7th Annual Meeting of the Infrastructure Consortium for Africa

(Paris, 17 and 18 May 2011)

Session 4 (Wednesday, 18 May, 11:15-13:15)

Financial conditions for private investment:

Instruments for risk coverage, financial return, pricing policy

1 Workshop themes

Before participating in public-private partnerships in the infrastructure sector, private partners require there be a level of profitability that matches the project's risks. The tariff level is a determining factor in profitability of a project, which must take effective demand into consideration. For a given tariff level, several levers can help achieve adequate financial return:

(i) Using risk coverage instruments and specific financial instruments;

(ii) Building institutional structures to ensure that certain major investments will be managed by the public sector;

(iii) Granting concession holders project-related development rights (for example real estate development around the project) that could improve their revenues.

1.1. Market and pricing policies

Infrastructure development in Africa is relatively costly, given Africa's narrow local markets, low population density and limited competition. For instance, in the energy sector, given the low demand (many countries have an installed capacity of less than 500 MW), power plants do not reach the size required to allow for competitive power generation costs. In the transport sector, there are few roads that have enough traffic to consider the participation of the private sector and award concessions. Moreover, energy, water or transport tariffs are often very political.

Given these market restrictions, tariffs ensuring a fair return for the private sector may be too high to ensure a balanced project. In this case, several paths may be taken:

- When preparing a public-private partnership project, it is important to determine whether users, taxpayers or official development assistance should cover the cost of the particular infrastructure;
- Reducing private sector investment perimeter could help mobilize less costly public funds, and thereby lower the tariffs and risks of a project;

- Conversely, related rights, for example in real estate development[1] could be granted;
- Private projects that involve selling directly to users (concessions) may seem more risky than private projects with public procurers (national power or water companies). Such companies have to deal with the political and economic restrictions on user tariff levels. As a result, they often have an operating deficit because they sell the service at a price below the cost to produce it.

In addition, in the course of a public-private partnership, a certain number of events (volatile commodity prices, macroeconomic shocks, political changes) may change the dynamics of a contract. Sector regulation and stipulations for returning to economic equilibrium of a contract may help increase visibility about changes in tariffs and the contract. However, there have been many cases where private partnerships have decided to give up a concession or abandon a project after several years because of low financial return or a change in investment parameters.

The main questions to address are:
- *How can competitive tariffs be ensured in the framework of a public-private partnership?*
- *How can concessions work over the long term in an increasingly volatile global context?*

1.2. Risk coverage and financial instruments

Long-term local currency debt financing options are relatively limited except in South Africa. This concerns both bank and bond financing. Yet things are improving. Projects (mobile telephone services, power plants with less than 25 MW capacity) that previously required support from donors can now be financed locally. Private equity financing options are also very limited, because the investment fund market has been developed very little locally, and sub-Saharan African countries are not attractive enough to international investors. Therefore, financial support from bilateral or multilateral donors remains crucial to infrastructure financing.

Donors mainly offer long-term debt financing and risk coverage instruments. Such instruments are now used relatively little, mainly due to their complex nature. Institutional equity financing options are growing, but are still limited by the capitalization of financial development institutions targeting the private sector. Subordinated instruments (mezzanine loans) have likewise greatly expanded, and both curb equity needs and facilitate debt raising by limiting risks of senior lenders.

[1] One example is the concessions in India in the airport sectors (Delhi, Bangalore, Hyderabad) or for the urban subway (Delhi, Bangalore), where the concession holder obtained development and operating rights to building stock near these infrastructures, which significantly lowers the prices charged to the users.

Questions:
- *Are the limited equity options for infrastructures an obstacle to conducting and completing projects?*
- *How can long-term local currency financing options be improved?*
- *How can risk coverage instruments be made more attractive?*

Possible guidelines for ICA work:

- Given that the paucity of bankable projects and the limited supply of risk coverage instruments are the major obstacles to private sector infrastructure financing in Africa, the ICA could help raise awareness and make recommendations to improve existing initiatives in this area;

- The ICA could play a more significant role as an intermediary or clearinghouse in order to better match private sector expectations to what members or other partners are offering in the area of project financing by regularly posting information on its website about the pipeline of projects, project preparation facilities and the risk coverage and finance instruments available.