LATIN AMERICA AND CARIBBEAN-OECD INVESTMENT INITIATIVE

Conference on bridging infrastructure gaps through smart investment

Peru-Lima
7-8 July 2014

SUMMARY REPORT

Conference co-organised by:

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The fourth high-level meeting of the Latin America and Caribbean-OECD Investment Initiative was held in Lima on 7/8 July 2014, hosted by the Government of Peru (though Proinversion) and supported financially by the IADB and AECID of Spain. The Prime Minister of Peru, H.E. René Cornejo, conveyed the special greetings from President Humala Tasso in opening and closing the *Bridging infrastructure gaps through smart investment* Conference, which also saw the participation of the Ministers of Economy and Finance and of Foreign Trade and Tourism of Peru, the Minister of Transport of Columbia, the Ambassador of Spain to Peru, and the IADB representative in Peru. A total of 154 people attended the event, including Peruvian and international business, civil society, media, international organisations and government officials (from capitals) of seven Latin American countries (Brazil, Chile, Colombia, Costa Rica, Mexico, Panama and Peru). The OECD delegation was composed by staff from four different departments (DAF, DEV, GRS and the International Transport Forum).

The conference focused on three main topics: investment in infrastructure, including energy and transport; the role of long-term-investors and private equity; and the promotion and facilitation of investment. It promoted a peer dialogue between governments of the region, and between governments, business and institutional investors. The results will enrich the ongoing process to update the Policy Framework for Investment.

General discussion

In Latin America, infrastructure investment is less than 3% of GDP, while it should be at least 5.2% to close the gap, even higher to reach the levels prevailing in Asia. The IADB estimates that infrastructure investment should reach US$250b annually. There is a general consensus that stable and cost-effective provision of energy and telecommunications is essential to expand the production possibilities for firms. The benefits of more and better roads, ports and railroads in reducing transportation costs and increasing the competitiveness of domestic firms are also well documented, including in the OECD Latin American Economic Outlook 2014. Better logistics would result in 35% growth in labor productivity, even more when combined with better public services. While insufficient and low-quality transport infrastructure is the main factor behind poor logistics performance, some “soft” solutions could considerably reduce transport costs. The “hard” components are associated with physical infrastructure which, given the huge costs involved, are difficult to overhaul in the short run. It is therefore necessary to accompany measures aimed at modernizing “hard” components with “soft” improvements such as improving governance to ensure a smooth integration of logistics policy, modern storage facilities, more efficient customs and certification procedures, and mainstreaming the use of ICTs in existing transport infrastructure. Furthermore, generalized access to infrastructure services, from water and sanitation, to transport infrastructure and telecommunications, plays a key role in fighting poverty and reducing social exclusion and income inequality.

Public investment in Latin American infrastructure has fallen in past decades, thus it crucial to increase it, but obviously a lot should be done to attract private funds. Many countries have made considerable progress in attracting private investment to finance infrastructure needs, thanks to appropriate macroeconomic policies. Peru is a case in point, with accelerating GDP growth rate and falling inflation rate in recent years, but the income gap remains huge – GDP per capita is only a third as high as in OECD countries. Some countries have done it better than other, institutional quality (rule of law, certainty, fair risk-sharing) makes the difference and allows to reduce the cost of capital.

Latin America has been at the forefront of Private-Public Partnerships (PPPs). The record of Peru, where more investment was received in the past three years than in the previous decade, is particularly encouraging. Recent projects equal to 8% of GDP, thanks to a competitive and transparent process which led to the selection of world-class investors. Awarded the week before the Conference, the Southern gas pipeline is the largest-ever infrastructure project.

At the same time, there is a consensus that private participation is not a panacea. One of the key challenges for governments has been to balance the sharing of risks and returns between the government and its private sector partners, while at the same time dealing with the technical complexities of projects. Success requires that governments invest heavily in high quality pre-construction studies and surveys, that they structure contracts carefully to achieve an appropriate distribution of risks and expected rewards, and that the mix of private-public investment and involvement be adapted to specific circumstances.

Moving from general objectives to practical solutions is anything but easy and it is fundamental to reinforce the public sector's medium-term planning capacity. In this regard, Ministers agreed on the value of the Initiative, and the Conference in particular, to learn from international best practices and contribute to the PFI update. As it was noted, unlike the World Cup, the ultimate goal is not to compete, but to share experiences and best practices. A number of specific challenges and their respective policy implications were discussed:

- With **concessions, PPPs and BOT agreements**, finding a risk-sharing balance between the public sector and private investors is far from easy. Rather than focusing on ideology, policy-makers should aim at pragmatic solutions. What is imperative is to maintain the rules of the game, last-minute changes carry a very high reputational cost. In this regard the value was noted of having a contingency fund to prepare for possible shocks without hitting private investors.

- **Financing** is a challenge, but far from the only one. Medium-term planning is welcome to avoid that the time horizon of projects coincides with the political cycle. Chile's 21-year experience with concessions, from relatively traditional sectors such as highways and airports, to newer ones such as hospitals, shows the importance of certainty and trust.

- Careful preparation of **bidding and post-bidding process** was deemed very relevant. In numerous cases initially there were few bidders, sometimes as few as one. Recent reforms aim at easing the post-bidding process, for instance streamlining the land acquisition process and clarifying the institutional framework of environmental licenses. Colombia has launched a US$ 25b fourth-generation PPP strategy that includes 30 projects, with growing number of participants, in particular by foreign investors. Infrastructure Law approved in 2013 to clarify tasks and responsibilities and accelerate execution of transport infrastructure works.

- **Multi-level governance** poses specific challenges (the Lima metropolitan area, for instance, is composed of 42 municipalities). Respective responsibilities of national and sub-national authorities are sometimes set in the Constitution. In urban transport, in particular, a multi-dimensional approach is needed that includes planning, evaluation and monitoring functions.

- **Execution times and overall costs** have frequently exceeded agreed terms, due not only to legal and institutional uncertainty, but also to difficult topography. Tangible improvements have been achieved recently in various countries.

The **social impact of projects** needs also be factored when funding projects with private sector involvement and in this regard governments must improve transparency and communication with the public to avoid negative perceptions. Affected groups, including indigenous people, must be informed about government projects and be given the opportunity to object to these projects moving forward. The adoption of laws of free prior and informed consent and their implementation through the *amigable componedor* system (as in Colombia and Peru) are very important to guarantee stakeholders' rights without impinging on investors' ones.

Participants also highlighted the importance of **clean energy investment** and **climate-related infrastructure adaptation and mitigation measures**. Climate change makes it important to accelerate the transition to a low-carbon economy and ensure that appropriate conditions are in place to finance the corresponding investment needs. In this context it is important to guarantee coherence among a broad range of policy interventions and identify ways to mobilize private investment in clean energy infrastructure. The OECD will host a high-level event on green infrastructure at the margins of the UN Climate Change Conference in Lima in December 2014 and will possibly undertake a *Clean Energy Investment Policy Review* of Peru.

Special climatic circumstances affect the Pacific Coast of South America, namely the periodic El Niño/La Niña phenomenon. In Colombia, the 2010 *Ola Invernal* affected 10% of population, especially poor people, and damaged 17% of roads; newly-elected President Santos included the improvement of infrastructure among the administration's priorities, together with achieving peace and reducing poverty (2.5 million people have exited the ranks of the poor). As part of the Presidency, a special risk-management unit was created, grouping government and business.

The benefits of OECD membership in improving policy coherence and the quality of governance were also mentioned. In this regard the experience of Korea since joining OECD in 1996 is very positive, as reforms have made the economy more resilient and enhanced its resilience to weather the post-2008 global economic and financial crisis.

Energy

Concerns regarding competitiveness, security, inclusion and climate change lie behind recent changes in the energy mix. LAC enjoys the benefits of abundant hydro-power capacity and efforts are underway to further reduce the importance of fuel-based generation. More attention is devoted to clean technologies and renewables and to ensure that tariffs are correlated to the environmental impact of different energy sources.

In Chile, 70% of electricity is imported and the generation industry is very concentrated. Tariffs are higher than in the rest of the region and this negatively affects productivity and competitiveness. The new energy strategy was unveiled in June 2014. Objectives include more private investment, lower fuel import dependency, more emphasis in renewables (currently 6%, mostly wind and solar, geothermic and biomass still insufficient), regional integration (transmission lines). A 141 megawatt solar power plant in the Atacama Desert region was inaugurated in June and the recently-signed Joint Statement on Enhanced Energy Cooperation with the Department of Energy reflects interest of US investors in clean investment.

Mexico also faces important issues. Power costs 25% more than in the US; oil production has been falling, while consumption has risen. The constitutional reform approved in 2013 marks a major watershed, as it finished the multi-decade monopolies enjoyed by Pemex and CFE, the oil and electricity SOEs. The *Programa nacional de infraestructuras* opens space for PPPs, while also considering the potential of spurring innovation through the participation of academic institutions.

The important role of international organisations was also underscored. Wind power in Oaxaca was only possible thanks to the World Bank, which allowed CFE to kick start the first such project in Mexico; in geothermic power, the IADB helped identifying international best practices for private participation. Regional networks, such as SIEPAC transmission interconnection in Central America and similar projects in the Andean region, were also mentioned as best practices.

For green technology projects, incentives are necessary. It is crucial to ensure consistency in their use of they and pulling then back in times of economic stringency is very problematic. When regulatory changes are made, it is also important to ensure that the motivations and the implications are discussed with investors.

Transport

The focus of the exchanges was on **urban transport**, reflecting the fact that 80% of LAC population lives in cities and that these will are the locus of future growth. Abundant evidence proves that public transport performs better in terms of land use and social inclusion. As they become more affluent, however, households want cars and motorbikes, but this creates congestion and pollution.

In general, LAC has a good track record. Major improvements have been made, even in smaller countries such as Guatemala and Uruguay. And the region is at the forefront in the use of cableways for urban mobility. Over the past two decades, however, a lot of attention on investment financing, neglecting exploitation and use. Insofar as transport costs can be covered by direct users, indirect beneficiaries (e.g. retailers) and general taxpayers, public policy is about deciding how to apportion among them in the best possible way.

The experience of Santiago attracted considerable interest. Metro de Santiago is a State-Owned Enterprise, in which government has committed to keep control. There is no strict rule regarding the financing of new investment, the rule-of-thumb is 2/3 from government contribution and retained earnings and 1/3 from other sources. Bonds for US$500 m were recently issued at 4.8%. Metro-bus integration (Transantiago) necessitated important accounting and operational changes and resulted in greater use of the subway network by lower classes and handicapped people. Fares remain much lower than in Europe, although average income is rising. Santiago has also pioneered variably-priced congestion management payment on its extensive toll road network.

In Peru, transport priorities include paving 85% of the national road network and enlarging the Lima Metro (with better physical and tariff interconnection with Metropolitano), as well as developing high-speed interconnectivity in rural areas. In passenger and freight transport, it is also crucial to fight unfair competition from non-authorized providers (motor-taxi). On 8 July, local newspapers reported the results of study showing that public transportation drivers in Lima presented higher rates of common mental disorders such as alcohol abuse, major depressive episode, anxiety symptoms and burnout syndrome than general population.[1] Against the background of increased use of private cars by households, improving the availability and quality of public transportation is a major policy priority.

Urban freight is also rising very fast, but this is seldom recognized in the public debate. Private freight forwarders are not interested in coordination and planning, so it remains indispensable to improve institutions to plan, set priorities, and coordinate different infrastructures (inter-modality, for instance between road transport and waterways). In this regard there are still unexploited opportunities from the use of ITC.

The Role of Long-Term Investors and Private Equity

After the crisis, including in the Eurozone, banks had to reinforce own capital and decided to reduce long-term financing. At the same time, LAC countries have managed to improve their own ability to fund large-scale projects. Against this background, the financing landscape has become more composite.

All multilaterals combined fund 5% of LAC infrastructure investment (larger in smaller countries); their role is also to reduce banks' exposure and allow them to meet Basel requirements. Regional integration is a strategic priority for the IADB (e.g. IRSA, Plan Puebla), its annual flows have passed from US$2bn to US$5bn. Aside from the funding itself, multilaterals facilitate regulatory reforms and monitor/benchmark their implementation. The experience in the Camisea Gas Project as honest broker between different stakeholders (public authorities, private investors and local communities) is also interesting.

National development banks are another crucial actor, with Brazil's BNDES being the region's largest. At the creation in 1952, the focus was on infrastructure, then BNDES diversified into manufacturing and services, including through BNDESPar, the investment bank arm. Nowadays, infrastructure accounts for 1/3 of assets (and in turn BNDES funds roughly 50% of Brazil's total infrastructure needs). A growing share is in regional projects where there is a high Brazilian content; terms are long (up to 18 years), only the Brazilian procurement portion of the whole project is financed. In fact foreign trade line was US$7bn in 2013, including aircraft, capital goods and infrastructure (also in sub-Saharan Africa). New instruments such as Equity Support Agreement, debentures and infrastructure bonds (19 since 2011) are being used. For this reason BNDES has strengthened project finance analysis in recent years, but also attention towards CSR and RBC by adopting specific environment requirements.

Long-Term Investors (LFIs) such as Sovereign Wealth Funds, mutual and pension funds are also emerging as a powerful force in the global economy. They only put 1% of their assets in infrastructure, and a marginal share in green technologies, so there are great opportunities. LAC needs LTIs and is ready to receive them thanks to macroeconomic and institutional reforms as well as favourable demographics. Finance in a way is not a problem – LTIs accumulate new funds constantly (in Peru, for instance, AFP are growing by US$300 m per month) and are therefore looking for applications. Their

[1] Paulo Ruiz-Grosso, Mariana Ramos, Frine Samalvides, Johann Vega-Dienstmaier, and Hever Kruger (2014), Common Mental Disorders in Public Transportation Drivers in Lima, Peru.

outlook is distinctively international and they enjoy the luxury of a wide choice in terms of sectors and geographies.

Decision depends on risks (economic, political and regulatory), track record is what makes the difference. It is therefore crucial to keep rules voluntary: when LTIs are subject to requirements regarding their portfolio composition, returns suffer (as it was said, "*una cosa es enamorar a los fondos de pension, otra es obligarles*"). On the other hand, rules must be facilitating: Peruvian AFPs have invested in all PPP projects, equal to 13% of assets, but only in debt, not equity.

Projects must be bankable – CCIB's investment in TGP provides a good example of overlap between a large investment with good business prospects and project management skills, on the one hand, and fair and transparent regulatory regime, on the other. In this regard it was highlighted that in Latin America most LFIs first went to Chile, a country with a low level of discretionary power in hands of the government and willing to give investors a fair forewarning concerning regulatory changes. Other markets have moved fast to adopt best practices, those that have not done it are excluded from opportunities.

The OECD activity in support of the G20 was also discussed. Infrastructure investment is very risky, when regulatory changes are frequent the returns suffer. High-Level Principles for Long-Term Investment were endorsed by Leaders in 2013. These high-level principles are intended to help governments facilitate and promote long-term investment by institutional investors, particularly among institutions such as pension funds, insurers and sovereign wealth funds, that typically have long duration liabilities and consequently can consider investments over a long period. Current OECD work aims to identify approaches to their implementation.

As regards private equity, according to LAVCA 2013 was a record year, with an increasing presence of international players. The success in renewable energy was noteworthy, as it occurred despite the lack of subsidies. The rise of the middle class is one factor (many PE investments are in consumer goods). But in infrastructure terms are not always favourable, e.g. in Brazil where crowding out by government is also an issue.

While these institutions have shorter time horizons than LTIs, the most important challenge is always to ensure legal, tax and institutional certainty. Exit options are mostly to sell to strategic investors, however IPOs are also increasing (in 2013 there were four each in Brazil and Mexico, and one in Chile). With the incorporation of Mexico into the *Mercado Integrado Latinoamericano* (MILA), the Pacific Alliance stock exchanges will become comparable to Brazil in size, liquidity and depth.

Investment promotion and facilitation in the Pacific Alliance

From its launch in April 2011, the Pacific Alliance has characterized itself for pragmatism, participatory approach, and constant business involvement (Business Council). Concrete initiatives in support of economic integration include the activities of the Committee on Trade and Investment and of the Working Group on Services. In general there have been significant improvements in business environment and dispute settlement mechanisms, more could be achieved through clear targets (e.g. better ranking in *Doing Business*).

There is also healthy competition among national and sub-national Investment Promotion Agencies, as well as collaboration in high-level forums like those organized in New York in 2013 and in Miami in 2014, where the four Heads of State jointly promoted the Pacific Alliance. Roadmap on what is needed for investment promotion is clear, but less so in facilitation and after-service activities. The experience with single-window initiatives is mostly limited to foreign trade. In this area the margins for doing better are considerable, especially in view of the considerable gaps that still exist – for instance, it takes 54 days on average to obtain a construction permit in Colombia and more than thrice longer in Peru (173 days).

For integration of promotion and facilitation functions, institutions and high-level leadership matter for policy coordination and coherence. Best practices can be identified from global (e.g. OECD, IFC) and regional (e.g. APEC) sources. Sharing of experiences also takes place within WAIPA, where the Latin American chapter is chaired by the IPA of Barranquilla and the Atlántico Region, a private non-profit organisation funded by the local government and more than 80 sponsoring-companies. Colombia's *Sistema de Facilitación de Atracción de Inversión* (SIFAI) was awarded a global WAIPA award in 2013.

Follow-up actions

The conference confirmed the value added of the LAC-OECD Investment Initiative and allowed to identify a number of possible follow-up actions:

- Preparation of a report on international investment in selected Latin America countries, similar to *Southeast Asia Investment Policy Perspectives*;

- Organisation in April 2015 in Chile of a meeting on the role of international investment in strengthening the region's participation in Global Value Chains (GVCs), as a joint activity of the LAC-OECD Investment Initiative and of the OECD Initiative on GVCs, Production Transformation and Development;

- Organisation in Brazil (possibly in Brasilia) in 2015 of a meeting on investment in infrastructures (focusing on selected sectors such as roads, airports, telecoms).