At issue: Infrastructure as an asset class

Financing development or developing finance?

A forthcoming report on private equity infrastructure funds by Nicholas Hildyard of NGO The Corner House,* More than bricks and mortar*, looks at the connections between infrastructure funding and international financial markets, and at the wider political project that infrastructure embodies. In this briefing, Hildyard argues that the transformation of infrastructure into an asset class has environmental and social implications far beyond what can be handled by stronger safeguards on investments.

When the World Bank focussed its 1994 *World Development Report* on infrastructure, it should not have come as a surprise that the report was not in fact about bridges and dams, but about privatisation and reducing the role of the state in development.

Until the 1990s, the vast majority of infrastructure projects in the developing world, from drinking water systems to power stations, were funded by national governments, with substantial project-specific loans from multilateral development banks (MDBs), such as the World Bank. The role of the private sector in financing infrastructure was minimal, but the last two decades have seen it increase substantially. From 2002 to 2007, the value of infrastructure projects in developing countries with private sector participation amounted to $603 billion. Private investment far outstripped the $64.6 billion loaned to developing countries for infrastructure projects over the same period by China (the biggest source of bilateral concessional development finance).

Infrastructure is now firmly back on the international policy agenda, with MDBs and the G20 all announcing support for major infrastructure initiatives. In Sub-Saharan Africa, long portrayed as a region shunned by private investors, private sector financing for water supply and sanitation exceeds that provided by rich countries in development assistance and by emerging country financiers, such as China. "Overall", notes the World Bank, "private finance to African infrastructure [has come] from nowhere to provide a flow of funds comparable in magnitude to traditional [aid]."

Pot of gold for the private sector

Governments argue that the sheer size of the 'infrastructure gap', coupled with the lack of government funds due to huge costs of propping up the banks in the wake of the financial crisis, means that they have no choice but to bring the private sector into infrastructure development. However, considerable untapped pools of public money exist in many developing countries, notably in public pension funds for state employees, which could be used for public sector investment in infrastructure. Governments could also restore their depleted coffers by abandoning low tax regimes or clamping down on tax evasion and capital flight. Such policies, though, would mean dismantling the political and economic alliances that underpin the current relationship between the dominant elements of the state and private sectors, a relationship in which state power is used not to restrain accumulation but to enable it, be it through privatisation, intervention, regulation or, indeed, deregulation.

The policy choice is not between the private sector, on the one hand, and the state, on the other. There is a new state/private combo, in which a realigned state is the lynchpin in creating new highly profitable investment opportunities through selling off state-owned enterprises at knockdown prices. Unsurprisingly, the infrastructure policies now being pushed by the MDBs are aimed at maintaining the current state-private combo rather than restructuring it. To attract infrastructure investors, the Indian government (like many other governments) is rolling back hard-won environmental and social regulations, particularly those protecting poorer people against forced evictions. It also set up a high-level committee (including investment bank Goldman Sachs' India director) to identify "regulatory or legal impediments constraining private investment in infrastructure" and to "issue specific recommendations for their removal". Other incentives now being offered by the Indian government include tax breaks and an $11 billion fund to provide debt finance through tax-free infrastructure bonds. Legislation is also being introduced in many countries to encourage public pension funds (which could be a major source of public finance for infrastructure) to invest in privately-funded infrastructure, for the profit of the private sector. Private investors in the North, particularly private equity firms, are leaping onto the bandwagon, increasingly looking to infrastructure investments in the South as a new source of profits.

The 'reforms' being pushed through to further increase private sector involvement in infrastructure development both respond to, and are shaping, changes in the way that infrastructure is financed and the demands of new actors in the sector. In particular, they are part of a wider effort by both state and private sector actors to transform infrastructure into an asset class.

Historically, private investors were reluctant to make direct equity investments in specific infrastructure projects. With the sector set to boom, investors are now keen not to lose out on possible profits. The solution, engineered by investment banks, has been to create 'infrastructure funds' – pooled vehicles through which investors can invest in companies within the infrastructure sector without having to directly finance the projects that the companies are building, thus reducing the risks inherent in the sector. In 2011, an estimated 50 new dedicated infrastructure funds were 'on the road', reportedly seeking to raise $26.8 billion for 'emerging market' investments, a sum which, if achieved, would put private equity on a par with the World Bank Group ($21 billion a year) as a source of infrastructure finance for developing countries.

Private sector investors in infrastructure funds include rich individuals and pension funds. Public sources, particularly funds from public development finance institutions (DFIs), such as the International Finance Corporation (IFC, the World Bank's private sector arm), are also involved. Of the 350 private equity infrastructure funds analysed by The Corner House, 125 have reported investments by one or more such publicly funded DFIs. Overall, the contribution of such public agencies to private equity infrastructure funds is reportedly some 4 per cent of capital raised.

Such investments reflect the growing use by DFIs of 'intermediaries' (primarily banks, but also private equity firms) to invest in the private sector, with the intermediaries, as opposed to the DFI, deciding where the money is ultimately invested. Although the IFC argues that this strategy encourages the private sector to take on riskier investments than it might otherwise do, the record suggests otherwise. Far from breaking new ground, the private equity funds in which the development agencies have invested are heavily focused on countries such as India, China, Brazil, Nigeria and South Africa, which already have considerable private capital available for investment, both from international and domestic sources. Indeed, the huge sums that private equity firms are now pouring into infrastructure suggests that such funds need no encouragement from DFIs to invest: the profits to be made are sufficient incentive.

Environmental/social implications

All infrastructure projects – whether state-financed or private sector-financed – have social and environmental repercussions. One response to the rise of infrastructure as an asset class has therefore been to treat private sector infrastructure investment like publicly-financed projects and to press for better application of international standards. Certainly, there is considerable scope for enhancing private equity standards, most of which currently have no environmental or social standards at all. Private equity funds which enjoy DFI support should be required to adhere to the environmental and social standards that DFIs apply to their non-intermediated finance. Even if this was done, it would leave unchallenged a range of adverse social and economic impacts that are intrinsic to the redefinition of infrastructure as an asset class.

Worryingly, the sectors that are benefiting most from private equity fund investments would appear to be fossil fuel extractors and burners – a profit-driven investment pattern that is locking society into a development path that makes transition towards a low carbon future more difficult. In India, Adhunik Power and Natural Resources is relying on private equity funds to part-finance its plans to dig new coal mines and build new coal-fired power plants producing 3,480 megawatts of electricity before 2015. The company has already secured investments from two funds, including the IFC-backed SBI Macquarie Infrastructure Fund.

Concern has also been expressed by NGOs that DFIs are deliberately using intermediaries to circumvent their environmental and social safeguard policies. With rare exceptions, DFI-backed private equity are often left to apply their own standards – or standards they have agreed with their DFI backers – and to monitor and self-certify their implementation.

When approached as an asset class, infrastructure has political and economic consequences that go far beyond the immediate social and environmental impacts of the projects that are funded. In particular, many of the new investment vehicles – notably private equity funds – are seeking turbo-charged profits (typically, returns of 30 per cent a year) whose pursuit is leading to the increased financialisation of the infrastructure sector – from manufacturers of equipment through to project developers – with profound implications for what infrastructure is funded and who gets to benefit from it. Moreover, many of the strategies that civil society have developed to hold infrastructure developers to account and to ensure positive development outcomes from specific infrastructure developments – including lobbying for ‘safeguards’ and ‘standards’ – are not keeping up with the swiftly-developing new realities.

The compatibility of investing via such turbo-charged profit-driven investment vehicles as private equity funds, with the stated poverty alleviation mandate of most DFIs, has also been questioned. Taking refuge in the widely discredited ‘trickle down’ theory of development, most DFIs generally judge the success or failure of investments primarily on the basis of their profitability, the assumption being that what is good for investors must be good for poorer people. Even fund managers, however, balk at making such outlandish claims.

Private equity funds do not invest in projects in order to provide public goods, but to generate above-market returns on investment. Entirely absent from the portfolios of all but a few philanthropically-financed infrastructure funds are projects that respond to the demands of poorer people. There is investment, for example, in privatised water utilities servicing those with the money to buy water, but no investment in rainwater harvesting that, once installed, provides water for free. If poorer people feature at all in the discussions of investors and developers, it is almost exclusively as labourers or obstacles to be removed. Many poorer people are priced out of access to essential public goods.

Tellingly, an IFC review of its private equity portfolio has concluded that any correlation between high profits and wider positive development outcomes was relatively weak, and that the most pronounced impact of private equity investments was in “improvements in private sector development”, such as encouraging changes in the law favourable to the private sector. In effect, what is good for private equity is good for private equity – but not necessarily for the wider public.

More than bricks and mortar

But, perhaps most fundamental of all, private equity infrastructure finance is about more than building bricks and mortar. It is part of a wider construction project, as yet far from complete, whose purpose is to enshrine markets, rather than democratically-accountable decision-making processes, as the means through which infrastructure is not only financed but its disposition decided. Now infrastructure embodies more than an agenda of privatisation: what is being constructed are the subsidies, fiscal incentives, capital markets, regulatory regimes and other support systems necessary to transform infrastructure into an asset class that yields above average profits.

A 2008 policy paper by Goldman Sachs, modestly entitled *Building the World*, identifies “adaptation of . . . regulatory systems” and a “move towards market pricing” as major priorities if the private sector is to be encouraged to participate in infrastructure development. Critically, private sector financing is seen as a driver of both financial innovation and the building of capital markets, stimulating the dismantling of “current onerous restrictions on investments” and the opening up of developing country economies to foreign banks. It also demands that “governmental interference” be kept “at a minimum”, whilst, on the other hand, it envisages its entire political project being underwritten by the continuation (and extension) of a raft of state subsidies in the form of “public/private partnerships, government credit guarantees, and coinvestment by governments”. The task for the private sector, thus, becomes one of persuading decision makers that it is in the public interest for the state to continue facilitating a massive transfer of wealth from the public to the private sector.

The problem of too much capital chasing too few investment opportunities has deepened, contributing to global financial crises. The planned interventions by the G20 and MDBs in the infrastructure sector are better viewed as a response to this problem, which will further entrench the current state-private settlement, geared to harnessing the state to extracting profit for the private sector. As such, infrastructure is less about financing development (which is at best a sideshow) and more about developing finance.

July 2012

Nicholas Hildyard, The Corner House

Based on a longer, fully-referenced report, More than bricks and mortar, *available this month at www.thecornerhouse.org.uk*

Published by **Bretton Woods Project**
33-39 Bowling Green Lane, London EC1R 0BJ, UK
Tel +44 (0)20 **3122 0610**
info@brettonwoodsproject.org
www.brettonwoodsproject.org/subs
The Bretton Woods Project is an ActionAid-hosted project, UK registered chairty no. 274467
Financial support for this publication was provided by a network of UK NGOs, the CS Mott Foundation and the Rockefeller Brothers Fund.