

DEVELOPING SUSTAINABLE REGULATORY INSTITUTIONS IN DEVELOPING COUNTRIES: SOME LONG TERM CONSIDERATIONS FOR INVESTORS

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A discernible, and potentially destabilizing, irony has emerged in the pattern of infrastructure privatizations and establishment of regulatory regimes in developing countries. Investor and lender fears of political and regulatory risk may well be leading to risk mitigation strategies that may, in the medium to long term, exacerbate the very risks to which investors were adverse in the first place. While there are clearly risks besides political and regulatory matters with which investors need to concern themselves, it is in seeking to protect themselves against those two categories of potential problems that investors may do more harm than good to themselves and the framework within which they operate in the long run.

The context of the irony is two fold, conceptual and historical. The conceptual aspect is the appropriate equilibrium between investor, consumer, and public interests. The historical aspect is the spectrum of past events within which the current wave of infrastructure privatizations are occurring.

From the conceptual perspective, it is the combined job of the regulator and the market structure to assure that an appropriate equilibrium between the various interests is established and maintained. The expectations of the interests, while self evident, merit mention. Investors are entitled to a fair opportunity to recover their investment and earn a return that is reasonably commensurate with the risk they undertook. Consumers are entitled to a satisfactory level of service at a reasonable price. The public interest in the services provided, however it is defined by policy makers in the relevant jurisdiction, should be respected and carried out. The problem for those who would put their money at risk, is, of course, while the ideas are simple and straightforward, putting them to work in reality is anything but simple and straightforward. There is ample room for disagreement and manipulation. The historical perspective is simply that there is nothing new about privatization of infrastructure industries. The history of infrastructure throughout the world is one of frequent shifts between private and public ownership, with an occasional dash of cooperative stewardship thrown into the mix. The determination of who should own infrastructure enterprises was usually decided based upon such practical considerations as who was best positioned to raise the needed capital and manage operations well as a variety of political, ideological, and public policy judgements. The history of ownership changes has been cyclical as the pendulum has swung back and forth between public and private ownership, although both nationalization and privatization have often been accompanied by controversies over the compensation to be paid for the enterprises whose ownership was being transferred from one sector to another. On occasion, of course, the owners of companies being nationalized have found their property simply expropriated with no compensation. It is also important not to lose track of the fact that political passions can be

greatly aroused by debates over nationalization an/or privatization of what many see as the national patrimony. No matter who owns infrastructure assets at any given moment in time, there is always a constituency that desires to shift that ownership. Missteps in stewardship of infrastructure can easily have the effect of unleashing powerful political reactions. Given that history is not at an end, there is no reason to believe that the pendulum will never swing again. It is also important to note that regardless of the general direction in which the pendulum is swinging at any given point, there have been numerous examples of counter-cyclical actions taken by governments largely as the result of displeasure with specific companies. In many cases that same displeasure can influence the general direction of policy in regard to ownership of infrastructure. Obviously, capital markets take note of these events and react. While the market's reaction may, on occasion, be proportionate to the actual triggering events, it is often disproportionate and non-discriminating in its effects. Thus, for example, events occurring in India may well impact the willingness of investors to put their money at risk in Brazil. For those countries with little track record in independent regulation of privately owned infrastructure and whose judicial decision making and processes have been less than exemplary, adverse reactions by capital markets will be characterized by investors seeking to ameliorate their fears about political and regulatory risk by seeking out mitigation measures to render their capital less at risk. Without judging whether or not such measures are really necessary, the problem, and the irony, is that some of the measures designed to mitigate political and regulatory risks may actually exacerbate and perhaps even create them over the medium and long run.

Obviously not all measures taken to mitigate political and regulatory risk are problematic. The purchase of risk insurance products, for example, particularly those issued from sources other than the host government is likely to have little adverse political impact. Forming a business alliance with local investors is another form of risk mitigation that seems prudent, although there have been circumstances where that strategy has proven to be fraught with difficulty. Some measures, however, are not likely to be as benign, and merit scrutiny. Before doing so, however, it is perhaps useful to discuss a general approach that investors would be prudent to follow as risk mitigation measures. They fall under the general categories of building a reservoir of goodwill, and of strengthening and reinforcing those institutions upon which an investor must rely or live with.

The first, and the most obvious, step to take is to provide a high level of service, a higher level than had heretofore existed in the predecessor, publicly owned enterprise. One of the arguments that proponents of privatization almost always make is that private ownership is more efficient and more responsive to consumers than parastatal companies. It is simply foolhardy to behave in ways that disprove those arguments. That is particularly the case where privatization has been accompanied by reductions in staff and/or increases in rates. The private investor is well advised to view itself as having a fiduciary obligation to increase efficiency. Merely cutting costs may be good for the bottom line in the short run, but it is a perilous course politically and regulatorily if it is not part of an overall program to increase efficiency in delivering a higher quality of service to consumers. It is very difficult, if not impossible, to establish a pricing regime for newly privatized entities that makes the subtle distinction between incentivising efficiency and incentivising mere cost cutting. It is incumbent, therefore, on the investor to see the "big picture" and produce a better product at lower cost rather than simply reducing its own costs regardless of the consequences. In short, the investor needs to see the overall public interest in high quality

service as being in its own enlightened self interest.

The second step is to do whatever is appropriate to help make the new processes and institutions that are being put in place to regulate privatized infrastructure industries effective and credible. Most countries have little or no experience with independent agencies regulating privately owned infrastructure industries. Thus, regulatory bodies are embryonic and in need of assistance in getting themselves established in a positive manner. Appropriate measures to contribute to the success of these agencies would include enriching the intellectual milieu within which these they will function through such measures as sponsoring university programs on regulation, supporting and participating in seminars on specific regulatory matters, taking the regulatory process very seriously by making arguments in proceedings that are thoughtful, sophisticated, and reasoned , and generally observing a respectful, and unalterably ethical, course in all interactions with the agency. While it is certainly not reasonable to expect that investors will agree with all decisions taken by regulators, they would be well advised not to go to war with the regulators over minor matters, and that when they do find it necessary to seek redress, that they do so respectfully, in a well reasoned manner, and through appropriate channels. The fact that disagreements become public information is, in fact, very healthy for the regulatory process. Observing and promoting transparency in the regulatory process is extraordinarily important. Nothing is as destructive of the credibility of a regulatory agency as widespread public suspicion of favoritism or "under the table" deals. Thus, the existence of public debate over appropriate regulatory policy is helpful to establishing the credibility of the process, especially when the various positions are articulated intelligently.

One step that would be advisable to avoid is to enter into an infrastructure investment outside of the framework of either regulation or transparent market mechanism. One never knows when a deal may be challenged in the political, legal, or any other arena. If that deal is rooted in some viable and acceptable market mechanism, or falls within the purview of regulatory processes, then it has roots that place it on a stronger footing than an arrangement that is derived outside of an established framework. Many developers and investors who encouraged governments to enter into deals with them without first establishing mechanisms such as competitive procurement regimens and/or regulation to discipline deal making, have found themselves naked and vulnerable when their deals were challenged. There can be no substitutes for credible market and/or regulatory structures.

Similarly, it makes sense that a foreign investor be respectful of the norms and institutions in the country in which the investment is made. Good corporate citizenship is always appropriate, but for foreign investors in infrastructure industries, it importance cannot be understated. That means not only involvement in the community being served, but also fair treatment of employees and customers, behaving in the most ethical and moral of ways, striving to meet public policy objectives in the business sector being served, acting in ways that are consistent with local business norms, and being respectful of the decision making processes and institutions. Often, taking on a local partner can prove helpful to negotiating unfamiliar local ways.

While observing local business norms and tolerating cumbersome bureaucratic processes may well prove problematic to investors, the fact is that a well informed investor should have already taken that into account before undertaking a country risk. There can be no substitute for due diligence before making an investment in another country. It is far better strategy to evaluate all of the country risks in determining the risk premium inherent in an investment and then accept

the developments within the host country than to cry foul later when something adverse occurs. While not all forms of adversity can be foreseen, investors would be well advised to make their best guess, calculate that into the bid they make to acquire assets, and then accept the risks of doing business in a particular country.

There are obviously, many other, perhaps more direct, risk mitigation measures that can be undertaken. Before being undertaken, however, investors and lender should carefully weigh the merits of such measures against their potential for being destabilizing and counterproductive. In so doing, both investors and lenders would be well advised to take the long run point of view. Nations embarking on privatization are doing so as part of their efforts at nation building and growing their economies. For investors and lenders alike, it would be prudent to see privatization and the establishment of viable regulatory regimes as consistent with their business interests of expanding the markets within which they can do business. While it is not reasonable to expect anyone to take on imprudent risks in the short run, it would be equivalent folly for investors and lenders to focus so much on near term risks that long term interests are either ignored, or, perhaps, actually harmed. It is from that perspective that analysis of some of the more common forms of risk mitigation merit analysis.

Sovereign guarantees are a good mechanism with which to begin the analysis. They come in many forms. Some are of a very limited nature, for example, providing guarantees against such uncontrollable risks as currency fluctuation, but others can be so broad as to arguably guarantee an investor against its own error or folly. Obviously, the more limited a guarantee, the less problematic its potential. Indeed, it might be useful to think of guarantees as having a spectrum ranging, at one end, from matters that are completely beyond the control of an investor, to, at the other end, all possible risks. It is understandable why some investors and lenders might seek out sovereign guarantees from the host country in order to insulate themselves from arbitrary actions that might cause them to lose money, particularly in countries with no history of private investment in infrastructure or independent regulation. Similarly, decision makers in a country trying to attract foreign capital may well offer guarantees in order to incentivize investment and to reduce the risk premiums that capital markets may demand. Regardless of the motivation for and the scale of the instrument, it seems clear that the mere seeking out of a sovereign guarantee by an investor constitutes a statement of lack of confidence in the host country, its markets, and its institutions (other than perhaps faith that the state itself will honor its guarantee obligations) at the very outset of the business endeavor. It is less than the ideal statement to make by a foreigner beginning to conduct operations in a foreign country, and adds an argument to the quiver of opponents of privatization and foreign investment in infrastructure.

From a purely economic point of view, sovereign guarantees distort markets, the cost of capital, and ultimately run counter to the very purpose of privatization in the first place by socializing a large element of risk. The broader the guarantee, of course, the greater the distortion. Rather than allowing capital markets to accurately assess risk and thereby incentivize countries to optimize their infrastructure markets, sovereign guarantees constitute a subsidy to an entire sector, an inherently inefficient and price distorting mechanism. If the sovereign is ultimately at risk for losses (or at least for some of them), then the government has a rationale, if not an actual incentive, to interfere with both management of the guaranteed enterprise or the regulatory process. Indeed, one could argue that it would arguably be imprudent for government officials not to interfere in order to assure themselves that the risks the sovereign guaranteed

against never come to pass. The broader the guarantee, of course, the stronger the incentive for political interference. Another aspect of how sovereign guarantees run counter to the rationale for privatization is that guarantees effectively preclude the market in a given infrastructure sector from fully evolving and internally generating sufficient revenue for the sector to become self supporting financially. It simply perpetuates inefficient subsidies. The net effect of the guarantees is to further delay the time for markets and infrastructure sectors to operate on their own. The broader the guarantee, the longer the delay in establishing viable markets and regulatory institutions. Thus, while guarantees may well have their attractions for investors and seekers of capital alike, they also hold the prospect of destabilizing and/or delaying the evolution of markets and regulation, and may, in many ways, negate some of the benefits of privatization.

A second type of risk mitigation measure that some investors and lenders find attractive is one that bypasses the regulatory, administrative, and/or judicial processes of the host nation. Examples of these types of measure are agreements that all disputes regarding the investment be resolved consistent with the laws of a jurisdiction other than the country in which the investment is located, agreements to have all disputes adjudicated by international or other arbitration panels thereby bypassing the laws, regulations, agencies, and courts of the country in which the investment is made, and preempting local decision making and dispute resolution by invoking clauses in international treaties rather than trying to resolve matters locally. It is certainly understandable that investors would be concerned about putting large amounts of capital at risk in locations where their ability to enforce contract and property rights in legal and regulatory systems that are, at best, unfamiliar and unpredictable. To be sure, the regulatory and judicial sectors of many countries are in need of reform. Nevertheless, such clauses, even more than sovereign guarantees, can easily be taken as a statement to the host country that its institutions and decision makers cannot be trusted to do the right thing. Such clauses, when taken to the extreme, make a mockery of the attempt to establish a viable regulatory system by raising the very real prospect that the new agencies will be simply be bypassed and disregarded if its decisions are not pleasing to foreign investors. Indeed, the creation of independent regulatory agencies is an example of the type of reform that should be encouraged if infrastructure industries are going to be opened up to private and foreign investment. It is hard to imagine a more counterproductive signal in terms of reform than demanding a mechanism for bypassing the very regulatory institutions whose very creation represents the type of reform being urged upon developing nations. In that context it is hard to imagine how regulatory agencies can assure consumers and the body politic that the appropriate balance between the interests of consumers and investors will be maintained and that the public interest will be pursued. The creation of the right to bypass regulatory is almost certain to have the effect of eroding public confidence in embryonic regulatory agencies even before they have the opportunity to establish themselves. Not only is the value of reform diminished by such bypass measures, but the seeds of major political difficulties are planted. The fact that efforts at reform have been cast aside and that basic decisions regarding a nation's essential infrastructure will be made by foreign tribunals in accordance with foreign law can be raw meat to a clever politician. The fact that such disputes may well be over service quality, profit levels, repatriation of capital, or other sensitive issues, only adds to the volatility of using foreign laws and foreign tribunals to resolve disputes.

The dilemma in regard to using foreign law and tribunals to resolve disputes over vital industries in another country is not easily resolved. On one hand, investors, understandably, want contentious matters to be resolved in accordance with rules and processes they understand, find somewhat predictable, and believe can be relied upon to be fair and impartial. On the other hand, countries that are opening up their national patrimony to foreign investors are not going to be enthusiastic over a further diminution in their ability to decide matters they may justifiably believe to be basic to their destiny. Indeed, they may understandably see it as a surrender of national sovereignty. The irony, of course, is that the search by investors and lenders for a predictable and "fair" means for resolving disputes, may in fact unleash passions and sentiments that produce more uncertainty than that feared by investors in the first place. Perhaps the best course to follow is to gain a full appreciation of the administrative and judicial processes in the host country, examine very closely the capability and independence of the regulators, and then decide which risk seems to be the most manageable. Indeed, if accepting the risk of local regulatory and judicial processes can be subsumed in the country risk premium that an investor or lender sees as warranted, that may well be, both politically and economically, the optimal way to proceed.

The risk premiums that are charged raise still another set of ironies. Privatization, absent major efficiency gains, is almost certain to lead to higher rates, particularly where rates were suppressed in the past. If there are no gains in productivity and rates merely go up without improvements in the quality of service, the risk premium, no matter how justifiable it may be economically, will be politically problematic. Those gains are typically realized by both cutting costs and investing in efficiency. Merely cutting costs will produce savings in the near term, but do not assure efficiency in the long run. It is, therefore, very important that private owners make investments in efficiency. The problem is that the economic incentive to do so is often not clear. The very same concerns about risk that accompanied the initial investment are likely to work as a brake on further expenditure of capital. While, in theory, the commonly used price cap regulation for monopoly providers provide an incentive in the sense that all efficiency gains during the life of the existing rates go to the bottom line, that signal is diffused by the fact that the payback period for such investment may extend well past the life of the extant rates. As a result, investors have no assurance that they will recover their investment. Moreover, merely cutting costs produces savings that also go directly to the bottom line with little or no financial risk. While these cost savings may well have the same short term effect on rates that actual efficiency gains do, the long run effects on the quality of service are obviously not salutary. Indeed, even in the short run, if the cutbacks designed to cut costs are too severe, there can be service related problems in the near term as well. The incentive to merely cut costs instead of investing in efficiency is heightened by the fact that investors may have bid a fairly high price for the asset in the first place. Certainly the dual forces of competition for acquisition and the desire of governments to maximize revenues from the sale of assets often result in high acquisition prices being paid. Having paid a high price in the first place, investors are even more likely to see the need for a risk premium, and, are, therefore, in such situations, likely to be even more loath to sink still more capital into their new acquisition. In short, the risk premium, and the perceived need for it, coupled with the pricing regime for the services rendered can have the unintended and unfortunate effect of reducing efficiency gains beyond the short term. Such a result, of course, would indeed be ironic, since one of the principal reasons for privatization was

to improve efficiency in the provision of basic services.

The risk premium, designed to compensate investors for the level of risk they are assuming, also has controversy inherent within it. That circumstance is a direct reflection of the fact that high levels of risk require authorization of high rates of return in order to attract capital. High profits, particularly for monopoly providers of infrastructure services, are likely to arouse protests from consumers. Those controversies are likely to be compounded in the near term, because rates are frequently front end loaded in order to allow accelerated recovery of capital. Indeed, front end loading may well be regarded as an element of the risk premium. Indeed, this inherent potential for controversy is one of several reasons why many price cap regimes have productivity ("X") factors built into the rates. The "X" factor is designed to return some of the benefits of efficiency gains to consumers, as well as to provide clear signals to investors as to a minimal level of productivity the regulators expect to be attained. The desired effect, of course, is that consumers, realizing service improvements and efficiency gains, will be less put off by high profits. The tension between risk premiums and the potential for political controversy is probably unavoidable. Certainly investors cannot reasonably be expected to put their capital without a fair opportunity to be compensated for the risk incurred. Moreover, the higher the degree of risk that is internalized into the anticipated return, the greater the likelihood that high levels of profits will lead to controversy and political difficulties. Perhaps the only effective response is demonstrable improvements in the quality of service that allow substantial profits to be drawn from productivity gains rather than higher rates and from improvements in the quality of service that prove to consumers that they are getting fair value for their money.

The final risk mitigation strategy that is followed almost everywhere in the world is political. Those with substantial capital at risk will invariably seek to influence officials with the authority to make decisions that will impact them. While lobbying and currying favor is inevitable, for foreign investors in infrastructure industries, it is a risky endeavor. Doubtless, having no access to those with power is also a risky proposition. How then should a foreign investor protect itself without putting itself at jeopardy? There are a few guidelines that would be prudent to follow. The first is to operate in a transparent a way as possible. If there are public proceedings, and such should be encouraged, then active and thoughtful participation in them is desirable. If there is an independent regulatory agency, then its independence should not be undermined by foreign investors seeking out political interference. Ironically, it may well be that much of the political interference in the regulatory process that people complain about is brought on by those very same people seeking out political support for the result they desire. Participation in the regulatory process ought to be done on a completely ethical and transparent basis. Established processes should be respected and no special favors sought. Obviously, joint ventures with local investors can be quite helpful in negotiating both the regulatory and political processes. Nonetheless, a foreigner ought to avoid clear identification with one political party or faction. One never knows when power will shift. One should also be quite cautious about seeking out the involvement of one's own government in disputes. Such involvement is a two edged sword. On one hand it can demonstrate the seriousness of a matter and elevate the awareness of the host country as to the stakes, but at the same time it can arouse resentments and encourage intransigence where one governments feels that is being put under undue duress by another. The key point is that political involvement is not only a risk mitigation course of action, but it also has the potential to be a risk exacerbation strategy.

It is somewhat hazardous to generalize about the experience of foreign investors in infrastructure industries. Each country, indeed, perhaps each project has unique characteristics that need to be carefully analyzed. Nevertheless, it seems clear that there are few risk mitigation strategies that are not fraught with the possibility of being counterproductive or even risk enhancing. For that reason, such measures need to be carefully evaluated and assessed for their relevance and efficacy on a deal specific basis. The rule of thumb ought to be to avoid investing in countries in which one has so little coincidence that a host of special risk arresting arrangements are needed, to internalize all risks into an overall determination of country risk to the extent possible, to always conduct oneself ethically, transparently, and above reproach, and to assist in building up the institutions and accomplishing the public policy objectives of the sector in which the investment is made. The risks of doing business ought not be exacerbated by unnecessary and potentially counterproductive measures designed to mitigate them.