MOBILISING FINANCE FOR INFRASTRUCTURE
A STUDY FOR THE DEPARTMENT FOR INTERNATIONAL DEVELOPMENT (DFID)

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FINDINGS SUMMARY

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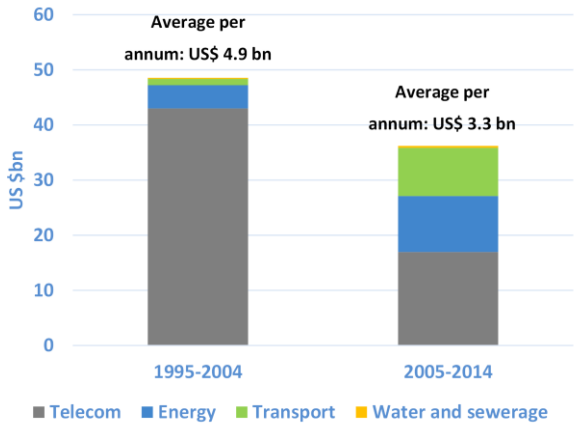
Objective and problem. The objective of private financing of infrastructure projects, and without the need for credit guarantees from governments, is to transfer financing risks to the private sector. This not only frees projects from the constraint of the size of government balance sheets, but also creates 'fiscal space' to finance other public services that cannot be financed privately. But Sub-Saharan Africa (SSA) lags behind other developing regions in attracting private finance to infrastructure. Why is this? Is it due more to *a lack of bankable project opportunities*, or *supply-side problems facing providers of finance*? Are these problems upstream (enabling environment) or downstream (inability to execute transactions) in nature?

Recent volumes and focus of private financing. Whereas initial public-private partnerships (PPP) in DFID's focus countries in SSA[1] were largely in cellular telephony, there is now more of a spread across sectors, particularly in energy and transport. However, the overall lower annual volume of financing, at just over US$3bn per annum, is well short of the flows required to underpin current and projected rates of economic growth. It is also highly concentrated in certain countries and sectors. For instance, in the period 2010-14, including South Africa, 98% of investment in the energy sector was in electricity generation while the Nigeria seaport sector has accounted for around 88% by value of all transport projects in DFID focus countries in SSA (excluding South Africa).

Figure 1: The telecoms share of PPP project financing in DFID focus countries shrunk and energy and transport grew between 2005-2014 compared to 1995-2004 (excludes S. Africa).



Source: CEPA analysis.

Downstream barriers such as limited capacity to originate, prepare, and appropriately package projects that meet the requirements of financiers are significant challenges but addressable with donor resources. A key result of a lack of capacity is a reliance on unsolicited bids in many countries. The evidence suggests that those countries with publicly originated PPP programmes, such as in Kenya's power sector, South Africa's renewables sector and Nigeria's ports, are much more correlated with success than ad hoc unsolicited transactions. A combination of early stage support such as DFID's Nigeria Infrastructure Advisory Facility and later stage support provided by recyclable project development funds can play a significant role in enhancing these capabilities. These resources need to be increased given the scale of the challenge.

Upstream barriers such as creating a commitment to PPPs can be more intractable than downstream barriers and difficult to influence directly through donor interventions, given a whole range of political economy challenges created by them. A key challenge is gaining acceptance that users need to pay cost reflective tariffs for infrastructure services if they are to be provided at the volume and scale required. Implementing PPPs, which force the payment of tariffs and raise other difficult issues is a political challenge for governments that often fails to survive political cycles.

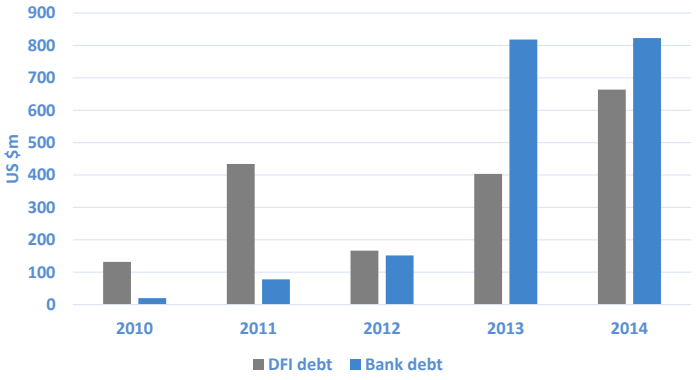
[1] All figures are for DFID focus-countries in SSA excluding South Africa, specifically: the Democratic Republic of the Congo, Ethiopia, Ghana, Kenya, Liberia, Malawi, Mozambique, Nigeria, Rwanda, Sierra Leone, Somalia, Sudan, South Sudan, Tanzania, Uganda, Zambia and Zimbabwe. CEPA also undertook more detailed fieldwork in Ghana, Kenya, Mozambique and Nigeria.

Bankability. In the electricity sector, retail power prices charged to customers by state-owned utilities are often lower than the costs of supply. This, combined sometimes with the failure of state-owned customers to pay for power, often renders state-owned utilities close to insolvent. Power projects become unbankable because of the payment risks created. In many transport sectors, the market risks created by limited willingness to pay similarly undermines bankability. A lack of bankability remains the single greatest barrier facing countries.

Longer term solutions to a lack of bankability require a mix of policy reforms. For instance, in the power sector, these involve regulatory, contractual, and market solutions to payment risks, such as through the development of power pools. In transport, project structures need to move away from the transfer of traffic risk to availability based, performance risk transfer structures.[2]

Partial risk guarantees. Unless the basic creditworthiness risk is mitigated, private finance will not flow to projects. However, in the short term, to attract private capital, PPPs need the protection of guarantees. The majority of infrastructure projects (outside of telecoms) involving commercial bank debt have involved the use of partial risk guarantees (PRGs). Five out of seven IPPs in Kenya, and all four power sector projects in Nigeria, closed in the period 2010-15 have required PRG support for a range of government commitments. These have been provided by the World Bank and the African Development Bank out of relatively limited International Development Association (IDA) and African Development Fund (ADF) resources. Supplemental concessional funds might therefore be required to support greater provision of these instruments. In future, PRGs also have the potential to support availability structures in the transport sector.

Figure 2: Bank debt has recently surpassed DFI debt as the primary long term finance for projects in DFID focus countries in SSA (excludes South Africa and telecoms projects)



Source: CEPA analysis.

FX financing. Historically, DFIs have provided most long term debt finance for infrastructure projects in DFID focus countries in SSA. However, increasingly projects are raising commercial debt (in the period 2010-14, 49% was provided by commercial banks and in the last two years commercial bank debt far exceeded DFI debt). Banks with a presence in SSA provided 95% of this. Many SSA-based commercial banks can now access long term FX markets. But financing in FX creates significant exchange rate risks that must be borne by customers or governments. Exchange rate fluctuations contributed significantly to the Asian crisis of the late 1990s.

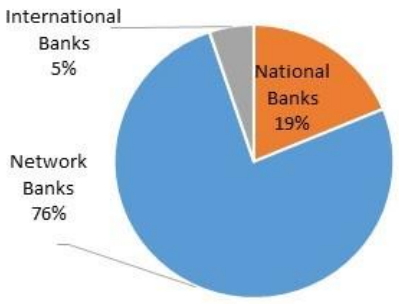
Local currency financing. There is only limited local currency bank financing of infrastructure. What exists is in the telecoms sector and for more limited tenors of five to seven years, due in part to a reliance by banks on short term deposits for their own funding. Commercial banks in more developed DFID-focus countries such as South Africa and India provide much longer term local currency finance to the full range of projects. However, local currency financing has higher interest rates and it is difficult to fix rates because of an absence of longer term hedging markets. However, there is a strong

[2] In availability structures infrastructure providers are paid for providing assets to a particular standard, rather than by how much they are used or utilised; thus removing demand uncertainty, a particular challenge of greenfield assets.

policy rationale for supporting local currency financing solutions in order to reduce exchange rate risks.

As with FX lending, banks will need credit enhancements. There are, however, many DFIs and entities such as GuarantCo that provide local currency PRGs. As well as addressing credit risk, however, liquidity risks will also need to be addressed if the tenors of local currency financing solutions are to be extended, given the nature of the liabilities faced by both banks and institutional investors (such as deposits and pension liabilities – which are not always as long term as commonly assumed).[3] To date, common donor interventions have had little emphasis on addressing the liquidity constraints of both bank and institutional credit providers.

Figure 3: Most bank debt for projects in DFID focus countries comes from banks with operations there, 2010 - 14 (excluding South Africa and telecoms)



Source: IJGlobal; World Bank PPI Database; CEPA analysis.

Financing policy interventions include greater provision of liquidity instruments such as 'put options' by DFIs, which enable banks and investors to exit performing investments, if they need liquidity. DFIs could also explore the potential to use their own balance sheets more to raise longer term local currency finance through local market issues, to on-lend direct to projects or else to provide wholesale funding to local banks. Where this creates additional risks for DFIs, donors may need to risk share in this.

The other way to deal with currency mismatches is to utilise currency swaps, in which borrowers effectively borrow in local currency, but investors have exposures in FX. The Currency Exchange Fund (TCX) is a donor-backed initiative which aims to create longer term swap markets in more exotic currencies, which do not exist at the moment. This enables projects to benefit from the lower cost and longer tenors of FX financing, whilst mitigating the resulting exchange rate risks.

Institutional finance. As with local currency financing, attracting institutional finance requires a different approach to FX financing. The currently widely used project financing approach, in which DFI and commercial lenders come in at financial close and hold debt to term, is badly matched to the needs of institutional investors. Investors such as pension funds require *operational* and *liquid* assets, not *greenfield, illiquid* ones. Attracting institutional debt finance to greenfield assets remains close to impossible without strong credit enhancements to mitigate risks. However, investment through structured funds including the provision of first loss capital may address risk sufficiently to mobilise capital for DFID focus countries in SSA. Alternatively, exploring more radical recycling of capital approaches is another way of creating opportunities for both local and international institutional investors. In such an approach, DFIs would come into projects prior to financial close, would take construction risks and then exit, once the project was proven operationally. This could provide opportunities for refinancing for local currency institutional investment too.

Conclusions. Creating bankable project financing opportunities is by far the most immediate policy challenge and remains a priority. But enabling infrastructure to access local currency financing and institutional markets, as opposed to the long tenor FX finance offered by DFIs and increasingly by SSA-based commercial banks, requires additional policy responses.

[3] Credit risk is the risk of a project defaulting; liquidity risk is that of financiers being unable to liquidate their performing assets in the event of a need for cash.