is needed.

In combination the three phases typically generate a long horizon. Design may take anything from 2-8 years; building the infrastructure may take 3-7 years; while the phase of operation is likely to extend for at least two decades. No African government can credibly commit for such a long horizon. A possible approach is use the project phases as milestones, so that not all decisions need to be taken in the first phase before any commitments are made. Given the limitations of credible commitment, it is helpful to establish the minimum sets of decisions that must be taken at each stage in order to be able to continue to the next stage.

Phase 1: Design

Parameter setting

The design phase sets the parameters which determine whether the subsequent stages can attract private finance. Since it sets key parameters, design is in many respects both the most critical and the most complex phase. It is critical because it defines the objectives and requirements of the project and needs to demonstrate credibly an ability to deliver at the subsequent phases. It is complex because it involves coordination with several different players and a commitment on their part to participate in the subsequent activities.

At the completion of the design stage, building the project needs to be a bankable proposition which is recognized as advantageous by the government. Hence, the most crucial element of the design stage is to define the governance of the programme. Investors feel exposed to risks of expropriation by governments and governments are exposed to exploitation by private sector contractors. There needs to

be a common purpose and understanding from the outset, means by which the different parties can credibly commit, and ways of resolving disputes in a low cost and effective manner.

The most effective way of achieving this is through joint “ownership”. The different parties – private sector funders, contractors and operators need to be brought together with public sector providers (donors and government) to define the roles and responsibilities of the different parties. Projects should be ring fenced as self-contained activities with the governance of each project delineated from that of other projects but within the context of a broader framework or architecture for the sector as a whole, set by the government after consultation with investors and other stakeholders. In other words there should be a hierarchy of collaborative arrangements between private and public parties from high level sector wide oversight to specific infrastructure projects.

The importance of the former is that while the management and financing of individual infrastructure projects can be contained and ring-fenced, the impact of other activities in the sector or indeed from other sectors cannot. So for example, the success of a road building programme might be seriously affected by the initiation of railway programmes. The potential for infrastructure assets to be stranded is therefore immense even in the absence of specific expropriation of returns from a particular project. The way to manage this is for the infrastructure programme of a country to be designed in close collaboration with investors.

Financing the design stage

Currently there is a severe shortage of bankable African infrastructure projects. This is symptomatic of insufficient resources being attracted into the design phase which, for a significant project, are likely to amount to tens of millions of dollars spread over several years. If this phase is to attract private finance, then at its beginning the prospects of commercial returns from investing in design must be sufficiently attractive. Evidently, this is not currently usually the case.

One major impediment to private finance of this stage is that it is difficult to ensure that a sufficient part of the social returns are appropriated by private investors. This stage only generates information – a document for signatures – in a form which is not well-suited to patenting. In particular, if standard sources of international public finance are envisaged for part of the project, the government will be subject to requirements of competitive tendering for the project itself, and so may face difficulties in giving one company rights on the infrastructure concept itself. A possible solution is for a trusted international public agency such as IFC to specialize in this catalytic role, acquiring *ab initio* defined rights as a founding investor should the project continue through to the build phase. A second major impediment is that at the beginning of the design stage too many issues are open-ended: discussion and negotiation could go on for many years only to fail. A possible solution is to close off some issues *ab initio* through international standardization. This could speed the design stage by reducing the number of decision points and so reduce the number of veto players.

Phase 2: Build

The build phase is when major finance has to be raised. It is also currently a high-risk phase. There are two critical components to effective management at the build stage. The first is commitment mechanisms and the second is collateral so there are costs and compensation for reneging on contracts. Building large infrastructure projects commonly involves substantial cost overruns and delays. There is an established psychological bias towards optimism among planners since best-case scenarios tend to

become adopted as the benchmark for outcomes. At the build stage these risks can potentially inflict high costs on the private contractor which are consequently priced into the project. Hence, these risks get borne by the private investor who undertakes upfront finance for building the project ahead of recuperating returns on the investment. To address this there therefore need to be mechanisms for imposing penalties on defaulting governments and ways in which private sector contractors can recover their costs.

MIGA has offered a very effective method of discouraging default by acting as a collection device backed by the threat of sanctions from the World Bank. The question is whether this can be scaled to a greater level than to date. This is in part a matter of resources and in large part a question of how much capital it can raise to underwrite its activities. With its very strong record in enforcing contracts it has a good base on which to build its capital. However, this requires a global initiative on the scale of that which was involved in establishing the EBRD. Capitalizing MIGA and similar organizations should be viewed as a very effective form of aid in which for the most part the aid does not need to be spent because the underwriting never has to be provided. Governments should recognize their collective power to promote economic development by creating agencies such as MIGA backed by the World Bank that act as commitment vehicles and allow developing country governments to commit in a way in which they wish to but cannot at present credibly do. It is therefore substantially welfare enhancing at very low cost.

The second element of compensating private sector providers for losses incurred is to offer the one form of collateral that many developing economies possess – natural resources. In essence what is being sought is to link revenues from natural resource extraction to the delivery of infrastructure projects. It creates a fund to convert current resource extraction into a long-term asset. Through a combination of governance arrangements and self-imposed commitment, developing economies bind revenue from their natural resources to the delivery of infrastructure projects. This is equivalent to individuals being able to commit their personal incomes to savings in housing rather than spending on less durable items.

A third possible element is for African governments, most of whom are currently eligible only for highly concessional credits from the Multilateral Development Banks (MDBs), to co-finance the build phase through borrowing ring-fenced finance from the hard windows of the MDBs. Access to such finance could be made conditional upon private co-finance. As with natural resource revenues, this would give governments a direct stake in the commercial success of the project. Since such debt is matched one-to-one by commercially viable public assets, it should be treated very differently in IMF debt sustainability calculations from unrestricted government borrowing.

Even with these elements, projects may struggle to raise sufficient private finance to be feasible. There may be an irreducible need for international public risk capital. The IFC and its equivalent bilateral agencies probably need radical scaling up once they have a clearly defined role at this phase. Since public risk capital will always be severely limited, it is important that it should not be tied up during the operate phase. Hence, an exit strategy at the beginning of the operate phase should be built in prior to the build phase.

Phase 3: Operate

At the operate stage, the risk is a government one that the private sector operators fail to deliver the promised level of services. This requires a commitment on the part of companies to meet obligations in

terms of quality and price of services and not to exploit their monopoly positions to the detriment of customers. This is traditionally achieved through regulation.

The regulatory process should be seen as a commitment device on the part of companies. It forces them to avoid abusing their monopoly power in the charges that they levy on customers and the quality of services that they provide. However, regulation has to balance the benefits it confers on customers through lower charges and higher quality services with the disincentives it imposes on providers to invest and operate in infrastructure markets. In particular, regulators can act in as arbitrary a fashion as governments in seeking to impose populist agendas. Alternatively they are subject to capture and fail to promote the interests of customers.

Learning about regulatory approaches from other countries will be an extremely valuable and important part of avoiding the pitfalls of regulation in Africa. There is a substantial amount of knowledge transfer that will be possible from developed economies. But it is not sufficient on its own. There needs to be a broader commitment by the private sector to operate infrastructure to the benefit of host countries. The trouble that has arisen in many developed economies is that companies have exploited their position in relation to weak regulators who are inevitably at an information disadvantage. There is an inherent conflict between shareholder driven corporations and the public interest and in general the regulator comes off worse from the conflict.

In a developing economy context this is particularly serious because of the reliance that has to be placed on overseas operators. There is therefore a real risk of the process of private sector engagement in infrastructure in Africa becoming rapidly discredited as it is perceived that utility companies are exploiting vulnerable economies. To avoid this it will be necessary to ring-fence the utility activities of foreign operators from the rest of their activities. It is a process that has been successfully implemented in utilities in the UK where, in particular in the water industry, the regulator requires a clear delineation between the utility and the non-utility parts of businesses. Assets cannot be transferred between the two, they are incorporated as separate subsidiaries with their own boards of directors and the payment of dividends from the subsidiary to the parent is limited. The ring-fenced activity should be the one that is involved in the partnership arrangements in the design phase described above.



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