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Madness and Prayers
The unintended consequences of power infrastructure investment in Africa

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"I did a lot of infrastructure development in my life," [Credit Suisse CEO] Mr Thiam said in a dinner speech... "To fund them with foreign currency is madness. Okay? Madness." [1]

"God save the kwacha. That's what Zambian President Edgar Lungu wants his people to pray for on a national day of devotion and fasting on Sunday to reverse a decline in the world's worst currency." [2]

After decades of underinvestment and a dramatic power crisis afflicting much of the continent, power investment in Sub-Sahara Africa (SSA) has picked up significantly in recent years. One unintended consequence is that public utilities in the region are now running growing currency mismatches on their balance sheets, as these investments are banked on hard currency while end-user tariffs are collected in local currency (LCY). This represents a huge contingent liability, creates uncertainty and thus undermines the sustainability of power sectors in the long run. Development Finance Institutions (DFIs) need to lead the way in finding innovative solutions to increase the share of local currency financing.

Struggling to turn the lights on

The existing power infrastructure in SSA is woefully inadequate: 600 million people remain without access to electricity; the entire continent boasts an installed generation capacity that is roughly equivalent to that of Spain. Almost all countries on the subcontinent are running a supply gap, which impedes socio-economic growth and development.

The good news is that many governments in the region have recognized the challenge – and have started to take action.

Reform bells are ringing

Governments have focused their attention on removing infrastructure bottle-necks, committing a more significant share of their public expenditure especially for power sector investments. Many DFIs (including KfW) have also stepped up support, providing concessional funding for new infrastructure projects.

Perhaps more importantly, some governments have also taken steps to put their electricity sectors on a reform path.

This includes efforts to enhance the financial sustainability of power sectors by moving towards cost-reflective end-user tariffs, and the opening of investment opportunities for the private sector, especially in generation, through Independent Power Producers (IPPs).

Investments is picking up – but hidden costs are not well understood

These reforms have engendered real results. Investment in particular in new generation assets, not the least in renewables, has grown considera-

[1] Wall Street Journal, 7 October 2015
[2] http://www.bloomberg.com/news/articles/2015-10-16/world-s-worst-currency-prompts-intervention-call-of-divine-kind

bly – countries like Ethiopia, Kenya, Rwanda and Uganda are even likely to move into overcapacity in the medium-term. Private investment has been rising steadily as well. According to World Bank estimates, IPPs account today for more than 25 % of installed generation capacity in SSA (excluding South Africa).

But with this new and much-needed investment come new risks that need to be managed properly. An often overlooked risk is the currency mismatch. To entice private sector participation, most countries are now offering USD-based generation tariffs to IPPs. This reflects three realities:

- Investment costs are still predominantly incurred in hard currency, and lenders (including DFIs) are unable to provide long-term lending in LCY.

- Foreign private equity is not willing to take Foreign Exchange risk in ‘exotic’ currencies with regard to their returns, and local equity remains scarce.

- Local banks do not have the capacity to provide long-term local currency lending for large infrastructure projects.

Is this just madness?

Power tariffs, however, are being charged in local currency. As a consequence, public utilities – and, by extension, host governments – are being loaded up with a growing – and largely unhedged – currency risk. African currencies however tend to depreciate vis-à-vis the USD over time.

This depreciation typically happens in waves. This creates financial instability, with either unpredictable impacts on public budgets or passing resulting surcharges to customers – or blackouts. Recent evidence from Kenya, Mozambique and Uganda suggests that these risks – and their consequences – are real: In Mozambique, the recent depreciation of the Metical viz. the USD means that the government would have to raise tariffs by more than 20 % just to play catch-up, as most of the utilities` liabilities are denominated in hard currency. This is especially hard to do in a difficult economic climate. The conclusion is that any significant growth in power infrastructure investment requires a shift away from hard-currency lending and USD-based generation tariffs to be sustainable.

Nothing but prayers?

Clearly, managing currency mismatches is not a new problem for developing countries. But with increasing investment in infrastructure, and power in particular, the issue is now returning with a vengeance.
In principle, there are two avenues through which something can be done:

- Increase hedging capacity – both in terms of volume and currencies covered. With support from KfW, The Currency Exchange (TCX) is already making a contribution. However, hedging capacity is typically only available for short term loans. Pricing is also an issue; there are indications for a ‘systemic bias’ against some African currencies in the hedging market.

- Foster local lending: GuarantCo and other guarantee instruments are already facilitating more long-term lending by local investors in LCY, but thus far at limited scale.

The challenges are significant: local commercial banks find trading in government bonds more attractive than lending for infrastructure; also, deposits of local banks predominantly are short-term, and savings rates remain low.

Some countries, including Kenya, have seen project bonds denominated in LCY. But most debt capital markets in Africa remain underdeveloped; debt instruments are often illiquid, and feature short maturities and a restricted and undifferentiated investor base. Also, typically a secondary market does not exist.

No silver bullet, but more needs to be done

The recent currency crises in many African countries underscore the urgency of the issue. So what can be done, and what can DFIs do?

One way to increase LCY lending is through enhanced partnerships between DFIs and local commercial banks that do have access to local currency deposits and also issue bonds in the local markets. However, more often than not they do lack the expertise to structure infrastructure finance deals, and they cannot provide maturities and interest rates required to make such deals work. DFIs should leverage their own expertise and experience. In addition, through intelligent products such as partial guarantees DFIs could do more to stretch loan maturities and bring down interest rates, with the ultimate benefit of making transactions bankable and at the same time reducing payment obligations of rate payers (such as power tariffs).

Finally, DFIs should make a more determined effort to help develop local debt capital markets, for example by providing credit enhancement for first-time issuers in local markets (as for example facilitated by the Africa Local Currency Bond Fund that KfW is anchoring) and providing expertise to regulators and governments to improve the growth and sustainability of debt capital markets.

One thing is evident: there are no easy fixes to the challenges. But there is also no room anymore for complacency. Prayers alone are not sufficient. Otherwise madness will prevail.

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