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Research Report

Infrastructure for ore: Benefits and costs of a not-so-original idea

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Infrastructure for ore: Benefits and costs of a not-so-original idea

by

Louis T. Wells*

Arrangements whereby host countries receive infrastructure “now” in exchange for access to natural resources in the future have received a great deal of criticism, generally based on few data.¹ Although Chinese investments in Africa have dominated discussions, some Korean and Western firms are considering similar deals to remain competitive. Because most contracts are secret, many commentators are inevitably skeptical of the benefits to the host country -- maybe wrongly.

In fact, the concepts underlying recent agreements are not so new. Developing countries have long received assets upfront for rights to resources in the future. For example, in 1926 Firestone arranged a loan to free Liberia from British debt and received a concession for rubber plantations. Host governments have frequently obtained cash at the outset under the benign name of “signing bonuses.” Examples include Mittal Steel in Liberia (2007) and oil agreements around the world. In at least one case, the asset was mercenary services (Sierra Leone, 1995), with diamond concessions going to an affiliate of the mercenaries.

Today the investor may arrange a package comprising financing and construction of major infrastructure unrelated, or only loosely related, to the mine (or plantation), while the host government simultaneously grants exploitation rights to the investor. Each part of the deal might appear to be independent, but one is conditional on the other. Importantly, the scale of upfront payments may have increased, but the deals are otherwise only a twist on earlier agreements.

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¹ For an effort to measure such investments, see, Vivien Foster, et al., “Building bridges: China’s growing role as infrastructure financier for Africa. Trends and policy options,” *Infrastructure Nr. 5* (Washington: The World Bank, 2008).

Of course, the host country eventually pays for the infrastructure. Explicit debt service is straightforward, but obligations might also include pledged revenue from extraction; arrangements can also, less explicitly, provide repayment in the form of reduced fiscal obligations for the investor; and even less explicitly, they might include higher-than-market costs for the infrastructure. Whatever the details, conceptually the deals involve loans: an asset now for payments in the future.

The arrangements can provide benefits to the host country. Importantly, they ensure that a country converts part of the revenue from a depleting resource into productive capital assets -- infrastructure -- instead of mainly increasing consumption, as often happens with signing bonuses or royalties. They may also short-cut slow government processes that otherwise slow constructing infrastructure. Some countries have used the deals to avoid external borrowing restrictions. And lower capital costs available to some Asian firms may lead to favorable loan terms. Like signing bonuses, infrastructure can also provide one solution to another problem: Capturing resource rents when fiscal terms are set by law and do not include a resource rent tax.

The obvious cost, of course, is debt service in the future. Interest, principal and explicit reductions in fiscal obligations of the miner are clear. Additional costs may be more hidden and difficult to measure: Higher charges for infrastructure not openly tendered, poor supervision over its quality, and mismatches between investors' offers and what is actually needed.

A government considering an offer of infrastructure for natural resources should begin with calculations that compare the costs and benefits to alternatives. Initial calculations are straightforward, but require some reasonable assumptions about the fiscal revenues and signing bonuses from the resource and the cost of infrastructure absent the tied arrangements. The results should be converted to an implied interest rate for the "loan" and compared to alternatives, such as costs for independent borrowing for infrastructure and "market" fiscal terms for mines. The results may favor the arrangements or show them to be costly.

Calculations rarely capture everything that matters. Here, important omissions would be gains from assurance that revenues from resource wealth are converted into productive assets and likely speedier completion of projects, but also the possible costs of lower quality or less desired infrastructure. Although calculations are imperfect decision tools, they are valuable. Doing the arithmetic at least identifies any costs that must be balanced against such non-quantifiable benefits.

Foreign investors should also worry about long-term arrangements that provide host countries a large portion of benefits upfront. History suggests that subsequent governments often forget early benefits and see only resources leaving the country with little payment at the time. The outcome can be demands for renegotiation. To be sure, the increasing bite of international arbitration appears to provide more protection to investors than they had in the past. Yet, turning to arbitration is likely to end an investor's involvement in the project, sour relations for other opportunities in the country and frustrate the investor's (or its home government's) goal of protecting access to minerals or crops. Perhaps there are good reasons, beyond capital costs and availability, that explain why arrangements with large upfront "payments" are being struck mainly by Asian investors with little experience in overseas extractive activities in risky

countries. Maybe experienced Western investors have been reluctant to imitate their competitors because they understand these political risks from their own history.

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