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POLICY BRIEF

PRIVATE SECTOR FINANCING FOR INFRASTRUCTURE DEVELOPMENT IN SOUTH AFRICA

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1. INTRODUCTION

The South African government is undertaking a massive infrastructure drive in an effort to revive growth and increase employment. This comes at a time when the country is facing a deep economic crisis that has progressively worsened over the past few years, greatly exacerbated by the COVID-19 pandemic.

The infrastructure drive also comes after years of weak infrastructure investments, and a widening infrastructure deficit. This is particularly relevant in communities where socio-economic conditions are characterised by over-crowding, deep levels of poverty and inadequate access to basic public services, such as water and sanitation.

The government's plan is to mobilise up to R1 trillion in financing from the private sector through an Infrastructure Fund over the next 10 years.[1] This is being done in the context of government's efforts to reach a budget surplus within the next five years, justified by substantially increased debt levels. The associated austerity measures have rationalised the need to source finance from outside the fiscus to meet socio-economic goals. It is envisaged that this Fund will finance large infrastructure projects that will incentivise, or leverage, private finance by de-risking infrastructure investments.

1. The South African Government. 2020. "The South African Economic Reconstruction and Economic Recovery Plan." [Online] Available: www.gov.za/sites/default/files/gcis_document/202010/south-african-economic-reconstruction-and-recovery-plan.pdf

2. DE-RISKING PRIVATE INFRASTRUCTURE INVESTMENT

Relying on private sector infrastructure investment to drive economic recovery poses many complexities. Infrastructure projects involve a number of risks, particularly for underdeveloped areas that require substantial resources. Because of this, the private sector is reluctant to invest in infrastructure projects that have higher risks than expected returns. Governments have therefore undertaken measures to de-risk infrastructure investments using various financing instruments that are most commercially attractive to private investors.

The three most prominent de-risking measures are:[2]

2.1 Blended finance

This refers to the use of public and development finance to attract private sector participation by providing incentives, such as subsidies, revenue guarantees, and capital grants.

2.2 Converting infrastructure into an asset class

A process whereby funds invested in infrastructure projects, like loans, are repackaged into financial instruments to be traded in the financial market. Processes are currently underway to amend Regulation 28 of the Pension Fund Act to accommodate private retirement funds to invest in alternative asset classes, such as infrastructure asset classes.

2.3 Public-private partnerships (PPPs)

A highly controversial form of infrastructure financing, which involves long-term contracts with private partners. PPPs are expected to be substantially ramped up over the next few years. Processes are also underway to deregulate the PPP framework to make it easier to set-up PPPs and attract private investors.

This current drive for infrastructure investment sits within a broader international development landscape, which has seen the proliferation of private sector involvement in numerous facets of development over the past decade, including as the sole legitimate partner in bridging the global infrastructure gap. In this regard, multinational development banks, such as the World Bank, have been at the forefront of promoting the use of blended finance and PPPs to achieve the SDGs by 2030.

In South Africa, local development banks, such as the Land Bank and the Development Bank of Southern Africa (DBSA), have joined forces with the government to provide concessional capital to leverage private finance for developmental purposes.

3. THE DANGERS OF DE-RISKING

De-risked infrastructure investments have the potential to carry greater costs to the fiscus than publicly provided infrastructure. This is mainly for three key reasons:

First, the government absorbs more risk than it ordinarily would for the sole purpose of attracting private investment. This occurs through government taking on increased contingent liabilities, or absorbing high transaction costs. Cost escalations also occur as a result of poor project planning or deliberate underestimation of project costs. An example of the potential of large costs being shouldered by the government is the PPP to build and operate prisons facilities in Bloemfontein and Louis Trichardt in 2002.

While both prisons were fully operational within two years, the cost to the government was over double the expected amount (over R2 billion at the time of contracting). This was because of improper feasibility studies that established affordability limits prior to procurement.

Second, without strict governance, the government stands the risk of repeating costly mistakes related to large-scale infrastructure. A good illustration of these dynamics is the Gautrain rail-link system, a PPP which generates revenue mainly from user fees and where the public sector has also assumed contingent liabilities related to user demand.[3] The Gautrain project is the most expensive public transport project in South Africa, exceeding R20 billion in costs in 2009.

2. The research methodology used in this paper is mostly from secondary data sources, however several interviews were conducted with key stakeholders who have been immensely helpful in informing the research.
3. Aldrete, R. Bujanda, A. and Valdez-Ceniceros, G.A. 2020. "Valuing public sector risk exposure in transportation public-private partnerships". Final report for the University transportation centre for mobility. Online [Available]: texashistory.unt.edu/ark:/67531/metapth303496/

Despite the relatively high user fees of the Gautrain (an average of 20 dollars per standard one-way train ticket), it is estimated that the average revenue the public sector pays is upwards of R250 million per year, which has required payment in every consecutive financial year for the past 19 years to date.[4]

Third, de-risked investments in infrastructure will not lead to developmental outcomes. Large-scale infrastructural projects often have detrimental effects on local people and the environment. The current narrative surrounding the Infrastructure Fund overlooks key historical failures in 'mega-projects' that can, and have been, socially and environmentally damaging. Some projects within the Infrastructure Fund portfolio are already mired in environmental issues. The Mokolo-Crocodile Water Augmentation Project, projected to cost R12.4 billion, has ceased construction because of appeals made by civil society organisations, Earthlife Africa and Groundwork, citing potential detrimental environmental impacts on local communities and the surrounding environment.[5]

While infrastructure development in South Africa is much-needed, the emphasis on de-risking for private sector buy-in overshadows the key role the state must play in leading on structurally transforming the economy. Furthermore, current fiscal consolidation measures undermine the governments' ability to do this, and instead has opened the economy to the fiscal risks associated with greater private-sector participation. The current narrative around the Infrastructure Fund also overplays the benefits of private capital and underplays the potential risks that come with public-private arrangements, underestimating the complexities of governing these relationships appropriately.

4. RECOMMENDATIONS

Fundamentally, government and its partners must maintain developmental goals as the primary purpose of infrastructure investment, and not set out to primarily establish a business-friendly environment. Infrastructure development must seek to close critical gaps in both social and economic infrastructure provision.

With regards to economic infrastructure, the need for structural transformation of the economy must not be overlooked. This would entail a shift away from the economy's reliance on fossil fuels and extractive industries such as mining and commodities, towards greater diversification, especially in industries that are not carbon-heavy and are employment-creating. This may not correspond with the interests of private capital. Nevertheless, infrastructure development must drive sustainable development and the government must take a leadership role this regard.

To ensure that infrastructure-led development serves these objectives, we make a number of recommendations to relevant stakeholders and policymakers.

State responsibilities should not be transferred to private parties.

The government's responsibility for meeting obligations on human rights, poverty reduction, and gender-transformative services, as stipulated in the Constitution and key policy documents such as the NDP, must not be transferred to private corporations, who are concerned primarily with making profits.

Private sector involvement must be justified.

A publicly available analysis indicating clear benefits of having private involvement for every project must be undertaken in the Infrastructure Fund.

The financing mechanisms chosen to deliver social services and infrastructure should be assessed for their ability to ensure cost-effectiveness, accessibility, quality, and gender-transformative services.

The government must build an evidence base that considers the impact on both the expansion of coverage (quantity) and on the affordability, accessibility, and appropriateness (quality), at all stages: design, implementation, monitoring, and assessment in all projects.

Policymakers must seriously consider and implement local resource mobilisation.

To ensure governments have a genuine choice in finding the best financing mechanism for infrastructure investments, infrastructure funding donors should support the prioritisation of progressive taxation at the national and international level, curb illicit international flows, and provide long-term concessional finance and loans from Development Finance Institutions (DFIs).

Enforce strict governance framework.

Governments and international financial institutions must enforce a strong regulatory framework requiring periodic evaluations in relation to environmental, social, human rights, and gender-equality standards for de-risked investments,

4. Thomas, D. P. 2013. "The Gautrain Project in South Africa: A Cautionary Tale". Journal of Contemporary African Studies, 31(1):77-94.
5. See www.engineeringnews.co.za/article/work-wont-start-on-next-phase-of-mokolo-crocodile-transfer-scheme-until-eia-appeal-finalised-2019-08-02 and constructionreviewonline.com/news/south-africa/works-on-phase-2a-mokolo-crocodile-water-augmentation-project-stalls/

particularly when working with the private sector. Compliance with local and international human rights standards should be built into contracts.

Enforce strong accountability mechanisms.

International financial institutions and governments must ensure that rigorous transparency standards are applied to ensuring transparency and accountability in all de-risked projects. This includes accessible accounting of public funds, and disclosure of contracts and performance reports. Broad civil society participation, before and during project implementation must be encouraged. Governments, and DFIs, must ensure that all claims about private finance mobilisation are verifiable and not over-estimated.

Ensure that all relevant public and private actors involved in infrastructure carry out human rights due diligence to inform and improve decision-making.[6]

For example, a comprehensive, publically available, appraisal of prospective private partners, especially showing that potential partnerships are not harmful to the economy. This is to ensure that projects safeguard against detrimental social and environmental outcomes.

Target domestic companies as a preferred option.

To ensure greater development impact, priority must be given to local private enterprises and to local-content requirements within contracts. There is a danger that international DFIs, fund managers, and other institutions may use de-risking mechanisms to entrench tied-aid, the practice of favouring a funder country's own businesses, consultants, and service providers to execute DFI-funded projects.

Ensure no undue risk transfers to the public.[7]

With the on-take of greater de-risked mechanisms, all fiscal risks must be fully accounted and provisioned for and must not exceed reasonable amounts (for example, the amounts commonly put at risk by publicly-owned development and investment banks).

While infrastructure development in South Africa is much-needed, the emphasis on de-risking for private sector buy-in overshadows the key role the state must play in leading on structurally transforming the economy. However, current fiscal consolidation measures undermine the government's ability to do this, and has opened the economy to the fiscal risks associated with greater private sector participation. The current narrative around the Infrastructure Fund also overplays the benefits of private capital and underplays the potential risks that come with public-private arrangements. It underestimates the complexities of governing these relationships appropriately and thereby fails to establish the necessary frameworks for maximising the developmental impact of infrastructure investment and limiting the risks to the public sector. This must be urgently rectified.

6. Office of the UN High Commission for Human rights. 2020. "The other infrastructure gap: sustainability – human rights and environmental perspectives."
7. Müller, J. 2015. "Harnessing Private Finance to Attain Public Policy Goals? How Governments Try to Involve the Private Sector in Times of Austerity and What Risks This Entails." *Centre for Research on Multinational Corporations*