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Promoting investment for development: Best practices in strengthening investment in basic infrastructure in developing countries – a summary of UNCTAD's research on FDI in infrastructure

Note by the UNCTAD secretariat

Executive summary

Investments in basic infrastructure are a prerequisite for economic development. There remains a significant infrastructure gap in many developing countries and especially in least developed countries (LDCs). Along with domestic public and private investment, foreign investment has a major role in addressing this gap due to its often superior access to finance, technologies, and skills. But policymakers face significant challenges in attracting and regulating these investors.

This note outlines key opportunities and challenges related to foreign direct investment (FDI) in infrastructure. Drawing off a series of country case studies in different infrastructure sectors, it then presents a set of best practice policy lessons for developing country policymakers. The note concludes with a cautionary tale for mature market infrastructure transnational corporations (TNCs) that may be overlooking investment opportunities in developing countries.

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Introduction

1. The Trade and Development Board, at its fiftieth executive session, on 8 July 2010, approved the agenda for the third session of the Investment, Enterprise and Development Commission, with the item "Promoting investment for development: Best practices in strengthening investment in basic infrastructure in developing countries". The present document is a summary of UNCTAD's research on FDI in that area.

2. Improvements to basic infrastructure, including utilities and transportation, are a fundamental prerequisite for economic growth. In developing countries, however, budgetary, financial and technical constraints make infrastructure development a major challenge. To overcome this challenge, many countries have looked towards private investment, particularly FDI by TNCs, to complement public investment within their overall infrastructure strategies.¹ Yet private investment in infrastructure contains its own risks that must be mitigated by well-designed policies that balance the interests of investors and host countries and ensure mutually beneficial arrangements.

3. Building on the *World Investment Report 2008*, chapter I of this note outlines the opportunities and challenges arising from FDI in infrastructure. Chapter II, based on findings from UNCTAD's case studies on best practices in investment for development, outlines policy lessons on how to attract and manage FDI in infrastructure. The note finishes with some concluding remarks, including the need to improve TNC perceptions of infrastructure opportunities in developing countries.

I. Using FDI to improve infrastructure in developing countries: opportunities and challenges

4. Whether in power, water, transport or telecommunications, the existence of highquality basic infrastructure is necessary for economic and social development. Low-cost access to infrastructure services supports industrial growth, increases an economy's competitiveness, helps alleviate poverty, and is a vital ingredient for many developing countries to meet their Millennium Development Goals (MDGs).

5. Most developing countries face a considerable "infrastructure gap". To meet their economic growth and poverty reduction targets, the World Bank (2008) has identified the need for these countries to invest between 7 and 9 per cent of their gross domestic product (GDP) annually to build and maintain infrastructure, yet actual investment rates are much lower, ranging between 3 and 4 per cent. In sub-Saharan Africa, for example, shortfalls in infrastructure financing are estimated at over \$20 billion per year. Similar gaps have been found in Asia, Latin America and the Caribbean.

6. To address financing shortfalls, developing countries have increasingly turned to the private sector. In addition to representing an additional source of funding, private investment shifts the financial risks of projects away from the government. Private involvement can have a positive impact on government budgets due to income from the sale, lease or concession of State assets, as well as reductions in public operating and

¹ As noted in a recent UNCTAD (2010) note for the third sessions of the Multi-year Expert Meeting for Investment for Development, infrastructure is one of the areas in which public investment can benefit from closer association with private investment. The report of the session is also presented to this Commission as part of this discussion.

capital expenditures and/or subsidies. Despite these benefits, the public sector still accounts for half of infrastructure investment in most developing countries. This suggests the existence of further opportunities for private involvement in infrastructure development.

7. The trend towards greater reliance on the private sector has also seen a growing role for FDI by infrastructure TNCs. FDI made up 28 per cent of total infrastructure investment in developing countries during 1996–2008, while domestic private investors made up 23 per cent (UNCTAD, 2010b). TNCs typically have access to superior technology and expertise, as well as significant economies of scale. Moreover, they have a greater capacity to mobilize financial resources to meet the huge capital requirements of major infrastructure projects. Opening the infrastructure sector to TNCs also increases the pool of potential investors, allowing governments to secure higher prices for infrastructure assets or concessions.

8. TNC participation in infrastructure can take several forms, ranging from full equity in the case of greenfield investments or privatizations, to management and lease contracts where the TNC is not required to invest any equity. In between these two extremes are concessions,² which typically require some equity commitment from TNCs, although this may be time-bound with the infrastructure assets being transferred to the government at the end of the term. Concessions are the dominant arrangement for FDI in infrastructure, representing 62 per cent of all projects in developing countries during 1996 to 2006, followed by greenfield and privatization FDI making up 16 per cent each. Management and lease contracts made up 6 per cent of the total.

9. Although FDI offers significant opportunities to enhance basic infrastructure in developing countries, it also poses two sets of policy challenges. The first involves attracting infrastructure TNCs to undertake projects. Given their significant capital requirements and long investment timeline, the associated financial risks can be quite high. Strong efforts are needed to craft a stable policy environment that ensures the viability of these projects.

10. Second, there are challenges related to ensuring that the activities of infrastructure TNCs are carried out according to the public interest. While this challenge applies to domestic private investment as well, large infrastructure projects in developing countries are more likely to involve foreign TNCs. Moreover, given their relative size and access to superior information, TNCs often enjoy considerably higher bargaining power in their relations with host governments, which may limit the demands that can be made of them in terms of investment commitments, risk allocation and performance requirements. This dynamic may also affect the ability of regulators to hold the company accountable to its contractual commitments. While the entry of new investors can increase competition among infrastructure providers, there is also a risk that TNCs find themselves in a monopolistic market position, allowing them to charge higher prices or fail to expand infrastructure capacity. Ensuring universal access to certain infrastructure services may also be an important policy goal, requiring additional considerations of cost sharing between the TNC and host government.

II. Best practice policies: a summary of UNCTAD's findings

11. This chapter outlines three sets of lessons for developing country governments on how to navigate the above-mentioned opportunities and challenges associated with FDI in

² Concession arrangements are typically what are implied by the term "private–public partnership" (PPP).

infrastructure. These lessons are based on the findings of UNCTAD's country case studies on best practices in investment for development, three of which have focused on key infrastructure sectors (electricity, roads and ports).³ They are general and cross-cutting, having relevance across different sectors and modes of private participation (see table below). Beyond these basic guidelines, any infrastructure policy must be suited to a country's specific characteristics and conditions; there is no "one-size-fits all" model.

| Stage | Lesson |
|------------------|---|
| Laying the | • Develop a strong legal and regulatory framework prior to the entry of |
| foundation for | FDI |
| FDI in | • Secure the capacity and skills to facilitate and regulate private |
| infrastructure | investment in infrastructure |
| | • Empower high-level taskforce to catalyze necessary reforms |
| | • Develop an integrated strategic infrastructure plan identifying key needs |
| | Proactively address community and stakeholder expectations |
| Promoting and | • Create a "pipeline" of pre-assessed, commercially attractive projects |
| facilitating the | that can be actively promoted |
| entry of FDI | • Open the bidding stage to as many investors as possible |
| | • Ensure that contracts take into account key issues over the project |
| | lifespan |
| | • Help mitigate political and regulatory risks faced by foreign investors |
| Ensuring | Monitor and follow-up on project implementation |
| effective and | • Understand and pay close attention to competition issues |
| efficient | • Private and State-owned players can co-exist within a competitive |
| project | framework |
| implementation | |

Best Practices lessons for FDI in infrastructure

A. Laying the foundations for FDI in infrastructure

12. Develop a strong legal and regulatory framework prior to the entry of FDI. Significant capital requirements, a long investment timeline and the fixed nature of the assets make infrastructure investments unique. Beyond the existence of commercial opportunities in host country markets, foreign infrastructure investors require a transparent and stable policy framework underpinned by the rule of law. Before committing funds to a project, companies consider whether laws and contracts are likely to be properly enforced, and whether their rights and responsibilities are well defined and likely to be well respected. This reinforces the importance of having the vast majority of laws, regulations and institutions in place prior to FDI entry.

13. Moving from a State-owned system to one involving TNCs requires significant adjustments to the existing policy framework. New laws must be passed to commercialize government agencies or privatize State-owned infrastructure, and to specify the anticipated form of TNC entry (e.g. the type of concession). These laws should also address the regulatory approach of the government, which can range from specific performance requirements set by the government for independent producers within a State system, to a

³ The lessons are drawn from four of these reports (UNCTAD 2009a, 2009b, 2010a, 2011). The countries covered include Chile and New Zealand, Peru and Australia, Croatia and Mozambique, and Nigeria.

competitive framework involving several private investors competing with each other for customers. In either case, new regulatory activities are needed to monitor and enforce contracts with TNCs or to prevent anti-competitive practices. Introducing FDI to the sector without these conditions in place increases the likelihood of disputes between the home country and investors, leading to sub-optimal outcomes for both.

14. In Chile and New Zealand, the legal and regulatory frameworks for their electricity industries were largely laid out before the entry of FDI. State-owned enterprises (SOEs) were first split up and commercialized into separate entities. Privatization occurred slowly, and primarily involved domestic investors first. This incremental approach allowed the Government to test and adjust its approach, laying a strong foundation for FDI-led infrastructure development.

15. Secure the capacity and skills to facilitate and regulate private investment in infrastructure. Inviting TNCs to deliver infrastructure services often puts more pressure on public authorities than a State-run system. Understanding the legal, economic, financial and political aspects of the infrastructure sector is necessary to perform demanding planning, negotiation and regulatory functions.

16. Often, existing government agencies or departments will not be able to muster the necessary staff to undertake these responsibilities. In Australia and Peru, special project authorities design and administer the tendering of each road concession. They are allowed to recruit outside engineering, financial and legal specialists. Absent domestic capabilities, technical assistance from international organizations and consulting firms can play a major role in providing expertise for infrastructure reforms. In the case of Nigeria's port reforms, the World Bank's Private-Public Infrastructure Advisory Facility helped finance an international consulting for concessions. In another example, UNCTAD has recently assisted Viet Nam and Guatemala to devise plans to expand the role of foreign investment in key infrastructure sectors (see box 1).

17. **Empower high-level taskforce to catalyse necessary reforms.** The many legal and regulatory prerequisites to private investment in infrastructure require strong political will and institutional coordination. The creation of an inter-departmental body with direct access at the ministerial level is one way to ensure that infrastructure reforms receive priority and that all necessary steps are accounted for. In Australia, the authorities in charge of road concessions report to a cabinet sub-committee, while in Peru the responsible agency, Proinversion, was already a ministerial body. The activities of these agencies were accompanied by legislation giving them precedence over some of the regulatory powers of other laws.

Infrastructure issues in UNCTAD's IPRs

UNCTAD's Investment Policy Reviews (IPRs) evaluate a country's legal, regulatory and institutional framework for investment and make recommendations to attract increased levels of FDI and maximize the benefits to the local economy. In addition to key FDI trends and policies, the reviews analyse strategic issues of priority for the beneficiary countries. In their respective reviews, for instance, Viet Nam and Guatemala requested that UNCTAD (2008a, 2010c) analyze their infrastructure policies and make recommendations to increase the role of FDI in the sector.

Having experienced huge growth in industrial output over the 1990s and 2000s, by 2008, electricity supply in Viet Nam was becoming a bottleneck, threatening to constrain economic growth and development. Although the government had already attracted limited FDI in the sector, UNCTAD suggested reforms in the structure of the market in two stages in order to gradually introduce competition into different segments of the electricity sector.

Additional operational recommendations were made to attract investors in power generation. Viet Nam has integrated some of these recommendations in its own long-term plan to guide the liberalization of its electricity sector.

Similarly, the forthcoming IPR for Guatemala includes analysis and recommendations to attract FDI in the country's electricity sector and road infrastructure. Guatemala has already promoted private investment in electricity generation, transmission and distribution, but it requested UNCTAD to identify areas for improvement. Guatemala is also seeking to attract private investment to rehabilitate and expand its roads network. Following the presentation of the review at a national stakeholders' workshop in 2010, UNCTAD has been providing technical assistance in the implementation of some of its recommendations. These include concrete policy measures to strengthen the country's energy policy, and to improve the commercial feasibility and competitive bidding process of road projects.

18. Even in cases where central efforts to coordinate reforms are strong, political challenges can be overwhelming. In Nigeria, although several executive-level bodies were used to plan for the country's port reforms and mobilize key institutions, some of the framework legislation has continued to lag developments on the ground.

19. **Develop an integrated strategic infrastructure plan identifying key needs.** The identification of priority infrastructure projects should be informed by the government's socio-economic development objectives. For example, in Australia and Peru, it has always been the responsibility of the government to select which roads to concession; investors have not been allowed to self-identify projects. The commercial viability of a project is certainly an important consideration, but cost-sharing can also be used to ensure the construction of less profitable projects that are nonetheless deemed to be in the public interest.

20. Long-term planning by the government allows it to better coordinate infrastructure development and optimize its impact. In Nigeria, some of the benefits of private investment in the port system have been undermined by rising levels of congestion on the connecting road system, underscoring the need for an integrated transport plan.

21. Proactively address community and stakeholder expectations. Specific social attitudes and expectations regarding private infrastructure investment have profound effects on the sustainability of reforms. Higher prices or limits on universal access associated with certain private investments (e.g. in cases where the government had been selling services below market prices), often run counter to the expectations of the public and generate political opposition. To prevent this, mechanisms can be sought to temporarily compensate infrastructure users for price hikes, or to partially subsidize the development and use of private infrastructure, especially in remote or poorer regions. In any case, public understanding and support can be encouraged by selecting and communicating to the public clear policy goals and measures of success. Performance outcomes should be compared against a counter-factual where infrastructure reforms did not occur in order to emphasize the net benefits.

22. Aside from the general public and infrastructure users, private restructuring of the infrastructure sector may involve significant adjustment costs for stakeholders, such as labour unions. Often, a major justification for reforms is to upgrade technological capabilities in the infrastructure sector, which can in turn limit the demand for workers. A major policy challenge is therefore to address the social consequences of privatization. In Nigeria, efficiency goals implied the need to phase out up to 10,000 employees in the country's ports, more than two thirds of the total. A Presidential Task Force was created for this purpose. After a year of negotiations, a suitable retrenchment and severance package

was agreed that enabled the transfer of operations from the Port Authority to the private operators.

B. Promoting and facilitating the entry of FDI

23. **Create a "pipeline" of pre-assessed, commercially attractive projects that can be actively promoted.** After an infrastructure project is identified as eligible for private involvement, there are a number of preparatory steps that the government can take to reduce the risks facing foreign investors, particularly in the case of greenfield investments. These include completing any necessary feasibility studies or environmental and social impact assessments, as well as land acquisition if required for the project. In Peru, before a road concession is offered to investors for bidding, a feasibility study is completed. The Institute for National Culture is also consulted to certify that a project is unlikely to disturb any cultural artefacts that could delay or affect road construction. These types of actions can clear a significant portion of the project risk, making it a more attractive opportunity for investors. Once a portfolio of potential projects is available, they can be actively marketed to foreign investors through a national investment promotion agency, for example.

24. In LDCs, market size may limit the commercial viability of private infrastructure investments, potentially requiring governments to shoulder the risk themselves through traditional models of public works. Post-conflict Mozambique, however, has successfully used a strategy of development corridors to attract FDI in infrastructure. This approach relies on an anchor project, such as the country's major aluminium smelter, to provide demand for infrastructure services, creating a profitable opportunity which can then be promoted to private investors.

25. Open the bidding stage to as many investors as possible. In most cases of private infrastructure investment, the government should have a competitive bidding or auctioning process to determine which investor can offer the best deal in terms of investment commitments, delivery of goods and services, price reductions, contribution to public revenues, etc. A highly competitive bidding stage maximizes the benefits accruing to infrastructure users and the government, making it imperative that the process be relatively free of barriers that could limit the number of bidders. These barriers often come in the form of requirements that bidders must meet, such as minimum standards related to company size or past experience, or a series of costly administrative procedures that must be undertaken during the bidding process. It is also important that the process be transparent, so that opportunities for favouritism towards certain bidders are limited. For example, bidding for Nigeria's port terminals was open to any foreign and domestic investors. They received 110 initial applications, which resulted in 59 qualified bids for 13 terminals. Of these, the preferred bidders entered into negotiations with the Government, where more detailed agreements were produced. This multi-step approach allowed the investors to enter the initial bidding stages with minimal administrative hurdles. As the bidding process progressed, remaining investors were required to produce more detailed financial and technical plans. Another option, as seen in Peru's approach to road concessions, is for the Government to subsidize a portion of the bid costs.

26. **Ensure that contracts take into account key issues over the project lifespan.** Once a bid is deemed to have met the necessary threshold, negotiations begin on more specific terms of the agreement. To limit the potential for future disagreements, which could result in costly legal proceedings or re-negotiation, service disruption, or divestment, it is important to ensure that all reasonably foreseeable issues be included in the initial contract. An exhaustive list of key issues that may need to be addressed includes:

(a) Allocation of different risks between the investor and government;

- (b) Capital commitments;
- (c) Level of user prices;
- (d) Performance standards for operational issues;
- (e) Contingencies for unforeseen changes in circumstances;
- (f) Revenues to be paid to government; and
- (g) Arrangements for the eventual transfer (if any) of assets to the government.

27. Ultimately, the necessary elements in a contract depend heavily on the model of private participation, as well as the regulatory framework. In Nigeria, performance benchmarks did not play a major role in concession agreements for the country's ports, since the model relied on inter-terminal competition to provide the adequate incentives to investors. A key focus of the contracts was instead on the contributions of terminal operators to government revenues.

28. **Help mitigate political and regulatory risks faced by foreign investors.** Many developing countries face the challenge of actual or perceived political instability, and weak legal and regulatory institutions. These countries may benefit from committing themselves to international arbitration in cases of disagreement between the investor and host government. This can be done, for example, by entering into a bilateral investment treaty with the home country or by offering legal and fiscal stability guarantees directly to the investor. Yet, governments should remain cautious when crafting these instruments, which may result in significant future liabilities. Despite only representing around 10 per cent of global FDI flows, the infrastructure sector makes up around one third of the total number of treaty-based investor-State disputes (UNCTAD, 2008: 164).

29. Another option to mitigate political risk for investors is to seek assistance from international financial institutions that can provide equity for the project or compensation to the investor for damages due to political risk. In post-conflict Mozambique, the International Financial Corporation and the Multilateral Investment Guarantee Agency were instrumental in mitigating the political risk facing infrastructure investors in several electricity and transportation projects.

C. Ensuring effective and efficient project implementation

30. **Monitor and follow up on project implementation.** Private investments in infrastructure are typically characterized by complex terms and conditions between the investor and the government. This is particularly the case for concession agreements. Positive outcomes for the host country depend on government efforts to monitor the project's progress and enforce agreements with infrastructure investors. In most infrastructure sectors, governments can create an independent body for this purpose. In Australia, for example, an independent verifier is created to oversee the construction for each new road under concession agreements. Both the government and investor appoint their own representatives, and the verifier hires the necessary technical expertise. Operational matters are monitored by government line agencies.

31. Another approach is to conduct high-level reviews with the purpose of assessing performance and identifying areas for improvement. In Nigeria, for example, legislative delays in creating an independent commission for the transport sector meant that the private port terminal operators were acting with limited oversight. To fill in this gap, the Minister of Transport launched a port reform evaluation committee to, *inter alia*, determine the extent of project implementation by investors, evaluate port performance, and suggest areas of improvement.

32. Understand and pay close attention to competition issues. In cases where a market is deemed large enough to support a competitive framework for infrastructure development, investors may face fewer specific regulatory requirements. In theory, properly functioning markets will provide the right incentives for investors to undertake capacity expansion, improve service quality and lower prices. However, governments still need to exercise proper oversight to assess and maintain a high level of competition. In some cases, direct price regulation may be required. In others, large integrated companies may need to be separated or forced to divest from aspects of their business.

33. Competition issues differ across and within infrastructure sectors. Competition authorities should be aware of which segments of a given infrastructure sector are characterized by natural monopolies, and thus more likely to need attention. These can be "unbundled" from other segments with competitive potential. In electricity, for example, while retailing and generation are potentially competitive, private investment in transmission is likely to need strong competition oversight, if not direct price regulation (UNCTAD, 2008b: 92). In the case of New Zealand, the Government opted to leave transmission under State ownership.

34. Even within potentially competitive segments, it is necessary to monitor and assess the extent to which markets are contestable, and how this may change over time. In Nigeria, for example, the Government has relied on inter-terminal competition to bring about adequate performance. Accordingly, this requires careful attention to regional port trends (e.g. container terminals in Lagos compete with others in West Africa), mergers and acquisitions across competing terminals, as well as similarities in the services provided between potential competitors (e.g. container terminals do not compete with bulk terminals).

35. **Private and State-owned players can co-exist within a competitive framework.** For strategic reasons, countries may be reluctant to fully privatize their infrastructure sectors. Beyond maintaining State control over natural monopolies, governments may also wish to retain control over some infrastructure assets within competitive segments. In New Zealand, SOEs operate alongside foreign investors in the electricity generation and retail segments, with competitive outcomes.

36. Yet there are risks to having SOEs compete directly with FDI. Foreign investors place a premium on a country's reputation for establishing and applying regulations to govern competition among public and private firms in a fair, transparent and effective manner. Developing countries need to consider carefully whether they can assure investors of impartial regulation in a system that retains significant State ownership.

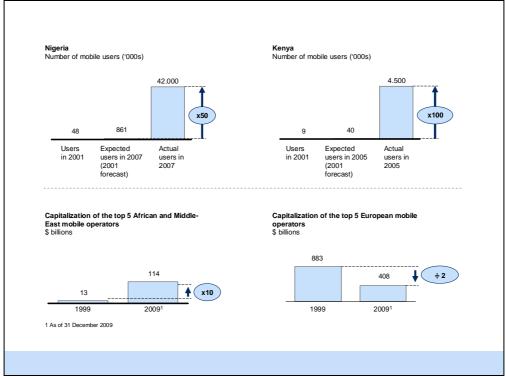
III. Concluding remarks: avoiding missed opportunities

37. Private sector investment, including by foreign investors, can make a significant contribution to infrastructure development in developing economies. This is true also in LDCs, where it is more difficult to attract foreign investors. The studies at the basis of this note have yielded a number of lessons on how to prepare the ground for the entry of foreign investors, how to negotiate with infrastructure TNCs, and how to manage the investment during the lifetime of the infrastructure investment.

38. A major challenge remains, however namely, to convince potential investors, on a systemic level, that there are significant and growing infrastructure opportunities in low-income economies.

39. The development of the mobile telecommunications in Africa illustrates how investment opportunities in developing country infrastructure are often overlooked,

particularly by mature market TNCs. In the 1990s, foreign firms looked at the opportunity of this sector in Africa with some doubt. The number of fixed lines per 100 inhabitants was less than 0.5 across the continent, less than 1 per cent of the level common in Europe. The cost of a mobile connection in Sudan, by way of illustration, was some \$750, more than 27 times the cost in Germany at the time. In 2001, Nigeria had 48,000 mobile users, and growth forecasts at the time projected some 860,000 users by 2007. In reality, by that date, Nigeria had more than 40 million users, and numbers have since swollen to over 60 million. Likewise, Kenya in 2001 had less than 10,000 mobile users, and projected growth was to some 40.000 by 2005. In reality, by 2005 Kenya had more than 4.5 million users and now stands at over 16 million subscriptions (see figure below).



Mobile telecoms in Africa: the opportunity that mature-market TNCs missed

40. These data show how business opportunities in infrastructure industries and services may be hugely underestimated by TNCs, slowing down investment flows. The sale of Zain Africa in the second quarter of last year to Bharti Airtel of India for \$10.7 billion shows how much value mature market TNCs have missed out on because of their misperception of opportunities in the region – while their market capitalization shrunk by half from 1999 to 2009,⁴ that of their African and Middle-Eastern competitors grew 10-fold. With most foreign infrastructure investment still originating from such mature market TNCs, the challenge thus is to demonstrate to those investors the growth opportunities available.

⁴ It should be noted in this context that stock prices in 2009 were still recovering from the financial crisis. However, both mature and emerging market TNCs were affected by this shock.

IV. Questions for the Commission

41. Questions for the Commission include the following:

(a) How can developing countries effectively create a role for private sector investment, including FDI, next to public sector investment?

(b) What are some of the different roles official development assistance can play in stimulating private investment in infrastructure?

(c) What are the long-term implications of employing private sector investment, including FDI, for the development of basic infrastructure industries?

(d) What actions should developing countries, and especially LDCs, take to make the infrastructure opportunity real for foreign investors, including in basic infrastructure industries?

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