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POLICY DIALOGUE

Soft Infrastructure: The foundational work for successful infrastructure development – interview with President K.V. Kamath

From his office room overlooking the iconic Bund of Shanghai, New Development Bank (NDB) President K.V. Kamath talked in-depth with JIPD Editor-in-Chief, Dr. Gu Qingyang and correspondent, Xu Mou about the critical importance of soft infrastructure. From the right policy environment for infrastructure development to pre-conditions for successful public-private partnership, Mr. Kamath expounded on different soft factors essential to sustainable infrastructure development. Mr. Kamath, overseeing the first development bank founded by developing countries, also shared with us his views on cooperation between BRICS countries.

Mr. Kamath is one of India's most accomplished and acknowledged business leaders. He started his illustrious career with ICICI Bank, India's largest private sector bank, and later joined the Asian Development Bank's Private Sector Department. He came back to ICICI in 1996 as its MD & CEO. In the following years, ICICI Bank expanded its boundaries and became India's first 'universal bank' under his leadership. He retired as MD & CEO to become the non-executive chairman from 2009 to 2015. Mr. Kamath has served as chairman for Infosys Limited and co-chair of World Economic Forum's annual meeting in Davos. He has also served on the board of Schlumberger Ltd., the world's largest oilfield services company.

The NDB is a multilateral development bank established by Brazil, Russia, India, China and South Africa with the objective of financing infrastructure and sustainable development projects in BRICS and other emerging economies and developing countries, complementing the efforts of multilateral and regional financial institutions towards global growth and development.

Soft infrastructure and policy environment

JIPD: We know that the focus of the New Development Bank (NDB) is infrastructure, and NDB is working towards achieving sustainable infrastructure growth in BRICS countries. Soft infrastructure, including the legal and regulatory frameworks, has been gaining recognition as a complement to hard infrastructure. In your view, with the practices in BRICS countries, what are the important aspects of soft infrastructure crucial for efficient investment in physical infrastructure? How can policies, institutional arrangements, and governance facilitate infrastructure development?

NDB President KV Kamath: Looking at my earlier work in the banking business and infrastructure investment, as well as my two years of experience here, I would say that the impact of soft infrastructure is critical. It is the building block to successful infrastructure development and, more importantly, it helps make sure what has been created is run successfully.

The whole issue, in a way, starts with the question: are the ground conditions right to set up an infrastructure project? Are the law and regulations, which will impact infrastructure projects, clear? Is the approval system clear? Are the time frames clear? It is important to ask the questions. These apply to all countries—whether it is only after asking the questions that you start the project, or if you are starting before this clarity, which can lead to problems.

One example is road projects. Are the issues of land acquisition for the road clear? Is the issue of compensation clear? Is the issue of thereafter changing policy or any government position on this particular part of land clear? Would that have an impact in terms of your regularity to implement the project and to de-risk the implementation? Otherwise, what could happen is that you start implementing the project in good faith and, halfway through, you have an obstruction to being able to move forward, leading to stalled or stranded projects. Another example is the power sector. In an earlier period, when coal-based plants were common, the questions were: Are the issues clear regarding the allotment of mines, pricing of coal, and take-or-pay agreement for power? Are these in place, are these inviolate, how secure are they, and how de-risked are you before you start projects?

If these soft factors are not in place, it ends up with stranded projects. So, at every stage of any infrastructure project, if the soft aspects regarding rules, laws, regulations, approaches and legal rights are not clear, we could land ourselves in changes or withdrawal mid-way, resulting in stranded projects.

JIPD: What is the role of government policies in improving results and efficiency of infrastructure financing? What kind of policy environment is critical in promoting infrastructure development?

Kamath: The policy environment, which the government creates, has a definite bearing on improving the results and efficiency of infrastructure financing. To summarise the benefits: it is a de-risked project implementation, leading to projects being implemented at lowest possible cost with the highest possible returns. These advantages happen when you adequately address the policy environment—a de-risked situation. Otherwise, it would lead to implementation delay. Implementation delay has lots of economic impacts because what could have been economically beneficially much earlier gets put to use much later. The increased cost then would undermine the financial viability of the project.

JIPD: How is good economic governance necessary to ensuring collective action, the reduction of transaction cost, the enforcement of contracts, and the security of property rights in the provision of infrastructure financing?

Kamath: I would stress economic governance. To use the earlier example, with economic governance you de-risk at the start of the implementation period and hence improve economic and financial viability. Without the reduction of transaction costs, the cost is going to be out of control. The enforcement of contracts ensures that contracts do not get changed midstream. In specific cases, contract conditions could change; these things come across in virtually every single project, and almost all of them emanate from the fact that the ground conditions, in term of soft aspects, are not in place.

JIPD: What would be your advice for policymakers on how to improve their economic governance in this regard?

Kamath: Get your policy equation right. It is easier said than done—I don't want to name countries; nevertheless, there is a working process in every country. My impression of China is that all is well set, and better than many countries. When the policy equation isn't right, when economic governance breaks down, the economic and financial returns from a project get impaired. The government is not able to service the debt. That is when policymakers suddenly realise something is missing here, when most of the understanding happens after the event.

Public-private partnership (PPP)

JIPD: Do you think PPP works for BRICS countries? What are the pre-conditions for successful implementation of public-private partnerships in BRICS countries?

Kamath: My own experience is that if the institutional framework, particularly for policies relating to everything that impinges on PPP projects, is not in place, the government's risk on the project gets even more heightened. The risks increase even more when these PPP projects have take-or-pay agreements attached for the output. For instance, if the soft factors of a project are not clear, the project, which is to be implemented in three years, instead gets implemented in four and a half years. The project cost is probably higher by 20 or 25 percent.

There are various impacts of delays, which immediately affects the take-or-pay contract in two ways: Typically, there would have been a term that the project would run 15 years after the implementation period, which is three years. The implementation is already four and a half year. You'd set in motion a chain-reaction of issues. Because the soft factors are not in place before starting work on PPP, there are now huge risks concerning the viability of this project. So, to me, these factors become even more critical and heightened when PPP is concerned. Also, if there are take-or-pay agreements and if other aspects seem to be fairly secured and de-risked, PPP projects end up getting more leveraged than normal manufacturing projects. It has much less ability to take the shock.

One of these risks in PPP is what I call mid-stream risk. Let's take coal-based power plants; there are now stricter environmental conditions and the discomfort with coal plants. What happens to the take-or-pay contracts? Solar power can now be generated much cheaper; is there a temptation to put solar on these contracts? All the issues, in terms of the sanctity of the contract and causing risks to the PPP, start coming out. So, I would think that in the very fast-changing dynamic situation, PPP is looked at with even more care and caution. We need to ensure anything that can negatively impinge on the projects is properly analysed and addressed.

The problem is that PPP can be purely market -driven, where there is no offtake from the government, and the offtake is the market. The risks are significantly higher, which get reflected in the pricing for the loan and end up in much higher product prices. In the financial world, bankers will tell you everything is structurable, and they will probably try to price in known risks. But I believe there are unknown risks coming in and creating significant problems. For that reason, if you can de-risk most of what you think could happen, then you are really left with what is clearly not foreseeable when you do the loan.

JIPD: How can government help implement PPP projects?

Kamath: This is a tricky question. As long as you have a loan, which is guaranteed by the sovereign or the government, the government must honour it. If it is not, the responsibility is entirely with the bank. The only thing you can do is to ensure that whatever needs to be in place is in place. Increasingly now, there is a call for more PPP-type projects. Both commercial and development banks are encouraged to have more PPP-type projects. To me, that becomes a challenge going forward, until we ensure everything that we could think of is addressed.

In India, projects are implemented both in PPP and the government sector. For a variety of reasons, a lot of PPP projects in the last 7–8 years or more got stuck. It has been due to the lack of soft parts we discussed earlier. This is a learning curve that the country is going through. For PPPs to come back, a whole lot of repair is required. The stranded projects in India are a clear example of a lack of soft factors in making sure these factors in place before starting these projects.

JIPD: What are the sectors suitable for government investment and what are the ones suitable for PPP?

Kamath: For the last two or three years, most of the investment in roads is entirely from the government sector in India. The government is building highway networks, rural roads, and large water linkages. The private sector is driving the telecom and solar industry. So I would think that the right stake for PPP is a sector where not only the soft factors are in place, but there is some market experience on financial viability. At that point, it can be done.

What an innovative development bank could do is structure a project with a government in such a way that the project starts as a government project. After the project is implemented and de-risked, and after the income streams are clear, it divests the project either as a PPP or as a private-sector one completely. These models will certainly be considered. A strong candidate for that model could be the road and highway sector. The government, as an investor, monetizes the asset by offloading in a market either by outright bringing in private parties or as a PPP. Of course, there are other areas where this could happen. There are also combinations to the PPP process that could happen. The government has done a public-good project which has economic viability and financial viability. Once it is de-risked, the project is put into the market as a PPP. Problem arises should the government block large and massive investment in these projects.

JIPD: How do you assess the importance of the protection of property rights in PPP?

Kamath: Land acquisition is where it starts. It is one of the softest of the soft issues. It is an emotional issue, with nuances in different countries. It could also have religious and cultural significance. All these need to be addressed to make sure that not just property right is protected.

JIPD: What is your view on land ownership in infrastructure development?

Kamath: Innovative ways need to be developed. India is forming new states and building new capital cities. Land has been brought from existing owners, who also have a right to the land as it is developed and its value increases. If you are a landowner and the government wants to acquire your land, in ten years the value is ten times from now or whatever the government says the economic value of the land is, and you can have a share of that value. This is an entirely different approach to land for large development of an old city.

International cooperation

JIPD: India and China have complementary business relations in infrastructure. What are the comparative advantages for India and China in infrastructure development? How can the two countries collaborate in infrastructure development?

Kamath: The biggest advantage of this relationship is that both are of a scale that the needs match. China went through addressing the needs of a billion-plus people; if I may put the sequencing of things: China first manages water, then infrastructure, manufacturing, and now the service sector. China built everything in scale to meet the needs of a billion-plus people. To me, all these learning and market opportunities can be leveraged in a significant way between the two countries. Anything you see is an opportunity that can be replicated—roads, rails, high-speed rail, city commute, Metro, ports, airports, water, and water harnessing. I would say opportunities for collaboration exist between the borders.

JIPD: What is the reason for different sequencing of infrastructure development in China and India?

Kamath: The main reason for different sequencing is an understanding of the capacity to invest. In China, the savings rate and ability to invest was very high 25 years ago. Infrastructure development in China happens very early in the development process. Massive infrastructure, which at times appeared far ahead of its time, got created. Looking forward, we found that all these infrastructures are now turning productive. China continues to invest in a large way. The reason is that China understands the soft factors, about how to go about projects, and how to implement projects in quickest possible time and lowest possible cost. The other reason could be the scale—in every area of infrastructure, it has been done in massive scale. That itself, the act of investing in infrastructure, leads to significant economic development. Once the work is over, assets are put to productive use, and there are further economic benefits from the project. China harnesses these benefits very well, which, apart from the soft factors, is a learning example for India and also other countries.

In India, the strategy is slightly different. The strategy in most infrastructure investments has been what I call "just-in-time". India would try to bring in infrastructure as it gets all stressed. That used to be the case; it is not that it is illogical—there was a view that the capacity to invest in infrastructure dictates how much the government could invest. The policy started to change only in the early 2000s. I think investment in infrastructure is going to be the biggest driver of growth and the current government is pushing this very strongly.

JIPD: How can international cooperation in policy coordination help to realise

infrastructure development among BRICS countries?

Kamath: The experience in all BRICS countries is particularly in how governments first take care of the soft factors before implementing the hard ones. We are promoting knowledge sharing because this itself is a soft area. Knowledge sharing of the soft factors is critical but is often missing. Hard factor knowledge sharing comes from consultants, contractors, and supervision agencies, but soft factors only come from knowledge sharing. For example, if I sit here and look at all the progress in Shanghai, it is easy to see what has happened, but what has happened underneath to prepare this to be successful is not visible. I sit here and see the Suzhou Creek [a once-polluted river passing through the Shanghai city centre]. What were all the preconditions for the Suzhou Creek to be cleaned and made into a proper waterway? What went into planning tunnels and bridges here? What went into the city waste management and sewage management? What went into the soft factors harnessing water from the Yangtze River and buildings' water reservoirs? We do not know.

Hard factors are visible, whereas the soft ones are not. To me, these are critical: learning from other BRICS countries and understanding how do we go about implementing similar things. So what did the Shanghai municipal government put in place as soft rules, laws and regulation to implement this? We need to know.

Additionally, in all these projects, there would be re-housing of people in a particular area. We need to see what agreements were made and how this issue was approached. As I understand it, they were given clear policies and re-housing. In all cases, when re-housing was done, rapid transit was completed and the relocated residents could come to work without delay. So, there was a whole lot of planning before putting in hard facilities. While the Shanghai experience holds important lessons for other countries, I fully appreciate that resettlement of people is an issue that has to be dealt with within the context of respective local and national rules, regulations, and systems. The Shanghai experience will probably not be directly transferable to all other countries, but it does provide lessons on what is possible with sound planning and implementation, within the local context. It is for this reason that NDB works with national systems on this and other similar issues relating to soft infrastructure for hard infrastructure projects.

I believe the experience from one city in China could be transferred to another city in China, leading to an efficient way of infrastructure development with speed, lowest possible cost, and greatest possible benefit. We can take the learnings as required by our five member countries and put them on the table. At our [NDB] annual meeting in India in April, the city of Shanghai made a presentation on what it did to transform the city. The experience from Shanghai is largely on how to make sure what you build would stay for the project's life and no changes in conditions were made mid-way.

JIPD: Thanks very much President Kamath. You have made some very perceptive points on soft infrastructure.

Kamath: I want to add one last point. Without soft aspects, the result is two things: inordinate delay in project implementation, and inordinate increasing cost in the project. This problem arising is an abnormal increase in the risk in the implementation period. All of these are consequences of soft aspects missing. However well your projects are prepared, if these are not in place, you carry risks. Ultimately, these are financial risks and economic risks, because you are pushing back the productive use of the hard facility you are setting up.

To sum up, this is probably the foundational work that any infrastructure projects require. We at times are missing doing foundational work and instead are jumping to other steps, landing us bankers in problems.