

Feasibility Study on the Use of Non-Grant Financing

Final Report

25 January 2019

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Feasibility Study into Expanding the Australian Aid Program's Development Finance Options

Introduction

In August 2018 the Department of Foreign Affairs and Trade (DFAT) commissioned this study to assess whether access to a broader range of development financing instruments, including more innovative use of grants as well as non-grant financing instruments, would increase the impact and influence of Australia's aid program (which until now has been almost entirely in grant form).¹

The team appointed for the study were: John Evers, team leader; Veronica Chau, Guarav Gupta, Keeran Sivarajah, Kapil Kanungo, Shreya Menon and Max Goldberg, of Dalberg Advisors; and Andrew Tyndale, Chair of Inspire Impact.

The study team were supported throughout by a secretariat of DFAT officials, comprising Vladimir Betov, Fabia Shah and Andrew Shepherd.

This final report follows three interim reports submitted by the team:

- a review of relevant literature, submitted in early September 2018
- a preliminary report on regulatory, legislative, budgetary and ODA-eligibility issues, also submitted in early September 2018
- a revision of that preliminary report, submitted at the end of September 2018.

Two key decisions in the area of this study were announced in November 2018, in a ministerial decision on a New Policy Proposal for 2019-20:

- to establish a financing facility for infrastructure in the Pacific, from which \$2 billion in loans, including concessional loans, would be available; and
- to provide the Export Finance and insurance Corporation (Efic) with \$1 billion of additional callable capital and a mandate to finance infrastructure investments that have a broad national benefit for Australia.

After the announcement of these decisions, the study team were asked by DFAT to continue and report according to the original terms of reference. This final report is arranged in the same sequence as those terms of reference, which are in Annex 1. In response to comments on a draft of this report, DFAT asked for an additional section on risks associated with new forms of financing and their management: this has been included, together with a risk-management matrix in Annex 2.

The study team have consulted a wide range of stakeholders in Australia's development assistance program - within DFAT, in other Australian Government departments and agencies, in a wide range of businesses and investors, in multilateral banks and specialist institutions, and in government agencies and others in the three places the study team visited – Port Moresby, Port Vila and Jakarta. These consultations are listed in Annex 6. They include cabled or emailed replies from DFAT officials at posts which the study team were unable to visit.

The study team wish to record heartfelt appreciation of the generosity and helpfulness of all those whom they consulted, and of the members of the DFAT secretariat.

This report is accompanied by advice about questions of constitutional and legislative authority which DFAT commissioned from the Australian Government Solicitor (AGS), and which DFAT has circulated separately.

¹ The current program is described at <https://dfat.gov.au/aid/Pages/australias-aid-program.aspx>.

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Abbreviations

Abbreviation	Expansion
ADB	Asian Development Bank
AGS	Australian Government Solicitor
AIIB	Asian Infrastructure Investment Bank
ASEAN	Association of Southeast Asian Nations
CRA	Consolidated Revenue Account
CTF	Clean Technology Fund
DFAT	Australia's Department of Foreign Affairs and Trade
DFI	Development Finance Institution
Efic	Export Finance and Insurance Corporation
EMIIF	Emerging Markets Impact Investment Fund
GDP	Gross Domestic Product
GoI	Government of Indonesia
GoPNG	Government of Papua New Guinea
GoV	Government of Vanuatu
ICT	Information and Communications Technology
IDC	Inter-Departmental Committee
IFC	International Finance Corporation
IMF	International Monetary Fund
IPFA	Infrastructure and Project Financing Agency
IPP	Independent Power Producer
JICA	Japan International Cooperation Agency
LDC	Least Developed Country
M&E	Monitoring and Evaluation
MDB	Multilateral Development Bank
MIGA	Multilateral Investment Guarantee Agency
MSME	Micro, Small, and Medium Enterprises
NGF	Non-Grant Finance
ODA	Official Development Assistance
OECD-DAC	Development Assistance Committee of the Organisation for Economic Cooperation and Development
OPIC	Overseas Private Investment Corporation
PIDG	Private Infrastructure Development Group
PNG	Papua New Guinea
PPP	Public-Private Partnership
SME	Small and Medium Enterprises
SOE	State Owned Enterprise
TA	Technical Assistance
TVET	Technical and Vocational Education and Training
USAID	United States Agency for International Development
WASH	Water, Sanitation and Hygiene
WB	World Bank

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Executive Summary

The challenges of economic development are increasingly being met through new methods, focused on raising private finance for public infrastructure and on encouraging private businesses to make greater contributions to development. This situation presents a widening range of opportunities for Australia's development assistance program. Using non-grant finance (NGF), and applying grants in innovative ways, could be part of grasping those opportunities, in two main ways:

- by multiplying the size or number of projects which Australia could finance directly, and
- by being a more effective catalyst for other finance in private-sector projects.

Strategic implications

Increasing the reach of the development assistance program in these ways would make it a more effective instrument of foreign and strategic policies, as well as substantially better in attaining development objectives:

- as a vehicle for applying Australia's policy advice, improving regulatory practice, and strengthening the state institutions which enable or implement large projects
- through expanding opportunities for Australian companies and service providers, and helping to foster competition and make markets more open
- through sharing Australian innovations across a wide range of technical fields
- through promoting open trade and investment policies, competition in the interests of users of public services, and a rule-based system of conducting business.

Helping in the provision of blended public-private finance is a role for Australia which will have relevance and value for decades to come. It could keep on supporting relations with governments which no longer want or qualify for older forms of development assistance.

Using a broader range of financing instruments would have strategic value in Indonesia, and several other countries in Southeast Asia where Australia has substantial bilateral programs, as well as in Papua New Guinea (PNG), Timor-Leste and the Pacific.

Demand

Despite the diversity of economies in the Indo-Pacific, there are development use cases for many types of NGF throughout the region. There are often complementary needs for grants and NGF across the full range of country contexts where Australia's interests are at play.

In consultations, stakeholders across a wide range of country contexts, sectors, and industries expressed demand for Australia to complement its present grant-based financing options with NGF or more innovative uses of grants in the following six areas: (1) financing large-scale infrastructure, (2) investing in smaller scale infrastructure that contributes to social and economic development, (3) promoting inclusive growth through financing micro, small and medium-size enterprises, (4) improving agricultural productivity, (5) developing natural resource industries, and (6) increasing access to risk and disaster insurance.

Across all of these instances, Australia's ability to deploy NGF will be a function of the addressable pipeline of investable opportunities and the nature of the business-enabling environment. When generally compared to grants, NGF can be particularly useful for minimizing distortionary effects in development finance and for assisting the transition to more sustainable public and private finance.

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Overwhelmingly, while many governments in the region acknowledged the need for NGF, nearly all emphasised the continued importance of grants as well, especially in terms of supporting social infrastructure and other areas where cash flows may seem relatively uncertain.

Employing an array of NGF and innovative grants could allow Australia to better tailor its development offerings to the needs of the private and public sector.

- Where an investment is considered for proven business models that require capital injections, loans can enable better incentive structures that minimize market distortion. These benefits are particularly helpful for infrastructure finance, or in agriculture where market distortions have particularly adverse impacts when available arable land is limited.
- Where co-investing is prudent, equity can be a useful tool where returns from a project or portfolio are likely, but less predictable or stable. It also can provide Australia with an avenue for exerting an investor's oversight to steer a firm toward development-focused outcomes.
- Given their mobilisation effect, guarantees are best suited for critical infrastructure projects, whose risks may discourage financiers from deploying capital. While several other organizations provide guarantees, there is significant residual demand that Australia can meet.
- In situations where only a subset of the qualities of NGF are beneficial (for example, some cases of directly capitalizing businesses with a development benefit), more innovative uses of grants allow them to mimic some aspects of NGF funding or convert to NGF under certain circumstances. This permits a spectrum of concessionality from grants to NGF that is responsive to a greater variety of needs.

Introducing NGF and expanding use of innovative grants could be additional to the multilateral development banks (MDBs) by providing blended financing instruments that enable countries to access more flexible and varied financing; by augmenting investment in critical sectors and countries of greater priority to Australia; and in the long term, by exploring possibilities for local-currency, innovative guarantee, and other financing for which there is large demand but limited supply.

The same tools could allow Australia to be additional to other bilateral funders in three ways – by taking advantage of Australian expertise to create packages that combine competitive finance with top-of-the-line capabilities, and becoming the preferred partner for certain sectors (as, for example, Japan is in urban public transport); by using best-practice open-procurement standards to optimize project quality and cost; and by focusing on demand for end-to-end implementation and adequate loan tenor, rather than seeking to compete on interest-rate concessionality.

Development impact

Financing instruments other than grants are proven tools in generating development impact. The implications of Australia's using them for development purposes lie in the possibility that using new forms of finance could mean working with different entities in lead roles in project development.

- If Australia used financing instruments other than grants to participate in projects similar to those in which it has until now used grants, the development impact would be similar.
- But if Australia participated with financing instruments other than grants in projects with private companies, fund managers or local super/provident funds, and without an MDB as lead financier, ensuring development impact could involve larger tasks for Australia.
- In other words, the need for additional measures to ensure development impact would vary according to the situation.

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- Many private companies use standardised methods for assessing development impact which would supply part of the framework needed in choosing projects to support with finance.

In several ways, having available a broader range of financing instruments could make positive contributions to development impact.

- Some high-priority objectives of Australia's present program are being met through funds or intermediaries which employ flexible financing methods. They might welcome contributions in matching forms such as equity shares and loans, rather than grants.
- The use of loans or equity can be positively helpful compared with grants, by building business discipline and independence. Equity stakes can also provide a means of influencing development impact at Board level. However, being an active equity investor is costly in terms of resources, and involves more reputational risk than being a financier.
- Loans and equities would in the long term produce reflows, at least in large part, of the amounts originally invested, enabling them to be "recycled" in new investments.

As for measurement of development impact, again the implications of using an instrument other than a grant lie in the practice and commitment of the lead sponsor. There are established impact investors which use measurement systems both to select investments and to evaluate their impact.

Sustainable debt management

There are well-established means of ensuring that offering loans for development assistance to governments or government-guaranteed utilities would be consistent with sustainable management of debt. Equity investments, and loans to non-guaranteed private companies, would not increase governments' indebtedness and could contribute in time to tax or other revenue. Similarly, the use of guarantees and other risk-sharing instruments would not increase governments' indebtedness.

Specific instances

With the benefit of our visits to Port Moresby, Port Vila and Jakarta, and input from other DFAT posts in the Indo-Pacific region, we have identified a set of possible projects or programs for which financing other than in grant form seems preferable, within the present financial envelope of the development assistance program and its present priorities and strategies. Forty of these projects and programs are shown in Table 1 below.²

While not ourselves recommending what to include in Australia's development assistance, we have concluded that if these projects or programs were judged worth supporting, it would be preferable for support to be in a form other than a grant. The most frequent reason is simply to make Australian money go further by leverage into more or larger projects. In other cases, the reason is that a different form of finance would be more suitable for the prospective partner, or for reducing risks in order to make suitable commercial finance available.

- While over half of these cases are in the Pacific plus Timor-Leste, 18 or nearly half are in Indonesia, the Philippines, Vietnam, South Asia or across the Indo-Pacific region.
- In just over half the cases loans seem most likely to be suitable, but in 20 cases, forms of NGF other than loans seem most likely to be suitable.
- The majority of cases (21) are projects for physical infrastructure, but in 19 cases they are projects or programs of different kinds.

² Table 1 omits three projects of which the particulars are commercial-in-confidence: they are infrastructure projects in PNG and the Pacific for which loans or offtake guarantees seem suitable.

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Budget and ODA-eligibility considerations

The basic principles for the budget treatment of NGF are that funds which create financial assets (loans or equities) should come from the Consolidated Revenue Account (CRA) through a special appropriation rather than from development assistance appropriations, but with deductions from the latter corresponding to the net cost of funding these assets and provisions for financial risks.

Because offering NGF on any significant scale would mean larger outlays and reflows, in some cases with less predictable timing, as well as because of the budget treatment we suggest, it would be necessary to dispense with the present “ODA cap” policy which equates development assistance appropriations with what is classified as Official Development Assistance (ODA).

Institutional, capacity and financing requirements

Administering NGF would require a step-up in specialised capability, and bring an additional task of coordinating the use of new financing forms with grant-form assistance. There are four institutional options which we think could be satisfactory as ways of achieving this. We suggest these options are best considered as choices of what to set out to have in several years' time.

The first three options—DFAT alone, a partnership with Efic, and a new entity within the portfolio of the Minister for Foreign Affairs—are compared, in terms of their respective strengths, weaknesses, opportunities and threats, in a table in the relevant part of this report. Choosing one of these, or a mixture of them (the fourth option), would depend on how the different factors are weighed. Estimates of the time needed to implement any of these options, and of establishment costs and operating costs, are included in the relevant part of this report.

Regulatory and legislative arrangements

Because of the novelty of NGF and its additional financial aspects and risks, it seems necessary for an inter-departmental committee (IDC) representing the coordinating departments and DFAT to have the initial task of formulating a framework in which proposals for NGF would be assessed. This framework should be submitted for approval by the Treasurer and Minister for Finance, as well as the Minister for Foreign Affairs, before it is put into use.

Advice provided by AGS about the constitutional power and legislative authority for use by DFAT of NGF is circulated separately and should be read in conjunction with this report. Reduced to very concise terms, this advice is that:

- for loans, authority could be established with low risk of a legal challenge being upheld either by inserting a new item in Schedule 1AB to the *Financial Framework (Supplementary Powers) Regulations 1997*, or by enacting new primary legislation;
- for equity, quasi-equity, guarantees or insurance, authority could be established with a similarly low risk only by enacting new primary legislation.

Because of the difficulty of estimating the scope for offering new forms of finance without a more detailed reconnaissance, we recommend that Ministerial decisions on NGF be in two sets, with the intervening period used for undertaking more detailed reconnaissance of financing prospects, and the related consideration of institutional options. The first set of Ministerial decisions need not involve adopting any of the institutional options as a medium-term objective.

Risks and their management

Offering NGF would involve several new kinds of risk – political, reputational and financial. They could be managed by adding the regulatory arrangements we suggest to the existing practices of risk management within the development assistance program. This is explained in the final section on page 31, and in more detail in the risk-management matrix in Annex 2.

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Table 1—Prospective projects or programs for which non-grant finance is preferable

	Shading code:			
existing	identified	possible	new non-loan finance	new leader
Development objective	Country /region	Prospective project/program	Preferable Aust financing	Project leader/s
Privately-owned infrastructure with economic and social benefit	A - Indo-Pacific	Co-invest with DFID through InfraCo Asia (Investments) in portions of project equity	Equity, or callable capital	InfraCo Asia
Inclusive growth through fostering SMEs	A - Indo-Pacific	Invest in Inclusive Ventures fund	Equity, or grant convertible to loan or equity on success	Save The Children
Inclusive growth through fostering SMEs	A - Indo-Pacific	Emerging Markets Impact Investment Fund	Equity co-investments through local funds	DFAT
Supporting businesses or social enterprises with	A - Indo-Pacific	Co-investing with established impact investors	Subordinated loans or equity - still unclear	Unclear
Supporting businesses or social enterprises with development impact	A - Indo-Pacific	Incentives for local Fis to expand lending to specified types of borrowers	Repayable grants for temporary loss-sharing	IFC (Global SME Finance Facility) or ADB
Supporting businesses or social enterprises with development impact	A - Indo-Pacific	Incentives for local Fis to expand lending to specified types of borrowers	Concessional loans	IFC (Global SME Finance Facility) or ADB
Privately-owned renewable energy with economic and social benefit	B - Pacific	Credit enhancement program for renewable energy producers	Partial guarantee of risks of offtake defaults and other specified disruptions	ADB
Insuring public assets against natural disasters	B - Pacific	Lines of credit for reconstruction	Concessional loans most likely - still unclear	WB, ADB
Tertiary education, support for innovative start-ups	B - Pacific	University of South Pacific itself, or Hi-Tech Lab within it	Equity for USP or start-ups - still unclear	Unclear
Increasing access to communications	B - Pacific	Telecommunication cables	Partial guarantees of offtake for private companies (still unclear)	Unclear
Improving infrastructure in a range of sectors	B - Pacific	Co-investing with Pacific pension funds, singly or through joint vehicle	Equity, loans or credit enhancements	Joint platform proposed but still to be formed
Inclusive growth through fostering SMEs	C - Fiji	Targeted expansion of lending by commercial banks	Repayable grants for temporary loss-sharing	IFC
Inclusive growth through fostering SMEs	C - Papua New Guinea	Finance for business incubator with commercial bank sponsor	Subordinated loans or equity - still unclear	IFC (perhaps BSP)
Improving roads in Morobe economic corridors	C - Papua New Guinea	Rehabilitation and maintenance in cooperation with national and provincial government	Concessional loans	DFAT
Wafi-Golpu mining project	C - Papua New Guinea	Finance for equity stake of Morobe provincial government	Loan, at commercial rate but with long tenor	Unclear
Improving infrastructure in area with high potential for business growth	C - Papua New Guinea	Develop NADZAB (Lae airport) area into mixed-use precinct	Loan, at commercial rate but with long tenor	Unclear
Improving infrastructure in area with high potential for business growth	C - Papua New Guinea	Redevelopment of waterfront into commercial precinct with public amenities	Loan, at commercial rate but with long tenor	Unclear
Agricultural development in Morobe province	C - Papua New Guinea	Finance for equity stake/s of national and perhaps provincial governments	Loan, perhaps at commercial rate but with long tenor	Trukai, owned by Sunrice (Aust)
Improving infrastructure in a range of sectors	C - Papua New Guinea	Financing support for companies in PPPs or concession arrangements with SOEs	Partial guarantees of offtake contracts or companies' commercial debt - still unclear	ADB in RE, unclear elsewhere
Increasing national income through resource extraction	C - Papua New Guinea	LNG #2 project	Loan for government equity	Unclear

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Table 1—continued

	Shading code:			
existing	identified	possible	new non-loan finance	new leader
Development objective	Country /region	Prospective project/program	Preferable Aust financing	Project leader/s
Improving agricultural productivity	C - Samoa	Loss-sharing for local banks lending to designated agribusiness SMEs	Returnable grant (currently by simple grant)	ADB
Improving agricultural productivity	C - Samoa	Loan finance for smallholder farmers	Concessional loans - still unclear	small business enterprise center
Extending access to electricity	C - Solomon Islands	Tina River Hydro Power Project	Guarantee of offtake contract or SIG debt	Korea Water Resources Corporation
Extending access to communications	C - Solomon Islands	Domestic cable network	Guarantee of offtake contract/s or SIG debt	Unclear
Growth through revenue and employment	C - Solomon Islands	Mining development at San Jorge in Isabel	Concessional loan for infrastructure - still unclear	Axiom (Australian company)
Improving agricultural productivity or infrastructure	C - Vanuatu	Projects identified by MDBs but too small or slow-moving for them to lend	Loans, on commercial or concessional terms according to need	IFC or ADB to pre-feasibility stage
Improving agricultural productivity or infrastructure	C - Vanuatu	Co-investing with National Provident Fund (NPF)	Equity co-investments through local fund	National Provident Fund, if confirmed on improved path
Extending access to utilities - C - Vanuatu telecoms, electricity, water or transport	C - Vanuatu	Support for company-led projects to improve or expand infrastructure	Guarantee of offtake or availability payments - still unclear	IFC or ADB
Growth of women-led businesses and other social enterprises	D - Philippines	Scaling up Investing in Women Program and Innovation for Social Impact Partnership	Seed-stage capital (equity or grants convertible to equity, or loan guarantees)	DFAT, UNDP
Inclusive growth through fostering SMEs	D - Indonesia	Investing in small, hi-tech businesses below the threshold of commercial borrowing	Equity in locally managed fund	Mekar
Inclusive growth through fostering SMEs	D - Indonesia	Helping to fund well-functioning credit cooperatives	Loans in term-deposit form through local platform	Mekar
Privately-owned infrastructure with economic and social benefit	D - Indonesia	Supporting path-finding PPPs or sales of infrastructure assets, especially airports and seaports	Subordinated loans or equity - still unclear	IFC or ADB
Infrastructure with economic and social benefit	D - Indonesia	Continue present programs of selective financing of high-impact infrastructure	Loans at near-commercial rates with unusually long tenor	DFAT alone or cofinancing with ADB, WB
Infrastructure with economic and social benefit	D - Indonesia	Helping to improve domestic financing of local-level infrastructure and hospitals	Subordinated loans to financing platform, or bond purchases - still unclear	WB or ADB
Energy micro-grids for remote communities	D - Philippines	Support for businesses near to commercial viability	Concessional loans, through green bonds	Unclear
Improving agricultural productivity	D - Philippines	Support for businesses near to commercial viability	Concessional loans, through green bonds	Unclear
Improving water and waste management	D - Philippines	Support for businesses near to commercial viability	Concessional loans, through green bonds	Unclear
Infrastructure with economic and social benefit	D - Philippines	Support for selected "flagship" infrastructure projects	Loans, at commercial rate with long tenor, or concessional	WB or ADB
Extending access to communications	D - South Asia	Infrastructure and Connectivity program	Equity, loans or guarantees for private companies - still unclear	Unclear
Privately-owned infrastructure with economic and social benefit	D - Vietnam	PPPs to deliver major projects at provincial level	Subordinated loans or equity - still unclear	Unclear

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Recommendations

1. **A full range of financing instruments, including both NGF and innovative uses of grants, should be available for the development assistance program.** This will require a change from the present ODA cap to new budget rules relating NGF operations to appropriations for development assistance.
2. **Judgements of what type of financing is most effective should be made according to the specifics of each situation in which a choice arises.** Assessments should be made by a specified method, and with enough specialist advice. They should also be integrated with how country and program strategies are determined and allocations made from the program's budget appropriations.
3. **There should be full flexibility about the degree of concessionality or financial support available to apply in each situation.** This flexibility is preferable to using bands according to countries' income levels or other rules, but it should be employed as far as possible in accord with the principles and best practices used by MDBs and development finance institutions (DFIs) in blended finance.
4. **Separate accounts would have to be kept for the financial assets created by loans, purchases of equity or hybrid types of finance.** While necessary for audit reasons, this would also provide for tracking through time the increase or decrease in value of these assets, individually and as a portfolio.
5. **Financial returns should be sought from NGF or innovative grants only as far as is consistent with development purposes.** There should be the same insistence on upholding the full set of standards and safeguards in the development assistance program whatever the form of financing chosen.
6. **Using NGF or innovative grants may in some cases mean having new, less well-known counterparts as project developers, investment managers or lead financiers.** In these cases there will be an additional task to ensure the full set of program standards and safeguards is upheld, and additional capability will be needed for this.
7. **Accordingly, progress should be made from secondary to primary financing roles only as capability for this is developed.** The use of NGF or innovative grants should begin in partnerships with MDBs, DFIs or other financiers with established, largely satisfactory systems for ensuring development impact, standards and safeguards.
8. **Associations with like-minded Australian investors should be actively sought.** Co-investors who share the development objectives of Australia's development assistance program, such as social-impact investors, can provide opportunities to learn and build a basis for mobilising additional sources of Australian investment.
9. **Given limits on Australia's ability to offer financing which competes simply by its amount and the softness of its terms, the development assistance program should make the most of other positive features:** accompanying assistance in project design, implementation and quality assurance, related assistance in regard to regulatory and policy context, or links with relevant expertise in Australian companies, utilities or research institutions.
10. **Offering a range of forms of financing would provide additional opportunities for cooperation or co-financing with the MDBs.** At the same time, there would be opportunities to finance independently of them in situations where their priorities or practices are not sufficiently aligned with those of the development assistance program.

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11. The next decisions should be for Ministers to approve in principle the provision of NGF, replace the ODA cap with new budget rules accommodating NGF, and form a high-level working group to undertake or guide the following actions:

- A. prepare drafting instructions for legislation to authorise DFAT to offer a full range of financing or credit-enhancement instruments for development assistance
- B. establish within DFAT a specialist support unit for this purpose and develop its operating framework, specifying in particular:
 - methods for assessment and documentation
 - methods for determining and adjusting offsets
 - a method for monitoring financial assets
 - methods of accounting for commitments, disbursements, interest, dividends, repayments and sale proceeds.
- C. seek the advice of the Infrastructure and Project Financing Agency (IPFA) on this operating framework, and agreement to it by the coordinating departments and their Ministers
- D. examine in more detail, in consultation with agencies of allied and like-minded countries and expert advisers, the scope for use of new financing methods in the development assistance program, including the scope for more joint financing
- E. plan the introduction and expansion of new financing methods in the development assistance program over coming years
- F. advise on the best institutional option for the longer term, in the light of the envisaged amounts and types of new financing methods, the most suitable application of budget principles, and the ODA eligibility of various instruments or institutions.

12. The following decisions should be made in due course, to:

- A. determine the best institutional option for the longer term
- B. prepare drafting instructions for additional authorising legislation, if necessary
- C. appoint an external advisory panel of people with relevant expertise, to help guide the expansion of new financing methods in the development assistance program, especially where coordination among institutions is needed
- D. publish a discussion paper to inform the interested public about this expansion and the chosen institutional option.

Strategic implications

The *Foreign Policy White Paper* of November 2017 indicates that development assistance will be an essential part of shaping international events to Australia's advantage.³

- The *White Paper* describes the strategic issues arising from a set of disruptive forces, including climate change and environmental degradation, and higher degrees of strategic uncertainty and risk in the coming decade.
- It contains the judgements that the security and stability of Papua New Guinea, the Pacific island states and Timor-Leste are a fundamental Australian strategic interest; and that Indonesia's success is of fundamental importance to Australia.
- Because of this strategic situation, the *White Paper* asserts that Australia will need to be more active and determined in efforts to help shape a regional balance favourable to its interests, and that development assistance will be an essential part of this in conjunction with strong defence, diplomatic and national security capabilities.
- The crucial issues for regional stability and prosperity described in the *White Paper* include infrastructure development, economic and social reform, climate preservation and food security – all of which are key components of Australia's development assistance program.

Using a broader range of financing instruments would make Australia's development assistance program a more effective tool of foreign policy, as well as helping attain development objectives.

- Using loans, in the numerous cases where they suit the situation, and after making full provision for the attendant risks, would enable a multiplication of the size or number of projects which Australia could finance directly.⁴ Assuming that the cases would be carefully chosen, this would bring corresponding increases in Australia's influence and visibility.
- Using credit enhancement,⁵ again where appropriate and after providing fully for risks, has potential to be a more effective catalyst than grants in many private-sector projects, in situations where capital-market finance is available if official sources share some risk.
- In addition, in a few selected situations taking equity stakes would be preferable to grants, as a means of obtaining the greatest influence over key projects' design or implementation.

Increasing the reach of the development assistance program in these ways would make Australia's assistance more visible, and at the same time serve several foreign-policy and strategic objectives.

- Large projects in physical infrastructure, or large programs in other sectors such as education, are vehicles for applying Australia's policy advice, improving regulatory practice, and strengthening the state institutions which enable or implement the projects.
- Private-sector projects can expand opportunities for Australian companies and service providers, help to foster competition, and make markets more open. They can also be ways of sharing Australian innovations across a wide range of technical fields.

³ Department of Foreign Affairs and Trade, "Foreign Policy White Paper" (Canberra: Department of Foreign Affairs and Trade, November 2017), <https://www.fpwhitepaper.gov.au/home>.

⁴ It would be prudent to advance as loan principal some single-digit multiple of estimated carrying costs (interest margin and provisions for financial risk): see p2 illustration in Indonesia, p21 about suggested principles of budget treatment, and p18 n45 about the "recycling" period of funds.

⁵ This refers mainly to first-loss cover for lending institutions, guarantees of utilities' obligations to private providers of electricity or water supplies, and guarantees of other financial obligations to providers of components or services to large projects. These usually provide only partial cover, so that counterparties and financiers have "skin in the game" as incentives to make their own credit assessments.

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- Helping to foster private-sector investments promotes open trade and investment policies, competition in the interests of users of public services, and a rule-based system of conducting business rather than one of ministerial discretions. Defence of this crucial Australian interest is more urgently needed when the current US Administration is less helpful in support and China is exerting a largely contrary influence.
- Helping in the provision of blended public-private finance is a role for Australia which will have relevance and value for decades to come. The investment needs of regional countries will keep growing as their economies grow and their domestic financial markets develop. So a financing role of this kind could keep supporting relations with governments which no longer want or qualify for older forms of development assistance.
- Having flexibility in financing methods would make it easier for Australia to cooperate with other countries, especially the US and Japan, in financing projects of shared importance.

Australia's development assistance must take account of China's greatly expanded role and influence. In part this is a vast presence as a bilateral financier, on a scale matching or exceeding the MDBs and best-resourced DFIs. In part it is a presence through Asian Infrastructure Investment Bank (AIIB), accompanied by a steadily growing influence on the policies and priorities of the MDBs. It is also the narrative of the Belt and Road Initiative, promising a new global system of infrastructure links, and implying not only a global system of resource supplies and market access for China, but also a system for exerting influence to further China's foreign-policy and strategic interests. And throughout the Indo-Pacific region including PNG and the Pacific, it is a system for publicising China's material contributions and friendship, and cultivating political leaders.

This situation of formidable strategic competition makes it necessary to use development assistance as effectively as possible as a form of statecraft—most broadly to make Australia visible and cultivate friendship, and most directly as a way of fostering Australia's cooperative relations with other governments in the Indo-Pacific region.⁶ It also supplies a reason for having enough financing flexibility to maximise the chances of securing for Australia a leading role in projects which are important for the sake of security alliances or open access to transport and communications.

Using a broader range of financing instruments would have foreign-policy and strategic benefits in Indonesia. Part of the current amount of bilateral assistance could, in loan form, be enough for Australia to finance substantial projects, costing say USD 300-400 million. The country report in Annex 3 outlines a range of apparent possibilities there. Already the development assistance program contributes advice and capacity building on aspects of public policy, including finance for infrastructure, which is valued by the Government of Indonesia. Being able in selected cases to finance projects which put policy innovations into effect would add substantially to that influence.

Our study has not enabled us to gather similar information about the Philippines, Vietnam or other countries of Southeast Asia, but it is reasonable to expect comparable advantages from extending the reach of Australia's financing to larger projects or programs there as well. This is not to detract from the strategic importance of being able to make loans for infrastructure in PNG and the Pacific. Rather, it is to observe that the strategic, foreign-policy and development opportunities in new forms of finance are much more extensive geographically.

⁶ This is emphasised on page 43 of the *Foreign Policy White Paper*: "Through our development assistance, we ... **work with partner governments** to help improve investment settings, regulatory frameworks, taxation systems" (emphasis added). Department of Foreign Affairs and Trade.

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Demand

This section has been developed by Dalberg Advisors, and represents their independent view of the scope for including NGF in Australia's development assistance program. The research and consultations on which it is based, including during the team's visits to PNG, Vanuatu and Indonesia, are more fully reflected in the reports on those three countries in Annexes 3, 4 and 5.

Recent economic development in the Indo-Pacific region is increasing demand for development financing in forms that complement and extend beyond grants. The imperative to mobilise not just billions, but trillions of dollars to achieve the United Nations Sustainable Development Goals in the region demands the mobilisation of resources that are beyond the scope of what donors can typically achieve with grants.

This section presents areas of addressable demand for NGF, as well as more innovative grant structures, that could be additional and complementary to Australia's current development assistance program.

Regional Needs for Development Finance

Despite the diversity in economic realities across the region, there are development use cases for many types of NGF instruments throughout the entire region.

- **Experiences of other providers of NGF would suggest that there will be some variation between countries in both the overall level of demand for NGF and the demand for various instruments.** Key variables affecting this variation include a country's risk level and income status, along with the maturity of local capital markets and the strategies of other MDBs and DFIs in the space.

As income levels rise and markets deepen, private sector demand for NGF increases relative to grants. Several countries in the region have grown rapidly into middle income status, leading to development of capital markets and substantial demand for NGF relative to grants. Between now and 2024, many countries in the region are predicted to graduate out of least-developed country (LDC) status, including Bangladesh, Kiribati, Laos, Myanmar, Solomon Islands, Timor-Leste, Tuvalu, and Vanuatu—all of which currently receive Australian assistance.⁷ Non-LDC countries have continued to develop as well; for instance, from 2010 to 2017, Indonesia's equity markets grew 2.4 times larger, with market capitalization making up 46% of the country's gross domestic product (GDP) in 2017.⁸ By comparison, in 2016, the most recent year for which data is available, net ODA was negative as Indonesia repaid more development aid than it took in.⁹ While grants continue to play an important role in higher income countries such as Indonesia from a development perspective, demand for grants on an economic scale is dwarfed by the need for NGF financing. For lower-income countries in the region, the demand for grants is more significant on a relative basis. For instance, ODA made up 61% of gross national income in Tuvalu (and 8.7% on average for Pacific Island small states), indicating a much stronger demand for grant and concessional financing compared to less-concessional NGF financing.¹⁰ For many lower income countries, the less developed status markets imply a far smaller demand for NGF financing and non-concessional funds. For instance, data from the Center for Global Development shows that International Finance Corporation (IFC) private sector financing is concentrated in less risky middle

⁷ UN Economic Analysis & Policy Division, 'Inclusion in the LDC Category,' 23 September 2010. <https://www.un.org/development/desa/dpad/least-developed-country-category/lcd-inclusion.html>

⁸ World Bank Global Financial Development Database, July 2018.

<http://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database>

⁹ World Bank Open Database, November 2018, <https://data.worldbank.org/>

¹⁰ Ibid.

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and upper-middle income countries that can reliably repay debt and is comparatively underweight in poorer countries with higher risk profiles.¹¹ However, capable private companies can still demand NGF for suitable projects.

In the public sector, credit risk levels greatly affect the ability and demand for countries to take on debt financing for projects. The lower a country's sovereign credit rating and the higher its level of debt distress, the less capacity it will have to take on NGF financing in the public sector due to decreased credit ability and higher market rates for debt issuances.

- **Our analysis revealed often complementary needs for grants and NGF across the full range of country contexts where Australia's interests are at play.**

In the context of poorer, riskier countries including many of the Pacific Islands and certain other countries such as Bangladesh, while grants continue to be in high demand as sources of development assistance, offering NGF could enable Australia to participate in a few, highly strategic investment opportunities, notably in energy, information and communications technology (ICT) and transport. Especially in the Pacific, offering NGF will allow Australia to maintain and amplify its existing role as a core development partner. Were Australia to have the capacity to offer loans, equity, and guarantee funding, it could increase its influence over how these strategic projects are governed and operated. While grants could certainly be used for these instances, NGF could allow Australia to participate in more and larger projects. For example, in the Solomon Islands and PNG, development loans are providing an important source of financing for hydropower projects to provide electrical access to thousands of new customers coming on to grids for the first time.

In middle and upper-middle income countries concentrated in South and Southeast Asia and increasingly in the Pacific Islands, Australia may grow to be a major source of bilateral NGF financing as these countries continue to develop the fiscal capacity to support the issuance of returnable and callable funding instruments. For larger and richer countries, Australia must recognize that the funds it has available to deploy mean that it will play a niche role in the overall market. Grant-funded efforts will remain important to lay the groundwork for effective NGF participation, especially in sectors with higher development impact and risk, such as agriculture and micro, small and medium-size enterprise (MSME) development. In these countries, grants can also be useful for blending with other countries' bilateral loans, conditional on robust procurement standards to ensure high project quality and development impact. Grants will remain the primary mode of support for projects that bear challenging-to-monetise development returns, such as in the sectors of governance, health, and education, human capital development and institutional capacity building.

Sectoral Needs for Development Finance

Below, we present six key instances where, within the current parameters of Australia's development assistance program, as well as the priorities articulated in the *Foreign Policy White Paper*, there is demand for new financing methods that complement existing grant-based approaches.

- Financing large-scale infrastructure projects:* Throughout the Indo-Pacific, financing to enable the rehabilitation, maintenance, improvement and extension of public infrastructure across sectors (specifically in telecommunications, energy, and other major utilities) are among governments' top priorities. The scale of infrastructure demand in the region is very large: G20 Global Infrastructure hub forecasts a funding gap of US\$ 14.8 trillion in infrastructure investments in Asia

¹¹ Charles Kenny, Jared Kalow, and Vijaya Ramachandran, *Inside the Portfolio of the International Finance Corporation: Does IFC Do Enough in Low-Income Countries?*, 17 January 2018.

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Pacific, between today and 2040. This need is 19% higher than existing investment growth trends.¹²

Australia is already very active in responding to this demand through a range of support, including institutional strengthening, monitoring and evaluation (M&E), planning, project preparation and, in select instances, grant-based financing of infrastructure projects. Most NGF instruments such as debt and equity could be introduced in a complementary fashion to existing grant-based approaches. NGF entails the repayment of capital in instalments of varying periodicity. Given that infrastructure supports economic activity and results in increased cash flows directly through fees or indirectly through taxes, Australia can leverage infrastructure investments to generate returns that can be reinvested in other development projects, revolving and multiplying the initial funding amount. In doing so, Australia could participate in more and larger projects as a direct funder, and in doing so, engage in a more robust economic partnership with a country government by providing them with a fuller range of solutions to meet their specific needs.

- b. *Investing in smaller-scale infrastructure that contributes social and economic development:* There is strong demand for external finance for infrastructure projects in sectors that increase access to essential services, such as renewable energy. There is also demand for financing public-private partnerships (PPPs) and the privatisation process of major infrastructure assets that play crucial roles in economic development through instruments such as equity, subordinated loans, partial credit guarantees, and offtake guarantees. In addition to the efficiency benefits indicated above, financing these opportunities through NGF can complement existing grant-based approaches. Similarly to well-designed grants, using returnable funds (equity and loans) or non-disbursable (guarantee) financing for these investments aligns the incentives of the private sector with the public benefits that infrastructure provides.
- c. *Promoting inclusive growth through financing micro, small and medium-size enterprises (MSMEs):* Despite a supply of finance for financing for MSMEs that outstrips gaps on a regional level, there remains significant unmet demand due to misallocation. Needs are greatest for women: of the US\$ 2.6 trillion MSME financing gap in the Asia Pacific, 1.2 trillion can be attributed to the gender financing gap.¹³ Credit constraint is common among businesses in the region, affecting 54% of MSMEs in South Asia and 33% in East Asia and the Pacific.¹⁴

Subordinated and term-deposit loans, equity co-invested through or managed by local funds, convertible grants, and guarantees each show promise to address this demand. Because enterprises generate returns, there are significant opportunities to build upon the grant-based modalities of technical assistance (TA) and patient capital. The most acute demand is from financial intermediaries that are seeking to address the “missing middle” of small and medium enterprise (SME) finance, defined as debt, mezzanine and equity tranches in increments of US\$ 500,000 to US\$ 2 million to finance growth. These financial intermediaries, including banks, funds as well as new entrants like financial technology firms, require a mix of equity, loans and TA to support the development and scaling of new financing models tailored to meet the diverse needs of SMEs.

- d. *Improving agricultural productivity:* There is also a growing demand for financing for the agribusiness sector, notably to finance the formalisation and growth of agribusiness firms that link farmers to markets, as well as from intermediaries that provide banking and other financial

¹² Global Infrastructure Outlook Database. <https://www.oxfordeconomics.com/recent-releases/Global-Infrastructure-Outlook>

¹³ Miriam Bruhn et al., *MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small, and Medium Enterprises in Emerging Markets*, 2017.

¹⁴ Ibid.

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solutions to smallholder farmers. The financing needs in the sector are large, with the most recent estimates for smallholder farmers in South and Southeast Asia alone reaching US\$ 120 billion.¹⁵ These types of entities require a mix of commercial and concessional loans, as well as green bonds. Here, NGF can complement existing grant-based approaches by offering greater efficiency terms noted above. Grants will continue to have significant utility for non-bankable agricultural applications. Additionally, given the limited supply of arable land in many Indo-Pacific countries, the benefits that NGF offer to minimise market distortion are especially important to reinforce market mechanisms as a determinant of production.¹⁶ This helps avoid the risk that Australian resources will merely redistribute wealth rather than create it.

- e. *Developing natural resource industry:* Demand for financing also exists from governments and firms that are seeking to generate economic growth through the extraction of natural gas and minerals. These projects seek commercial-rate loans with extended tenor. Because the returns of natural resources projects depend heavily on global commodity markets, the application of grant financing runs enormous risks of subsidising inefficient production, whereas loans can offer the possibility of returns to the Australian Government while avoiding distortionary effects.¹⁷ In addition, there is enormous demand for public and private infrastructure and services to enable these large natural resource projects, including transport, power and, potentially, processing.
- f. *Increasing access disaster risk insurance:* Given the vulnerability of Pacific infrastructure to natural disasters, there is some demand for insuring public assets and extending credit for reconstruction, most likely through concessional loans and returnable or partially returnable grants. Due to the limited capacity of many disaster-affected countries to finance reconstruction and insurance through commercial rate instruments, grant financing will likely remain the dominant form of assistance for these countries. However, in cases where there is some ability to pay, appropriately adjusting the degree of concessionality using NGF and innovative grants by identifying gaps in what MDBs and insurance companies provide will allow for Australia to more efficiently and fairly allocate limited resources to the areas of greatest need and impact.

For each of the instances above, Australia's ability to deploy NGF will be a function of the addressable pipeline of investable opportunities and the nature of the business-enabling environment. Our analysis points to a strong continued demand for the work that Australia is currently performing to increase the pipeline of investable projects and companies through grant-funded modalities. These include efforts in innovation infrastructure, regulatory reform, technical advisory, and institutional capacity building.

Table 1 in the Executive Summary presents illustrative examples of opportunities where NGF and innovative grants could add value. In addition to analysing the value proposition of the instrument categories detailed below, the study team took note of specific opportunities where some gains in efficiency and efficacy might be possible were the development assistance program to have access to a broader range of financing instruments including NGF and innovative grants that offer similar benefits. The table is not intended to be a set of programmatic or investment recommendations. Indeed, the examples listed vary considerably in their likelihood to be a realistic or suitable specific project for Australia. We have presented them, rather, as an illustration of the range of opportunities that Australia would be better able to consider and interrogate further, were it to have a broader range of financing instruments.

Overwhelmingly, while many governments in the region acknowledged the need for additional NGF, nearly all emphasised the continued importance of grants, where opportunities for cash flows may

¹⁵ Graeme Smith et al., *The Development Needs of Pacific Island Countries*, 2014.

¹⁶ FAO, *Non-Distorting Support Measures to Farmers*, 2009.

¹⁷ William Ascher, *Why Governments Waste Natural Resources: Policy Failures in Developing Countries*, 1999.

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be relatively uncertain. Several stakeholders emphasised how for public sector recipients, innovative grants, such as convertible grants, contingent grants, or milestone-based payments, could be used to amplify impact and provide “leverage” in the same way as NGF.

Demand for Innovative Grant Financing

Using innovative grants, defined here as ways of using grants that play similar roles as NGF in terms of aligning incentives towards impact, will allow for Australia to help its development assistance budget go further to achieve development impact. While Australia has already used grants to leverage private sector financing, notably in Sri Lanka, an expanded set of capabilities would allow Australia to do so on a greater impact scale. Several innovative grant modalities, only some of which are within DFAT's current scope of authorization, are described below:

- As defined by the IFC, a **results-based (or output-based, milestone-based) grant** program is one that rewards the delivery of one or more outputs or outcomes by a financial grant incentive upon verification that the agreed-upon result has actually been delivered. DFAT has and continues to experiment with these types of grants, though consultations have revealed that the contingent nature of these payments is not easily harmonized with DFATs budgetary practices.
- As defined by the World Economic Forum, a **convertible grant** is a financing instrument with a hybrid capital character. The funder provides the enterprise with a grant that is converted into equity under certain, predefined success conditions. Because DFAT has no capacity to hold equity, it cannot currently extend convertible grants.
- As defined by the Global Environment Facility, a **contingent grant** is repaid to the funder if the project is successfully financed. If the project is unsuccessful, the funds that were initially extended become a grant. Because DFAT is not authorised to accept reflows, it cannot currently extend contingent grants.

Broadening authorization to employ a wider array of innovative grants (especially alongside NGF) could allow Australia to better tailor its development offerings to the needs of the private and public sector. Some illustrative examples of what could be possible with wider authorities are listed below:

- The United States Agency for International Development (USAID) used a grant to provide the equivalent of a first-loss equity to the first energy fund of CrossBoundary, a frontier market finance firm.¹⁸ USAID contributed US\$ 1.3 million in grant funding to the CrossBoundary Energy Fund as subordinated capital. The funding was used to attract US\$ 7.5 million and US\$ 10 million in private sector equity and debt, respectively. Once fund investors are paid back their principal investment in the fund, the United States government will receive the entire amount of the grant back, plus a capped return. Similar approaches could be particularly useful for infrastructure and energy projects in the Indo-Pacific, as first-loss equity is an extremely effective way of supporting early-stage and pioneer business ventures in development.
- The Inter-American Development Bank and Clean Technology Fund (CTF) have used contingent recovery grants, alongside loans, in the Geothermal Financing and Risk Transfer Facility (GFRTF) in Mexico.¹⁹ The program uses this mix to specifically target scaling up private investment in geothermal power generation projects. It provides financial mechanisms tailored to meet the specific needs of each project's stage of development, targeted at reducing risk and thereby removing the main barrier to investment for the private sector. Through conservative estimates, the GFRTF has had enormous development impact, with the potential to reduce carbon emissions

¹⁸ U.S. Agency for International Development, *The Crossboundary Energy Partnership*, 22 September 2016.

¹⁹ Inter-American Development Bank and Clean Technology Fund, 'Geothermal Financing And Risk Transfer Program,' *Inter-American Development Bank*, July 2018. <https://www.iadb.org/en/node/1867>

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by 1.10 million tonnes of CO₂ per year. The GFRTF project demonstrates how adding additional authorisation for these types of innovative grants, alongside NGF, will allow Australia to provide financing mixes that can more closely match the needs of the private sector.

- The Asian Development Bank (ADB) and CTF have introduced a US\$ 33 million Mezzanine Finance for Climate Change program that includes 13 Asian countries, as well as the Pacific Region.²⁰ In terms of types of financial instruments, the program is broad, and includes the ability to deploy several types of grants, equity, and debt financing. The primary goal of the mezzanine financing facility is to bridge market gaps. The embedded flexibility within the facility is crucial to maximising its impact-for-money. In any program of this level of complexity, grants are likely to have a critical role alongside NGF, as many projects with meaningful development impact may not reach ordinary thresholds for commercially viable investment. In consultations, the ADB highlighted a need for additional funders for renewable energy projects, raising the possibility of additional Australian involvement in the projects via NGF.

Debt Issuance

Where an investment is considered for proven business models that require capital injections, loans can enable better participation in financing, especially for infrastructure. Typically, governments in the region see debt financing as well suited to projects that are costly, but will provide significant, predictable cash flows or produce taxable economic activity in the long run. Here, offering loans has the potential to increase Australia's impact for two reasons.

- First, while Australia participates in select infrastructure projects by means of grants, there is considerable demand from regional governments for Australia to increase the amount of funds that it dedicates to infrastructure. Doing so without unsustainable increases in the development assistance budget requires the ability to reap returns from aid flows.
- Second, while Australia often funds the initial stages of large-scale project pipelines through grants that fund feasibility studies, planning efforts and technical advisory support and the like, unlike other funders, it lacks the means to sustainably and consistently participate on equal footing in project finance, since doing so often implies participation in projects' SPVs and other financing mechanisms through debt or equity. In doing so, Australia misses an opportunity to build development partnerships and meaningfully support the foreign policy goals outlined in the White Paper, notably around the promotion of transparency and a rules-based approach to trade. These missed opportunities were quite explicitly highlighted in a consultation with a Pacific Island post. In this country, DFAT had sought to support an ADB loan with TA. When the ADB asked on behalf of Australia and other interested donors whether the host government would allow TA donors to participate loan steering committee meetings, the response was that they could join only "once they contributed funding." In this case, while providing either grant or NGF would allow Australia to participate, doing so via NGF where possible would be a more efficient use of limited financial resources.

Equity Investment

Where co-investing is prudent, equity can be a useful tool for promoting private sector and infrastructure development in the Indo-Pacific, especially where returns are possible but less predictable or stable. In the Pacific, equity investments could form an important means of infrastructure finance through an equity stake in a collective investment vehicle, a co-financing mechanism that would allow a consortium of funders to make direct investments in impactful

²⁰ Asian Development Bank and Clean Technology Fund, *ADB Mezzanine Finance for Climate Change*, 28 November 2018.

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infrastructure projects. Through funds or direct investment, Australia could meet these needs through equity financing alongside private and public actors that could buy into a fund, distributing risk on both the project and investment side. Equity investment is especially useful for facilitating Australia's support of social impact ventures and start-ups whose work aligns with Australia's development finance objectives.

There may also be opportunities for equity instruments to allow Australia to enter into co-financing agreements with other individual national financiers, such as the Vanuatu National Provident Fund, to promote agricultural productivity development. Equity investments in local financial intermediaries may also be useful to complement existing efforts to support the growth of SMEs, with due consideration of any accompanying reputational risks or capacity to provide post-investment "hand-holding" support. Efforts such as the Investing in Women Program, and Innovation for Social Impact Partnership in the Philippines help entrepreneurs to build their capacity for growth, but critical missing ingredients in many markets are local funds and financial intermediaries that have the capacity to finance the growth of these businesses.

Instruments such as equity or mezzanine financing can complement DFAT's current approach to working with local financial intermediaries by capitalising them to enable them to better support the growth of local entrepreneurs. While the risk of loss (including uncertain return of funds, resulting in impediments to recycling funds invested) with equity investments is comparatively large compared to guarantees and loans (but not grants), especially since the secondary market can be limited or non-existent, the differing behaviour of these assets makes them a desirable addition. This is both in terms of financial diversification and the benefits they bring to development impact by bridging funding gaps that other NGF cannot reach, and that grants alone will find insufficient to address. Further, co-investing can potentially provide influence through participation in formal governance mechanisms such as boards or steering committees. This may prove worthwhile in cases where operational-level matters are of interest to DFAT, for instance in projects with high social or reputational risks.

Given their mobilisation effect, guarantees are best suited for critical infrastructure projects, whose risks may discourage financiers from deploying capital. Nearly half of private finance mobilised from 2012-2015 was through guarantees alone.²¹ In South Asia, East Asia and the Pacific, for every dollar of concessional capital invested, an average of US\$ 3.8 was raised.²² This data suggests guarantees could be a very useful instrument for Australia to use to galvanise greater amounts of private capital from existing sources, in addition to redirecting capital flows towards Pacific Island countries and other regions deemed too risky for long-term investment. Indeed, consultations—while not indicative of firm opportunities, and without precise references to existing guarantee products available from the Multilateral Investment Guarantee Agency (MIGA), ADB, Efic, and others—revealed market demand for guarantees from both private and public sector actors, as well as from existing guarantors looking for co-financing partners. Conversations with potential Australian investors revealed a preference for packaged guarantees provided alongside export finance and advisory services, while governments expressed difficulties supporting the full risks of critical infrastructure projects and registered an interest in increased guarantee-based funding.

²¹ The precise figure is 44%, according to a 2016 survey by the OECD of 35 major institutions providing development finance, surveying private finance mobilised by five instruments: guarantees, syndicated loans, shares in collective investment vehicles, credit lines and direct investment.

²² Convergence Database. <https://convergence.finance>

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Guarantee Provision

Other established guarantors in the region present a niche for Australia to enter. As of 2016, there is only US\$ 20.3 Billion in outstanding guarantees, 70% of which are provided by MIGA.²³ While MIGA provides guarantee financing in the Indo-Pacific, some of these efforts have been hampered by capital accounting restrictions that lead banks to treat guarantees as identical to loans, severely limiting utilisation.²⁴ Further, MIGA's offerings are limited to political risk and non-honouring of financial obligation insurance, and do not include instruments such as offtake guarantees. Lastly, the diplomatic power of MIGA means that in almost all situations where any type of expropriation raises the possibility of a guarantee call, the World Bank (WB) can use its clout to resolve the issues involved: our consultations have indicated that Australia could leverage its own strategic ties in the region to offer similar guarantees. In certain countries, its assurances could be even more powerful, given its full-time diplomatic presence and government-to-government relations. Admittedly, Australia's heightened engagement also presents a risk: Australia has a range of political and economic interests with countries in the region that it may not wish to risk through advocacy on a single project; in contrast, WB has a narrower range of interests in-country.

Specific instruments for Australia to consider that could respond to demand in the market include:

- *Offtake guarantees* typically insure agreements where a purchaser promises to buy a specific amount of future production from a producer. This type of guarantee is used in natural resource development projects, or instances where the upfront capital costs are considerable, making it crucial to assess future demand viability. For instance, there is potential need for guaranteeing offtake contracts for the expansion of domestic cable networks and the construction of a hydropower plant in Solomon Islands. Hence, these guarantees are uniquely suited to public-private partnerships, since they help to push large infrastructure projects "over the line" and attract foreign investors.
- *Partial credit guarantees* (PCGs) are a credit enhancement mechanism for debt instruments such as loans and bonds, and represent a promise by the guarantor to pay the principal and/or interest, up to a predetermined amount. The category of PCGs includes *first-loss guarantees*, a technique used in the securitisation of assets to provide credit enhancement where a guarantor agrees to indemnify holders for a given amount or percentage of any losses from the asset pool. PCGs are particularly useful as a minimally-distortive way to extend tenor for commercial-rate loans.²⁵ By using a PCG to effectively roll over a loan, DFIs can provide concessional funding while allowing for the utmost function of capital markets. As interest rates continue to climb globally, demand for tenor extension via PCGs will only increase. Consultations in PNG, in particular, revealed residual demand for longer tenors that would provide more time for projects' return to be applied to loan payment.

Additionality to multilateral funders

Australia's introduction of NGF and expansion in the use of innovative grants could be additional to MDB financing in the following ways:

²³ Pablo Pereira Dos Santos and Matthew C. Kearney, *Multilateral Development Banks' Risk Mitigation Instruments for Infrastructure Investment*, 27 February 2018.

²⁴ Chris Humphrey and Annalisa Prizzon, *Guarantees for Development: A Review of Multilateral Development Bank Operations*, 2014; Nancy Lee, *Billions to Trillions? Issues on the Role of Development Banks in Mobilizing Private Finance*, 17 November 2017.

²⁵ Pablo Pereira Dos Santos and Matthew C. Kearney, *Multilateral Development Banks' Risk Mitigation Instruments for Infrastructure Investment*, 27 February 2018.

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- Providing blended finance instruments (concessional capital, guarantees or innovative grants structured as interest rate buydowns) that could enable countries to access more and better forms of finance.** The supply of MDB financing to any specific country or sector is constrained, among many factors, by their rigid standards for regional diversification, occasionally limited ability to support on project implementation, and highly conservative balance sheet management. In practice, this means that MDBs have far less flexibility to offer the types of project finance demanded. Demand from partner countries for MDB financing is constrained by concerns around debt service obligations, especially when it comes to using MDB financing in critical sectors for social outcomes such as health and education. Further, only 7% of the private sector resources mobilised by existing public development finance go to LDCs, providing an additional opportunity area for Australia, in spite of the imminent graduation of several countries from LDC status in the coming years.²⁶ To bridge these gaps, Australia could be additional to existing MDB lending by using innovatively structured grants (such as interest rate buydowns, potentially with an output-based structure²⁷) or deploying highly concessional capital to blend down the costs of loans from MDBs²⁸ to make financing to sectors with lower rates of monetization but high impact (e.g., health, education) more accessible to partner countries. Another means to achieve the same goal, suggested in consultations with the IFC, could be to create a blended finance facility offering a full range of instruments, with flexible terms, to crowd in a variety of private-sector investors (including superannuation and pension funds), as well as to offer DFI-style financing to private sector entities.²⁹
- Augmenting investment in critical sectors and countries of higher priority to Australia than the MDBs.** The size and scale of MDB operations in various Indo-Pacific countries are constrained by internal policies that determine eligibility and allocation formulae, as well as the pipeline of viable projects. MDBs and other financing vehicles typically have specific investment strategies for each country that involve investing in specific sectors or regions within a country, often to the exclusion of others with equal or greater funding needs. More broadly, the priorities of MDBs do not always align with Australia's, in spite of active engagement by Australia as a shareholder in various MDBs.³⁰ While the scale of MDB operations in various Indo-Pacific region countries is increasing, consultations with the World Bank, ADB, and IFC revealed consensus that the scale of the external financing needs in most countries in the Indo-Pacific far exceeds their existing ability to service those needs. Each of these institutions expressed strong demand for Australia to participate in transactions as a co-investor to increase the scale of current operations, or in sectors or regions of the country where they are not active. Specifically, many MDBs pass over projects that are too small-scale, too labour-intensive, or just a touch below the bankable threshold. Tactical Australian

²⁶ UN Capital Development Fund et al., *Blended Finance in the Least Developed Countries*, 2018.

²⁷ For example, see the Global Concessional Financing Facility, that offers concessional financing to Middle Income Countries that are affected by the refugee crises; the facility uses grants to buy down the interest rate of IBRD lending so as to increase host country's capacity to serve the needs of refugee populations. While this facility does not currently have active projects in the Indo Pacific region, it provides an example of how grants could be used to augment the deployment of NGF in the region.

²⁸ For example, see the ADB Regional Health Fund, which includes a USD 150 million grant funding facility that the ADB will use to increase government demand for a blend of loan and grant financing to address critical gaps in domestic financing for health systems

²⁹ Such a facility could offer a similar suite of instruments as the IFC-MIGA Blended Finance Facility (BFF): <https://ida.worldbank.org/financing/replenishments/ida18-replenishment/ida18-private-sector-window/blended-finance-facility-bff>

³⁰ For instance, the Australian Parliament has commented as follows on the World Bank: "on all major issues Australia has had to work within the parameters set by the major developed countries, notably the USA, Japan, Canada and the West Europeans." Increasingly, China is also gaining major influence in these organizations. See: Australian Parliamentary Research Service, *A Critical Analysis of the World Bank*, 1994.

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intervention via NGF and innovative grants could make these projects viable and attractive to MDB funders. In these circumstances, Australia can also be socially additional to MDBs by leveraging its credible leadership in gender issues commitment to gender lens investing through targeted finance that supports gender equality.

- **Consultations and independent analysis revealed local-currency lending and innovative guarantee funding as two areas of unmet demand potentially worthy of future exploration, but unlikely to be appropriate for Australia to operationalise in the near term.**

In consultations with WB, AIIB, and ANZ Bank, bankers emphasised large unmet needs for lending in local currencies. While new institutions such as TCX and some smaller-scale operations by the multilaterals have begun to bridge these gaps, there appeared to be a strong consensus that providing the ability to borrow in home currencies would enable a new set of infrastructure projects to become economically viable. Primary research revealed that even China, the donor in the region with a reputation for the greatest flexibility in lending standards, provided only 6% (by value) of its development finance in the Indo-Pacific region in local currencies.³¹ Given such lending practices may likely expose Australia to currency risks, and hence require expert management, local currency lending may not be prudent for Australia, especially in the near term. However, its feasibility could be explored further, in due course, given the considerable demand observed in the region.

Consultations with the AIIB and research from the Center for Global Development³² and the Overseas Development Institute³³ indicated two operational limitations on how MDBs deploy guarantees, causing the instruments to not reach their full potential for utilisation and mobilisation of private funds. First, MDBs back equivalent value loans and guarantees with the same amount of equity. Second, MDBs assess the risks of guarantee calls the same way as loan defaults. Evidence suggests that these approaches may be overly cautious, as guarantees are called significantly less frequently than loans go into default or arrears.³⁴ Experts and practitioners alike emphasise a need for a new approach to guarantees that diverges from the MDBs, and doing so presents an opportunity for Australia to participate in the creation of a new set of best practices by formulating its own policies around equity backing, pricing, risk targeting, and product standardisation. Undertaking this effort could give Australia an opportunity to shift paradigms and greatly increase the ability and scope for guarantees to crowd in private sector investment in the Indo-Pacific. However, as with the previous suggestion, feasibility should be explored further, given the considerable demand observed in the region.

Additionality to bilateral funders

Australia could be additional to other bilateral funders in the following ways:

- **Taking advantage of national areas of industry and government expertise to provide packages of Australian capabilities alongside competitive financing options.** Stakeholders from developing countries in the region indicated that the major value of Australia's partnership would primarily from the technical expertise that Australia can bring to key projects. Country governments and private sector actors already view Australia as an important partner, with this credibility earned

³¹ Since China publishes no data on its development finance, this analysis was conducted using crowd-sourced, unofficial data compiled by AidData, available here: <https://www.aiddata.org/data/chinese-global-official-finance-dataset>. Given the nature of the data, this analysis is intended as indicative rather than authoritative.

³² Nancy Lee, *Billions to Trillions? Issues on the Role of Development Banks in Mobilizing Private Finance*, 17 November 2017.

³³ Chris Humphrey and Annalisa Prizzon, *Guarantees for Development: A Review of Multilateral Development Bank Operations*, 2014.

³⁴ Ibid.

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through the deployment of long-term technical advisors across several sectors. These potential partners mentioned considerable industry expertise, notably in mining, land and maritime transportation, agriculture, health and education, that positions Australia as an exceptionally capable partner. Australia is also a leading donor when considering how to integrate gender equality and women's empowerment into development assistance. Other funders have taken advantage of their own national expertise to great effect; for instance, by capitalising on its experience with urban public transportation, Japan International Cooperation Agency (JICA) has become the go-to funder for these projects.³⁵ By offering funding packaged together with export assistance and TA, Australia can offer a more valuable product that provides outsize influence relative to an equal-cost amount of funding alone.

- **Using open procurement processes to optimise implementation quality and cost and compete with highly concessional finance.** Where other donors in the region offer highly concessional funding, it often comes at the cost of poor financial sustainability or rigid procurement rules, which may lead to budget and timeline overruns. While there is a strong demand for funding in the region, consultations with many multilateral and national institutions emphasised the need not only for financing, but also for open procurement and capable project management. Opening procurement, and adopting other measures focused on lowering project cost and uncertainty, will allow Australia to compete with donors that have expressed a clear willingness to freely offer highly concessional financing with tied procurement.³⁶
- **Focusing on demand for effective project implementation, rather than seeking to compete on concessionality.** National governments in the Indo-Pacific plan for a level of infrastructure investment that exceeds the level of external financing available. Many of the unfunded projects have the potential to be both financially viable and create positive development outcomes, notably those in power generation, transportation and water and sanitation. In consultations, stakeholders emphasised that their demand for funding wasn't only for capital or technical expertise *per se*, but for well-designed projects implemented by capable contractors. Australia's TA with project delivery is widely viewed as high quality and relevant, and is a critical way through which Australia has demonstrated its commitment to the long-term development of its partner countries.

Across the region, extremely diverse and idiosyncratic funding demands require from Australia the flexibility to use a full variety of financial instruments, including both grants and NGF. Opportunities depend on particular situations, each of which may be particularly suited only to a subset of the financial instruments that this report recommends for Australia's use. Because many of the needs that NGF can meet appear across a variety of country contexts, no single variable dictates the applicability of NGF financing within those countries. The assessment of how to finance a given opportunity is more likely to reach an optimal solution, regardless of geographical context, if Australia were to offer a range of financing options including loans, equity, guarantees, and grants.

³⁵ For an example of how Japan operationalises this expertise, see: Japan International Cooperation Agency, 'Learning Japanese Experience in Urban Public Transport,' JICA, October 2017. <https://www.jica.go.jp/uzbekistan/english/office/topics/171115.html>

³⁶ There may be politically sensitive projects, including critical infrastructure, for which limited procurement is appropriate.

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Development Impact

Australia has for long supported the use of NGF among ways to achieve the development program's objectives, predominantly by helping to finance MDBs and specialist intermediaries.

Examples include:

- **Loans:** commercial and concessional loans have been made to public and private sector entities and projects, most notably through WB, ADB, Green Climate Fund, Private Infrastructure Development Group (PIDG) and IFC.
- **Equity investments:** these have been funded by DFAT through IFC, ADB and InfraCo Asia.
- **Risk mitigation instruments:** guarantees, insurance (including for political risk), securitisation, currency hedging and other instruments have been promoted by DFAT through MIGA, GuarantCo, and Overseas Private Investment Corporation (OPIC).

The development impacts of NGF-based programs have been evaluated and validated, along with the grant-based ones in Australia's development assistance program.³⁷

The implications of using NGF for development purposes do not lie in the financing mechanisms themselves, but in the possibility that using them could mean working with different entities in lead roles in project development.

If Australia used NGF to finance projects that were similar to those it now finances with grants, the development impacts would be similar. For example, if ADB financed an Independent Power Producer (IPP) and Australia supported it with an off-take guarantee, ADB as lead financier would have the main task of ensuring development impact, and Australia would assess the project as in other instances of co-financing with ADB, possibly supplementing with TA for M&E.

As another and obvious example, if Australia financed a project to rehabilitate roads through economic corridors in low-income areas of Sri Lanka, choosing to finance the project through a loan to the provincial government rather than grants, Australia's design, implementation and subsequent evaluation of the project would be just the same.

If Australia participated with NGF in programs with private companies, fund managers or local super/provident funds, and without an MDB as lead financier, ensuring development impact could involve larger tasks for Australia's development-assistance officials.

Australia's policies and safeguards are excellent and the envy of many of its peers, including those on the importance of gender equity, and protections around child exploitation, whistleblowing, sexual harassment and the environment. To ensure development impact is achieved, these principles and policies must be applied throughout project design, procurement, construction, operation, maintenance and M&E.³⁸

Where Australia relied on a project leader that was not an MDB or a reputable multinational corporation, or where Australia took the lead role in the transaction, then the responsibility for embedding practices to ensure development impact would fall to Australia, directly or through its specialist advisers.

³⁷ See, for example: Department of Foreign Affairs and Trade, *Performance of Australian Aid 2016–17*, 2018; Department of Foreign Affairs and Trade, *Performance of Australian Aid 2015–16*, 2017; Asian Development Bank, *2016 Development Effectiveness Review*, 2017; Office of Development Effectiveness (ODE), *Banking Our Aid: Australia's Non-Core Funding to the Asian Development Bank and the World Bank*, 2015.

³⁸ DCA consultation, 2 Nov 2018

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For example, if Australia were considering supporting an IPP project developed by an international company in negotiation with a government-owned utility, with the lead financier being the company's commercial bank and other banks taking small syndications, there would be a major task for Australia in assessing the project *ex ante*. If Australia went ahead as, say, a part-guarantor of offtake, it would quite likely need to provide TA for M&E of a kind which neither the company nor the utility would have a strong motive for undertaking.

The design and procurement process for the role of Manager of the Emerging Markets Impact Investment Fund (EMIIF) has demonstrated the challenge of applying non-negotiable standards to EMIIF's investee funds where DFAT will be a minority funder. Considerable TA is likely to be needed (over and above project cost) in the form of training and M&E.

But the need for additional measures to ensure development impact would vary with situations.

For example, if a major PNG super fund wanted Australia to co-invest in an agricultural business with an excellent track record in innovative development and plans for further expansion, assessment of development impact would be straightforward and in line with work currently done by officials at the post, although structuring the co-investment would be a specialist task.

Again, if an international company which for some years had been operating a port in Fiji planned to expand the port's capacity, and its commercial bank asked for a subordinated loan from Australia so that it could more readily provide the bulk of the finance through a loan with unusually long tenor, assessment of development impact would be relatively straightforward, and might be done in conjunction with due diligence by Efic.

Or if Australia chose to co-invest in Indonesia with a local fund specialising in "angel capital" for hi-tech, hi-growth businesses that were not yet eligible for commercial finance, the fund's track record would substantiate the prospect of development impact from co-investing.

Many private companies use standard methods for assessing development impact, which would supply part of the framework needed in choosing projects for financing support.

There is a growing movement, both among large internationally-operating companies and among the contributors to blended finance for infrastructure, to follow common methods of defining and measuring the development impacts of their investments. For example:

- The World Benchmarking Alliance promotes measures of companies' performance in respect of the Sustainable Development Goals, in particular areas including climate action, gender equality and empowerment, and seafood stewardship
- The Global Environmental Management Initiative's Metrics Navigator helps companies in rigorous specification of their non-financial objectives and in choosing measures of success in attaining them
- The Measuring Impact Framework, developed by the World Business Council for Sustainable Development, helps companies understand their contribution to society and use this understanding to inform their investment decisions
- The Global Reporting Initiative—a partner of DFAT since 2015—encourages organizations, for example through the Corporate Reporting Dialogue, to report publicly on their economic, environmental and social impacts, and thereby show how they contribute towards sustainable development.

These standard methods are promoted by MDBs and DFIs in their blended finance arrangements.

In order to guide DFIs and bilateral agencies selecting projects for blended finance and other private-sector operations, IFC and the European Bank for Reconstruction and Development led

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an effort which resulted in 25 different international finance institutions from around the world agreeing to the Harmonized Indicators for Private Sector Operations (HIPSO). There are currently 38 reporting indicators, across 15 different sectors and industries including cross-cutting.³⁹ The HIPSO indicators have definitions agreed upon by the participating institutions, and are available for any entity wishing to use them.

The Donor Committee for Enterprise Development is a network for donors to share best practices in private sector development, and has developed a standard for measuring results which is currently used in about 150 donor-funded programs.⁴⁰

Gender lens investing has shown that building capability through working with new partners is already part of the development assistance program.

As impact investments have grown as an asset class, and the range of specialist advisers and funds has increased, there have been more opportunities for Australian development assistance to be channeled through investors that apply a gender lens - see Box A. Grasping these opportunities has involved a process within DFAT of learning and building capability, then increasingly taking the initiative in forming funds and programs.

In a similar manner, if Australia were to have NGF available for company-led projects, it could begin by choosing partners which use these methods, and learn how far they can be relied upon, and how far they need supplementing, when there is no MDB as lead financier.

BOX A—GENDER EQUALITY

Immense and persistent gender disparities exist in developing countries across nearly all outcomes the Australian development assistance program cares about, ranging from agriculture (where female productivity is 30% less than the male equivalent) to ICT (where 25% fewer women than men have access to the internet).

The McKinsey Global Institute estimates that between USD 12 and 28 trillion could be added to the global GDP by 2025, simply by advancing gender parity. Empowering women has also been shown to yield disproportionate developmental returns, resulting in greater investment towards children's health, nutrition, and education.

Australia recognises (and has enshrined, in documents such as the *Gender Equality and Women's Empowerment Strategy* 2016 and the *Foreign Policy White Paper* 2017) the importance of women's empowerment, as a valuable end in itself as well as in achieving inclusive and sustainable development. It has prioritised its international assistance to support initiatives that improve gender equality, and has substantially tied its aid performance targets to the realisation of gender outcomes. The programs of gender lens investment which DFAT supports involve partnerships with several fund managers with best-practice systems for incorporating a gender lens in their investments – Patamar Capital, SEAF, IIX Asia and Women's World Banking Capital Partners – and with contributing think-tanks such as Criterion Institute.

With the benefit of these partnerships and growing in-house expertise, DFAT has increased its roles in design and management of recent programs, including the EMIIF and the Scaling Frontier Innovation Program.

³⁹ Harmonized Indicators for Private Sector Operations, *Indicators*, accessed 3 December 2018, <https://indicators.ifipartnership.org/indicators/>.

⁴⁰ DCED website, accessed 5 January 2019, <https://www.enterprise-development.org/intro-to-the-dced/>.

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Some high-priority objectives of Australia's present program are being met through funds or intermediaries that employ flexible financing methods. They might welcome contributions in matching forms such as equity shares and loans, rather than grants.

Especially in pursuit of its objectives of gender equality and private sector development (including incubators and accelerators), DFAT currently uses grants to support programs that provide flexible financing for enterprises, including equity and concessional loans. It seems likely that in at least some of these programs, Australian financing would be more efficient in forms other than grants, and this would be accepted by those agencies and fund managers.

The use of loans or equity can be positively helpful for development impact, compared with grants, by building business discipline and independence and by aligning incentives.

Loans to SMEs or equity in them (rather than grants) can build financial muscle and the discipline necessary to repay the funds, service the customer, or expand operations. While grants can foster dependence,⁴¹ investment builds management capacity and market-readiness in investee companies. Participating in emerging businesses through patient or capped equity could provide their other owners with added incentives for achieving development objectives.

Microfinance practitioners have found that charging interest on funds provided by donors or investors to microfinance institutions (MFIs) can increase efficiency in terms of numbers of loans and thereby borrowers' welfare, compared to grant or concessionary funding.⁴² Pricing loanable funds strengthens the MFIs' incentives to put effort in credit administration or monitoring and/or reduce overhead costs. This brings them closer to being able to sustain similar lending from their own sources of funds.

It may also be more generally defensible, when development assistance is provided to for-profit companies, for it to be in the form of NGF rather than grants.

Equity stakes can provide a means of influencing development impact at Board level

The rights that accompany an ownership share allow access to critical documentation and influence on decision-making for as long as the equity stake is held. These rights could be used, for example, to ensure proper procurement process, to encourage hiring and training of local employees with gender equality and inclusion of people with disabilities, to ensure maintenance in due course, and to promote good governance of the business—all of which enhance development impact.

In businesses which are prominent in the economies of Pacific island countries, regular involvement as an equity holder (for example at monthly management or board meetings) would offer a long-term opportunity for relationship development—and so for influence more broadly than on the business itself. It would also make Australia's contribution continually visible.

However, being an active equity investor is costly in terms of resources, and involves more reputational risk than being a financier.

Such a role should be chosen only selectively, either through funds or in companies. In general, the additional resourcing and risk involved are likely to be justified only where Australia envisages, for whatever mix of development and foreign-policy purposes, to maintain for at least some years a close relationship with the entity involved, and any government agency which figures in its business environment.

⁴¹ PNG, Jakarta Post consultations

⁴² Alexander Karaivanov, *Non-Grant Microfinance, Incentives and Efficiency*, 2018.

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NGF can magnify the development impact from each dollar of assistance by catalyzing and crowding in other investment

GuarantCo provides local currency guarantees for infrastructure financing and dollar-denominated guarantees in fragile and conflict-affected countries. Over ten years, its US\$ 300 million in funding has catalysed investment commitment of US\$ 4.7 billion, of which US\$ 3.8 billion is private sector.⁴³

Small amounts of first-loss cover, or partial guarantees, can release significant multiples of capital for investments that generate development impact. For example, the IIX Women's Livelihood Bond, raised US\$ 7.5 million using a US\$ 500,000 first loss piece and a 50% partial guarantee from USAID and DFAT.

For this reason, first-loss cover is a tool now in widespread use through cooperation between MDBs and donors, to reduce an obstacle for local financial institutions (FIs) to extend their lending in ways that serve development—that is, to groups targeted for the sake of social inclusion, fostering employment or reducing greenhouse gas emissions.⁴⁴ Donors usually provide support in grant form, but repayable grants can serve the same purpose, and for Australia could represent more efficient use of funds.

Social impact investing can, as well as leveraging private funding, bring private-sector know-how to help emerging businesses develop into ones that provide revenue, jobs and income.

Loans and equities would produce reflows, at least in large part, of the amounts originally invested, enabling them to be “recycled” in new investments.

Loans and equity investments made for purposes of development impact should, unlike commercial investing, be expected overall only to break even, or perhaps to incur some small loss. In other words, most rather than all of the original investments could be expected to flow back and be available to re-invest in the long term.⁴⁵

In the case of guarantees, there would be no possibility of recycling; and since for the sake of maximising development impact the guarantee fees charged would often be sub-commercial, there could be losses at the portfolio level in the long term.

There are well-established means of ensuring that offering loans for development assistance would be consistent with sustainable management of debt

Debt sustainability analysis has been used since 2002 by the International Monetary Fund (IMF), WB, ADB and other institutions to guide assessments of how well countries' governments can afford to service the amounts of external debt they have incurred.

According to assessments made in 2017 or 2018 for countries to which Australia provides development assistance, and which are shown in full in Annex 8:

- in the immediate region, Kiribati, Marshall Islands, Micronesia, Samoa, Tonga and Tuvalu are at high risk of debt distress, while PNG, Solomon Islands, Timor-Leste and Vanuatu are at moderate risk

⁴³ PIDG, *Annual Report 2016, 2017*.

⁴⁴ The MDBs involved usually offer funding to the FIs as a positive incentive; for “green” lending the Green Climate Fund or others may offer concessional funding; and donors may offer in conjunction with first-loss cover other kinds of grants—for incentives for FIs or borrowers, or for advisory support—depending mainly on how demanding the targeted type of lending is likely to be for the FIs.

⁴⁵ There are several relevant factors – including grace periods and tenors for loans, exit plans for equities, and possibilities of rescheduling or losses in \$A value – and working estimates would require financial modelling. Put very simply, the bulk of sums lent or invested is likely to be “recyclable” between five and fifteen years.

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- in Southeast Asia, Laos is at high risk
- in South and West Asia, Afghanistan and Maldives are at high risk, and Bhutan is at moderate risk.

In order to help some of its member countries avoid unsustainable amounts of debt, ADB offers them grants from the Asian Development Fund instead of concessional loans or in combination with them. ADB is currently providing 100% grants to seven of the smallest Pacific island countries, 50% grants to two others, and concessional financing to three that are not eligible for grant financing.⁴⁶

It is clear that if Australia's development assistance program were to include loans for governments or government-guaranteed entities, it should be a policy tenet that such loans could be offered only where they would not add materially to risks of debt distress. Grants, or combinations of loans and grants, would have to be used instead to take account of the relevant government's debt-service capacity.

This would leave open the possibility of loans to private companies or non-guaranteed state enterprises provided they, as distinct from their governments, were credit-worthy.

Equity investments, and loans to non-guaranteed private companies, would not increase governments' indebtedness and could contribute in time to tax or other revenue.

Private-sector projects assist in building economic activity and raising tax revenues, increasing the ability of host governments to meet debt-service obligations.

Similarly, the use of guarantees and other risk-sharing instruments would not increase governments' indebtedness.

Use of these instruments incurs fees rather than debts, and projects which they help to finance could contribute in time to tax or other revenue.

The implications of using NGF for measurement of development impact are much as was noted at the beginning of this section: the issue lies not in financing by itself, but in the practice and commitment of the lead sponsor.

In the example above (p14) of ADB financing an IPP and Australia supporting it with an offtake guarantee, ADB as lead financier would have the main task of ensuring the measurement at least of outcomes, as part of the usual completion report and subsequent evaluation. Whether or not Australia had chosen to supplement the project with TA for M&E, its shared responsibility for impact measurement would be a familiar one.

Taking an equity stake in a company-led project would provide strong leverage for ensuring that adequate provisions for impact measurement were built into the project.

There are widely adopted methods for measuring the impact of private-sector investments.

Many large international companies operating in emerging markets adhere to international standards for measuring the impact of their projects, or at least their outcomes, as was described above (p15). Choosing such companies to work with would reduce, although probably not fulfill, Australia's task in ensuring adequate M&E.

One measurement system is IRIS (see Box B). It is an initiative of the Global Impact Investing Network, a non-profit organization dedicated to increasing the scale and effectiveness of impact

⁴⁶ Asian Development Bank, *ADB's Submission to the Parliament of Australia's Inquiry into The Strategic Effectiveness and Outcomes of Australia's Aid Program in the Indo-Pacific and Its Role in Supporting Australia's Regional Interests*, June 2018.

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investing—investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return.⁴⁷

Other examples are the methods promoted by Benchmarking Alliance, and the standard indicators of development results used by PIDG, which DFAT has supported since its inception, for projects which it develops: they are shown in Annex 9.

Box B—Example of IRIS Measurement Metrics—Social Impact Objectives

<ul style="list-style-type: none"> - Access to clean water and sanitation - Access to education - Access to energy - Access to financial services - Access to information - Affordable housing - Agricultural productivity - Capacity building - Community development 	<ul style="list-style-type: none"> - Conflict resolution - Disease-specific prevention and mitigation - Employment generation - Equality and empowerment - Food security - Generate funds for charitable giving - Health improvement - Human rights protection or expansion - Income/productivity growth
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A further example is LeapFrog Investments, a Sydney-based investment firm. It has invested around US\$ 1 billion in financial services, insurance and healthcare across Africa and Asia. It reaches some 140 million people in 33 emerging markets, of which 117 million are low-income consumers. To drive profit-with-purpose performance, LeapFrog developed a proprietary in-house measurement framework called FIIRM, which encompasses financial, impact, innovation and risk management factors. FIIRM is used to rate investments prior to investment, and embedded in the company as a management tool, making impact and operational measurement readily available in real time.

Experimenting and learning about new ways to generate and measure development impact in challenging contexts is already part of Australia's development assistance program, for example through partnership with the Global Innovation Fund, and through the innovationXchange.

⁴⁷ Global Impact Investing Network (GIIN), 'About IRIS,' *Impact Reporting and Investment Standards (IRIS)*, 2018. <https://iris.thegiin.org/about-iris>

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Budget and ODA-eligibility considerations

Budget

Our suggested principles for the budget treatment of NGF instruments are as follows. The basis for these suggestions is to reflect the Government's present budget principles, and to minimise the impact of using NGF on allocations of appropriations to other development assistance.

1. Funds which create financial assets (loans or equities) should come from the Consolidated Revenue Account (CRA) by a special appropriation, without affecting appropriations for other development assistance. Similarly, reflows from assets (loan repayments and proceeds from sales of equities) should go to CRA and not affect appropriations for development assistance.
2. Receipts of loan interest and equity dividends should go to CRA, with offsets for net cost in Public Debt Interest deducted from appropriations for development assistance.
3. Creation of each new financial asset should be accompanied by deduction of a Financial Risk offset from appropriations for development assistance. Although this would be a single amount rather than an annual one, the asset's risk level should be reviewed at least annually and the FR offset adjusted if necessary by an increment, positive or negative.⁴⁸
4. Creation of contingent liabilities through guaranteeing financial obligations of other parties, or by offering insurance, should similarly be accompanied by deductions of FR offsets from appropriations for development assistance. These would be in the nature of provisions against possibilities of later obligations to make payouts from CRA. If fees were charged for such guarantees or insurance, they should be paid to CRA and the relevant FR offsets adjusted.
5. If a guarantee contracted for development assistance purposes were to be enlivened and trigger a payout, or an insurance payout be required, it should be paid from CRA by a special appropriation, with the proceeds of any subsequent realisation of security being repaid to CRA.
6. Scope for creating financial assets as part of the development assistance program should be subject to a ceiling set by a decision of Cabinet or senior Ministers. The scope for creating contingent liabilities through guarantees or insurance should be subject to a separate ceiling, set similarly. In conjunction with these ceilings, a limit should be set for single exposures, with reference to assets and contingent liabilities combined.
7. If small grants were made in repayable form as part of the development assistance program, the amounts involved should be found from appropriations for development assistance, and any repayments should be added back to those appropriations.
8. The offsets mentioned in 2 and 3 above should be seen as uses of part of appropriations for development assistance, to be weighed against other uses within the development assistance program. While it is desirable that these offsets should be eligible for inclusion as ODA, this should not be regarded as essential (see next page).

Several options for institutional arrangements will be described on pages 23-26. They involve having financing transactions of new kinds made by DFAT in Option 1, Efic in partnership with DFAT in Option 2, a new entity in the same portfolio in Option 3, or a mixture of these in Option 4. It will be noted in that section how the suggested budget principles should be applied in the latter options.

⁴⁸ In due course these reviews of risk levels would be informed by actual experience of the incidence of defaults on loans, and of gains or losses from equities. Therefore prudent management of these financial assets could be expected to help contain their cost to appropriations for development assistance.

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ODA eligibility

Many countries in the Development Assistance Committee of the Organisation for Economic Cooperation and Development (OECD-DAC) use DFIs, investment funds and other vehicles to finance private-sector entities in developing countries, employing NGF. OECD-DAC members agreed in 2016 that the guidelines for ODA eligibility should reflect donors' efforts in private-sector financing for development purposes. Provisional guidelines were agreed and published in December 2018 that outline an *institutions-based* and an *instruments-based* approach to calculating ODA.⁴⁹

The OECD-DAC guidelines for the *institutions-based* approach mean that contributions to a DFI or other vehicle for private-sector finance can be counted as ODA, either in full or in proportion to the share of ODA-eligible activities in the vehicle's portfolio, and with any reflows (including profits) counted as negative ODA. The application of the OECD-DAC guidelines to the institutional options described on pages 23-26 remains to be determined definitively, but it appears:

- that contributing to a development-finance fund within DFAT, as in all of those options, might be eligible as ODA, but DFAT would need to clarify this with OECD-DAC; and
- that contributing capital or operating expenses for a new development-finance entity, as in two of those options, could be eligible as ODA, at least in some proportion.⁵⁰

Table 2 below shows how the provisional guidelines for an *instruments-based* approach would apply.

Table 2—Provisional guidelines for ODA measurement by financial instrument

Loans to private-sector entities	Eligible to be measured on a cash-flow basis if they have sufficient concessionality, namely a grant equivalent of at least 25% when the present value of obligations is calculated using a discount rate of 10%; if so, repayments are measured as negative ODA
Purchases of equity, including first-loss equity, in private-sector entities	Eligible to be measured on a cash-flow basis, with subsequent sale proceeds measured as negative ODA
Mezzanine finance for private-sector entities	Purchases are ineligible, while accounting treatment is disagreed
Guarantees and insurance extended to private-sector entities	Provision of these is ineligible, while accounting treatment is disagreed; but payouts of guarantees or insurance obligations are eligible, measured on a cash-flow basis

Offering NGF in Australia's program of development assistance would require dispensing with the ODA cap – that is, the policy of identifying appropriations for development assistance with what is eligible to classify as ODA. This is for two reasons: first, the size of asset-creating flows and reflows, and unpredictable timing of some of them, are incompatible with stability from year to year in forward estimates and appropriations; and second, the budget principles which we suggest applying to NGF would lead to development assistance appropriations differing from ODA-eligible amounts.⁵¹

⁴⁹ OECD, DCD/DAC(2018)47/FINAL, 12 December 2018, especially paragraphs 9 and 14 (x).

⁵⁰ The OECD-DAC guidelines say vehicles are eligible which have the economic development and welfare of developing countries as the main and primary objective of operations, and provide finance which is additional. It's unclear whether they refer to vehicles which principally, but not exclusively, finance private-sector entities.

⁵¹ For example, we suggest FR offsets should be deducted from development assistance appropriations if guarantees were extended, but if these were internal transfers they might not be eligible as ODA; or in the other direction, amounts outlaid to purchase equity stakes would be eligible as ODA, but what we suggest should be deducted from development assistance appropriations in these cases would be smaller amounts.

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Institutional, capacity, financing and risk-management requirements

In order to offer and administer NGF on even a modest scale, a step-up in specialised capability would be needed, and there would be an additional task of coordinating the use of new financing forms with grant-form assistance.

Institutional options

The first institutional question is whether a new development-financing function should remain within DFAT, for the sake of the closest integration with its foreign-policy and economic roles, or whether it would be better performed in a separate entity for the sake of having transparent operating policies, concentrating the necessary expertise, and developing a distinctive work culture.

If the choice is to have a separate, specialised entity, there is then the question of whether to combine the development-financing function with the functions of Efic, enlarged as planned, or keep it distinct from Efic in a new entity within the portfolio of the Minister for Foreign Affairs.

These two questions lead to three institutional options which could be satisfactory as ways of adding NGF to the development assistance program, as follows.

Option 1—DFAT with authorisation and capacity to manage a development finance fund

DFAT would be authorised to provide development finance in asset-creating forms, and to provide guarantees or insurance related to development finance.

DFAT would need to form a specialist unit to initiate and manage development-finance investments. This would require new skills in structuring or examining financing arrangements, and in financial negotiation and contracting. Special arrangements would be needed for remuneration and continuity in the unit, so that fully capable staff could be recruited and retained. Secondments from other departments or agencies might be helpful at least in the initial years.

This option would work better if Efic could provide (with cost recovery) both advisory support and a back-office function for DFAT. However, DFAT could need itself the ability to act as a project sponsor dealing with Efic at arm's length. It would help if IPFA could also provide support to DFAT (with cost recovery).

Option 2—partnership with Efic, which would be authorised to operate, when directed by its Minister, to provide foreign development finance of benefit to Australia⁵²

This option is separate from the proposal recently decided upon by Ministers for broadening the scope of Efic's commercial operations in respect of infrastructure. It is concerned instead with operations for purposes of development assistance which would be the object of DFAT advice and directions to Efic from the Minister for Trade.

In line with present policies of the development assistance program, Efic when operating in this additional mode would not require projects to source procurement from Australia, nor require

⁵² Additional budget principles for Option 2:

Efic would continue to operate commercially: any sub-commercial elements of financing arrangements which it undertook on DFAT's initiative for development purposes would be funded from appropriations for development assistance. This could be in any of three ways, chosen case by case according to the situation:

- as payments from DFAT to Efic, for example as interest-rate subsidies or guarantee fees;
- through DFAT finance or financial support provided directly to a government, project sponsor or project contractor/s, in conjunction with Efic finance; or
- for transactions on National Interest Account, through the existing arrangement for Efic's losses to be recompensed from CRA, with equivalent deductions made from appropriations for development assistance.

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project sponsors to be Australian companies. It would put part or all of such transactions on the National Interest Account as necessary, and remain subject to OECD rules for export credit.

While the bulk of the work of examining and structuring proposals for development-related financing and of conducting transactions would be done in Efic, it would still be necessary for DFAT to have a specialist unit to manage its part, for two reasons in particular:

- for reasons of ODA eligibility, it would be best for DFAT to have the ability to provide finance directly to project sponsors or contractors; and
- in developing proposals initiated internally, DFAT could need to negotiate with Efic as a separate party to transactions, so that Efic could avoid conflicts of interest.

This option too would be assisted if IPFA could provide advice to DFAT (with cost recovery).

Option 3—a new development finance entity⁵³

This would be a new Commonwealth entity in the portfolio of the Minister for Foreign Affairs. It would be established by legislation and meet the legal and institutional requirements for such entities, including by having its own governance, policies on investment and internal matters, and staff. These requirements are less extensive for non-corporate entities than for corporate ones.

Careful consideration would be needed of what functions to group in a new entity, for the sake of clear direction in its operations, and of developing and maintaining expertise among its staff.

- The new entity might be most effective if it focused on *infrastructure projects with development benefit*, rather than the whole range of development programs in which NGF could be used. This would mean leaving with DFAT the management of NGF for other development programs.
- Alternatively, the new entity might be most effective if it focused on infrastructure projects with development benefit, *plus other development finance with private-sector project leaders or private-sector finance*. This broader range of operations could include blended finance in other sectors – health, education, agriculture or local-level services – and NGF for MSMEs. This would mean leaving with DFAT the management of NGF for public-sector counterparts.

It would be best to have DFAT, as well as the new entity, authorised and equipped with capacity to manage NGF where this was judged most appropriate—but not to offer guarantees, or insurance for finance from other sources, because of the more specialised financial capabilities this requires.

These three institutional options can be compared in terms of their respective strengths, weaknesses, opportunities and threats, as shown in Table 3 below.

⁵³ Additional budget principles for Option 3:

- If this new entity were established with a special appropriation, having notional balances and not being separately capitalised, its principles of operation would be as for option 1.
- Separate capitalisation appears to have nothing to recommend it in the near term—that is, the next several years. But it should be kept for later consideration whether the new entity might be made a corporate entity, so that it could provide a platform through which Australian (and perhaps other) institutional investors could participate in financing the entity's portfolio of investments in regional developing countries (or selected ones of them).
- Funding for the new entity's operating expenses would be provided as part of annual appropriations for DFAT: it would require consideration whether to treat this funding as diversion of part of appropriations for development assistance.
- For the NGF functions remaining within DFAT, it might not be necessary to use appropriations other than those for development assistance. Reflows from maturing loans and investments should be added to appropriations, and so be available for new outlays of development assistance.

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Table 3—Comparison of institutional options

	Option 1 – DFAT alone	Option 2 – partnership with Efic	Option 3 – new entity
STRENGTHS	<p>Assured of being responsive to foreign-policy interests</p> <p>Assured of integrating the selection and implementation of new forms of financing with the rest of the development assistance program</p> <p>Readiest use of network of posts for identifying opportunities</p>	<p>Efic has much of the needed technical capacity</p> <p>Efic already has a Board, management and staff focused on finance</p> <p>Efic would present a distinct face to clients and the public as official provider of large items of development finance</p> <p>Efic can lend in foreign currency, subject to its own risk management</p>	<p>Would have a single, clear focus, and could develop its own corporate culture based on expertise in development finance and closeness to private financiers</p> <p>Would acquire its own standing among other countries' development finance institutions, and thereby be able readily to co-finance with them</p>
WEAKNESSES	<p>Specialist capacity would need to be established, with an initial period of reliance on contracted expertise</p> <p>DFAT's systems – in particular, for handling appropriations, making and managing contracts, and keeping accounts – would need modification to handle new forms of financing</p>	<p>Efic has at present no capability for making equity investments</p> <p>Efic has slightly higher cost of funding than Commonwealth</p> <p>Arrangements would be needed for coordination with the rest of DFAT's development assistance</p> <p>DFAT would have little in-house capacity to provide other development finance in non-grant forms</p>	<p>Probably more than 18 months would be needed for establishing the new entity's governance, staff, systems and in-house technical capacity</p> <p>It would be likely to involve significant additional cost to run</p> <p>Mandate would overlap considerably with that of Efic when the latter is extended as planned</p> <p>Arrangements would be needed for coordination with the rest of DFAT's development assistance</p> <p>As a separate entity, it would lack DFAT's close links with intelligence agencies</p>
OPPORTUNITIES	<p>Would most readily fit with reconfiguring the development assistance program to build economic partnerships with countries graduating from previous forms of assistance</p>	<p>Efic could enhance its links with other countries' export credit agencies, capable Australian companies and investment banks</p>	<p>Might help to bring about a more integrated approach to Australia's participation in multilateral banks, development funds and investment platforms</p>
THREATS	<p>Recruiting and retaining specialist staff with sufficient capability could be undermined by subordination to DFAT's practices in remunerating and reallocating staff</p> <p>Contains the risk that development objectives would be unduly subordinated to foreign-policy priorities</p>	<p>Legislative change might encounter resistance from Efic stakeholders concerned at weakening its function of assisting Australian businesses and employment</p> <p>Might appear as DFAT subsidising Efic's operations</p> <p>Might lead to preponderance of commercial objectives over development or foreign-policy objectives</p>	<p>Would create expectations of its soon operating on a substantial scale, which unless fulfilled could lead to criticism and embarrassment for the Government</p> <p>Other agencies with related functions, especially DFAT and Efic, could compete with the entity and make coordination problems outweigh its benefits</p>

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Multi-institutional Option 4

An external reviewer of our draft report has suggested that because the different instruments of NGF correspond to different purposes and counterparts, the best institutional arrangement could be to distribute responsibilities for them among DFAT, Efic and a new entity. We accept that such an arrangement should also be considered, and that the following allocation could also be satisfactory.

Instrument	Best institutional fit
Loans – concessional, subordinated, commercial or in local currency – if to a government or state-owned entity	DFAT – because it should handle the associated relationships with governments, their agencies, state owned enterprises (SOEs) and state-controlled joint ventures
Loans to private entities, including JVs with minority state equity	A new entity, separate from Efic , and specialising in finance for private-sector investments with high development value
Equity	Mainly for the new entity - although DFAT should keep EMIIF and other shares in small, high-social-impact funds, until they mature
Loss-sharing by repayable grants	The new entity , because these rely on expertise in how local FIs and investment funds operate; including arrangements with MDBs
Insurances for foreign exchange	The new entity , because these rely on relations with local FIs and their central banks; including arrangements with MDBs
Guarantees	Partnership with Efic <ul style="list-style-type: none"> would fit with Efic's expertise and its expanded mandate perhaps Efic could charge normal fees, and DFAT pay them on behalf of counterparts if DFAT paid counterparts who then paid Efic, this might still be ODA-eligible
Insurance for natural disasters	Split between DFAT and the new entity depending whether counterparts are governments and SOEs (DFAT) or private entities and MDBs (new entity)

This would have the advantage of a more suitable allocation of specialised capacities, but it would have the disadvantage of adding to the challenge of coordination.

If decisions are made to add NGF and innovative grants to the development assistance program, careful consideration will be needed of how best to balance the factors described in Table 3, and involved also in the multi-institutional Option 4. For this purpose, the study-team members from Dalberg Advisors have prepared a table of DFI benchmarks in the region, which is in Annex 10.

Capacity requirements

All the institutional options above would require a specialist support unit to be created, either wholly in DFAT or as a collaboration between DFAT and a new financing entity. This unit would have the core function, in respect of investments proposed for inclusion in the development assistance program, of assessing how they could be financed with the most effective and economical use, actual or contingent, of Australian funds. The unit's assessments should be made using specified methods, to ensure that they have enough scope, enough transparency, and enough attention to risks. This assessment method for any proposal would need to include –

- cost-benefit analysis, relating the proposal to the host country's public investment program
- (if considering loans) forecasting debt sustainability in the host country's public sector
- assessing any business case or pre-feasibility study
- identifying how the proposal relates to Australian trade and investment interests
- identifying how the proposal relates to Australian foreign-policy and strategic interests

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- examining the proposal's design quality, in terms of prospective development benefits, social inclusion, gender aspects and environmental protection
- examining the proposal's management, in terms of procurement, supervision, prevention of corruption or fraud, other legal compliance and monitoring of outcomes
- identification of risks—operational, financial, reputational and political—and planning methods for managing them.

It follows from this that certain types of capability would have to be added to what DFAT has already among its staff. The types of experts in the specialist support unit, either as core staff or available to be contracted quickly to add to them, should include –

- economists with knowledge of cost-benefit analysis, public investment programs, debt sustainability forecasts and pre-feasibility studies
- specialists in infrastructure of each type being proposed for finance
- specialists in types of investments other than infrastructure, such as agribusiness, natural resources, microcredit, support for SMEs and women-led businesses, renewable energy, energy efficiency, financial sector, logistics and tourism
- advisers on structuring and finance
- financial lawyers
- specialists in after-care, such as managing hands-on investments (equities, accompanying TA, equity exits), asset management including maintenance, and sovereign debt management, including rescheduling as and when necessary.

It would be necessary also to equip with additional capacity the posts which would share responsibility for the financial aspects of projects or programs with NGF.

A full matrix of the specialties likely to be needed for NGF is in Annex 11.

Timelines for developing capacity

Option 1—DFAT with authorisation and capacity to manage a development finance fund—essential arrangements to begin offering new forms of financing could be made within much the same period as would be required for drafting, consultation and consideration by Parliament of amending legislation—that is, at best six months.

Option 2—partnership with Efic authorised to operate, when directed by its Minister, to provide foreign development finance of benefit to Australia—the policy and operational frameworks, including risk management processes, to be developed and implemented under this option would be more complex than for Option 1—at best twelve months.

Option 3—a new development finance entity—establishing the new entity's governance, staff and systems, and building enough in-house technical capacity, would require considerably more time than preparation and passage of amending legislation—at least eighteen months.

Option 4—a multi-institution arrangement—parts of this involving DFAT's provision of loans and Efic's provision of additional guarantees could be authorised and established in a similar period as Option 1, at best six months, while those involving a new entity would as long as Option 3—at least eighteen months.

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Financing requirements⁵⁴

The establishment costs of pursuing any of the institutional options above would be mainly in DFAT staff time: perhaps the equivalent of 20 full-time staff for a year (20 FTE) at a range of levels for Option 1, 10-15 FTE for Option 2, and 20-30 FTE for Options 3 or 4. There would also be a cost in fees for AGS to prepare drafting instructions and related advice, of around \$1 million, and costs which we have not estimated – in fees for IPFA if it provided advice on the operating framework, and in other departments.

As for operational costs, offering new forms of financing at an initial level of several new loans each year with asset-creating flows of, say, \$400 million each year would, we estimate, probably involve additional internal costs of around \$2.5 million in a full financial year. Offering new forms of financing on a more substantial scale – say, ten new financing transactions each year, creating each year up to \$1 billion of new assets and up to \$500 million of contingent liabilities, would probably involve additional internal costs of around \$10 million a year.

⁵⁴ We have had the benefit of information from DFAT about the expected costs of establishing the financing facility for infrastructure in the Pacific, mentioned in the Introduction on page iii. Even so, our estimates are largely conjectural, and better estimates would help in deciding on the minimum viable level of NGF operations.

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Regulatory and legislative arrangements

Regulatory

Because of the novelty of NGF and its additional financial aspects and risks, it seems necessary for an IDC representing the coordinating departments and DFAT to have the initial task of formulating a framework in which proposals for NGF would be assessed, including:

- a) a method for choosing the best type of financing for each project or program;
- b) a method for determining Public Debt Interest and Financial Risk offsets;
- c) recommendations of separate ceilings to apply to financial assets and contingent liabilities, and a single-exposure limit to apply to financial assets and contingent liabilities combined;
- d) standard forms of documentation for proposals being adopted, including identification of risks and plans for managing them; and
- e) accounting treatments for individual NGF transactions, as well as the resulting portfolio of assets, in order to provide a basis for later determination of net gains or losses.

It would be helpful if IPFA could also participate in formulating this framework. Before the framework is put into use it should be submitted for approval by the Treasurer and Minister for Finance, as well as the Minister for Foreign Affairs. Ministers' decision should include setting separate ceilings for financial assets and contingent liabilities, and single-exposure limits.

This IDC should remain in being for a "running in" period of at least a year. During that period, documentation of proposals being adopted should be sent by DFAT, Efic or the new entity to IDC members, to give them an opportunity to convene and to refer issues to Ministers if any of them wish, before the proposals are implemented.

At intervals of six months during the "running in" period, and thereafter annually, there should be reports to the IDC on the overall progress of NGF and the state of the asset portfolio. These would be the basis for reviews of the financial risk offsets which had been made in respect of portfolio assets. When members consider the IDC is no longer needed, these reviews should continue through bilateral arrangements with the Department of Finance.

Legislative

The study team has had the benefit of advice provided by AGS in draft form early in our work, and subsequently finalised, about questions of constitutional power and legislative authority for use by DFAT of NGF in the development assistance program. Here the advice received from AGS is summarised in concise terms.⁵⁵ In Annex 12 there is a more detailed summary. The full AGS advice has been circulated separately and should be read in conjunction with this report.

For equity or quasi-equity—there is authority in s 58 of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act) for making equity investments with the main purpose of obtaining a profitable return; but since this would not be the case in aid contexts, authority could be established with low risk of a legal challenge being upheld only by enacting new primary legislation.

For loans that include concessional ones—authority could be established with low risk of a legal challenge being upheld either by inserting a new item in Schedule 1AB to the *Financial Framework*

⁵⁵ The AGS advice included some options for establishing legislative authority which AGS consider to contain a medium risk that a legal challenge would be upheld, and others containing a low risk of a legal challenge being upheld. Only the low-risk options are summarised here.

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(*Supplementary Powers*) Regulations 1997 (FFSP Regulations), or by enacting new primary legislation.

For guarantees— legislative authority could be established with low risk of a legal challenge being upheld only by enacting new primary legislation. At present the PGPA Act confers only on the Minister for Finance the power to grant guarantees of the kind likely to be useful for development assistance. It would be a substantial policy issue whether, and with what conditions, to enable the Minister for Foreign Affairs or DFAT to grant guarantees for purposes of development assistance.

For insurance— Legislative authority could be established with low risk of a legal challenge being upheld by amending Schedule 1AB of the FFSP Regulations or by enacting new primary legislation. This legislation could also put beyond doubt non-application of the *Insurance Contracts Act 1984*.⁵⁶

Next steps for Ministers

Because of the difficulty of estimating the scope for offering new forms of finance without a more detailed reconnaissance, we suggest that Ministerial decisions about the matters in this study be in two groups, with the intervening period used both for preparing a legislative proposal and consulting on it, and for undertaking one or several missions for detailed reconnaissance of financing prospects.

That would enable a second set of decisions to be better informed by an estimate of the likely scope and scale of the use of new forms of development finance, and by more extensive consideration of how this new set of operations would relate to the Government's most relevant institutions.

This is reflected in our recommendations on pages xi-xii above. In brief terms, we suggest the next Ministerial decisions should be to:

- agree on offering NGF and innovative grants as additional elements of Australia's development assistance, and replacing the ODA cap with budget rules accommodating NGF
- establish a high-level working group to guide the formation of a specialist support unit and its operating framework, to prepare drafting instructions for legislation to authorise financing in new forms, and to examine in more detail the scope for use of NGF, including in joint financing, and plan its introduction and expansion.

A second, later set of Ministerial decisions should be to:

- determine the best institutional option for the longer term
- prepare drafting instructions for additional authorising legislation, if necessary
- appoint an external advisory panel, especially to guide coordination among institutions
- publish a discussion paper to inform the interested public.

⁵⁶ This is explained in paragraphs 88 and 89 of the AGS advice.

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Risks and their management

This summarises only the main risks added through NGF. A risk-management matrix is in Annex 2.

Political risks might arise if other governments or their agencies resisted directly, or criticised publicly, actions needed to protect the value of investments, for example to realise security assets in the event of guarantee or insurance enlivenments. The methods we suggest for managing these political risks are those DFAT uses when host governments resist or criticise actions needed to protect the purposes or standards of investments in the development assistance program. Choices of NGF as financing methods should include recognising such risks and providing for managing them.

Reputational risks are not necessarily associated with any form of NGF: they would arise only if choices of NGF involved association with unfamiliar project sponsors or financiers which were not committed to meeting the aid program's standards and safeguards, and without having sufficient means of influence on them. The method we suggest for managing these reputational risks is, in using NGF, to work initially with known, reputable partners and learn from them, before adopting financing roles involving greater reliance on new corporate or fund-manager partners.

The **financial risks** arising from use of NGF are of incomplete recovery of sums lent or invested through various possibilities of defaults on loan repayments, losses in value of equity investments, or reductions in \$A value of repayments or sales denominated in foreign currency. The methods we suggest for managing these financial risks are additional capability in a specialist support unit, a structured approach to choosing financing methods, deductions from aid appropriations of FR offsets, and a decision-making framework including limits on financial risks.

Addressing financial risks, while necessary, itself contains a risk of getting them out of proportion. Risks of incomplete recovery should be assessed in comparison with the complete non-recovery of sums outlaid as grants; and uses of NGF should be primarily for development purposes, and so not primarily for obtaining financial returns. The need to keep financial objectives in proportion is our main reason for recommending integration of decision-making about NGF in DFAT's existing management of the development assistance program, at least for an initial period.

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ANNEX 1—TERMS OF REFERENCE OF FEASIBILITY STUDY

The Feasibility Study will address opportunities, challenges and risks in relation to the following:

- **Strategic Implications.** In the context of growing geostrategic competition, the degree to which use of a broader range of financing instruments in the aid program would:
 - improve capacity to deliver on Australia's *Foreign Policy White Paper* priorities relative to a "business as usual" approach
 - enhance Australia's influence in promoting open markets and regional economic integration in the Indo-Pacific.
 -
- **Demand.** The degree to which the use of a broader range of financing instruments in the aid program would:
 - add value above and beyond what is available from other multilateral and bilateral donors in the areas of geographic and sectoral priority for Australia's aid program, noting the limited absorptive capacity of many Pacific island countries
 - address unmet demand from developing country governments or private sector entities in the Indo-Pacific region
 - enable instruments to be tailored to the particular needs of the private sector entities interested in investing in development projects in developing countries, including but not limited to Australian companies
 - be able to compete with other sources of finance given the high degree of concessionality (and other benefits) from some parties.
 - address the different financing needs of small island states in the Pacific and emerging economies in South and South East Asia.
- **Development Impact.** Provide evidence (where available) of the degree to which financing instruments such as loans, equity investments, guarantees and insurance products:
 - have demonstrated development impact, including relative to grant aid
 - have development impact beyond the immediate investment, including through catalysing other investment and recycling funds
 - are consistent with sustainable debt management in partner countries
 - enable measurement of development impact.
- **Budget and ODA-eligibility considerations.** Identify and consider the options for managing the Australian budget treatment of different financial instruments (including on the balance sheet) and the ODA eligibility of
 - the start-up phase, including any initial capital injection
 - ongoing operations
 - financial reflows generated from grant and NGF
 - closure of operations
 - financial losses from defaults, restructuring or guarantee calls.

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- **Institutional, capacity and financing requirements.** Present a range of options for institutional arrangements, analysing the strengths, weaknesses, opportunities and risks of each, including with regard to:
 - effectiveness in delivering strategic and development objectives
 - time, cost and feasibility of developing or recruiting the necessary capability
 - start-up and ongoing operational costs, including with regard to any initial capital investment
 - sustainability of financing and operations
 - pricing and sale of illiquid equity investments
 - DFAT's safeguard and policy requirements.
- **Regulatory and Legislative Arrangements.** For each instrument, analyse and make recommendations with regard to regulatory and legislative requirements and the associated institutional arrangements, including:
 - means of ensuring compliance with relevant existing legislation, such as the *PGPA Act* and the *Financial Framework (Supplementary Powers) Act*
 - requirements for new legislation or amendments to existing legislation
 - requirements for new or amended regulatory arrangements.

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ANNEX 2 - Risk-management matrix

This matrix is confined to the set of risks which would be associated with adding NGF to choices of financing methods in the development-assistance program, while maintaining the program's present policies, safeguards and practices. It therefore addresses a small set of risks compared with those already associated with managing the program – for example, those identified and addressed recently in preparing EMIF and the Southeast Asia Economic Governance and Infrastructure Facility.

Estimates of likelihood cannot at this stage be made with any precision, and so are presented in terms of bands: small = less than 10%, moderate = 10-24%, substantial = 25-49%, large = 50% or more.

risk category (shaded for importance)	risk event	risk source	risk impact	likelihood without treatments	recommended treatments	likelihood with treatments	target risk rating
political	host government, as borrower or guarantor, objects to Australian action to protect the value of investments	government hosting investment	damage to cooperative relations	substantial	<ul style="list-style-type: none"> apply the same diplomacy as when host governments resist or criticise actions necessary to protect the purposes or standards of development investments include in appraisals to advert to such risks and need for diplomatic resources to manage them work where practicable with MDB and DFI partners 	moderate	medium
	host government objects, on behalf of borrower or guarantor, to Australian action to protect the value of investments	government hosting investment	damage to cooperative relations	substantial		moderate	medium
	host government has difficulty managing tasks as borrower or guarantor added by Australia	extra tasks associated with NGF by Australia	damage to cooperative relations	moderate	<ul style="list-style-type: none"> include in appraisal to check borrower's loan-administration capacity offer additional TA if Australian creditor requirements are additional 	small	low
reputational	association with project sponsor or financier not committed to fulfilling required standards and safeguards	project sponsor or financier	difficulty in "crowding in" other investors	substantial	in using NGF, work initially with known, reputable partners, so as to learn from them before adopting financing roles involving greater reliance on new corporate or fund-manager partners	moderate	medium

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risk category (shaded for importance)	risk event	risk source	risk impact	likelihood without treatments	recommended treatments	likelihood with treatments	target risk rating
impact	failure to “crowd in” other investors	developments in local financial markets	less indirect benefit from use of NGF	substantial	<ul style="list-style-type: none"> use specialist capability in assessing market conditions work where practicable with MDB and DFI partners 	small	low
	failure of supported local incubators and investment funds			substantial		small	low
generic for new DFAT activities	problems finding expertise	limits on pay and career expectations	inadequate operational expertise	large	special arrangements for remuneration and contracting	small	low
	understaffing over time						
	counter-productive internal competition for resources	management practice	inadequate level of operations	substantial	Ministerial and management commitment to developing use of NGF in long term	small	low
	unrealistic expectations about rate of delivery	public statements, media coverage	embarrassment for Ministers and DFAT	large	realism in statements, responses to questions, workplans and performance measures	substantial	medium
linked with institutional options 2-4	failure of coordination	managements of relevant institutions	unsatisfactory performance of NGF operations	substantial	Ministerial and management commitment to sustained cooperation on NGF	small	low
	competition in external contacts			substantial			
	competition for staff and funding from Budget			substantial			

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risk category (shaded for importance)	risk event	risk source	risk impact	likelihood without treatments	recommended treatments	likelihood with treatments	target risk rating
financial	incomplete recovery of loan interest or principal	borrower	\$ cost	substantial	<ul style="list-style-type: none"> specialist assessment capability structured approach to choosing financing methods deductions from aid appropriations of offsets for financial risks decision-making framework including limits on financial risks taking security for guarantees wherever practicable limiting exposure to exchange-rate risk to a small proportion of investments 	moderate	low
	reduction in \$A value of loan payments in local currencies	foreign-exchange market	\$ cost	substantial		small	low
	enlivenment of guarantee or insurance obligations	entity guaranteed or insured	\$ cost	substantial		small	low
	loss in local value of equity	project outcome, local market	\$ cost	substantial		moderate	low
	loss in \$A value of equity sales in local currencies	project outcome or local market	\$ cost	substantial		small	low
	non-recovery of equity because of illiquidity	foreign-exchange market	\$ cost	substantial		moderate	low

ANNEX 3—Country Report: Indonesia

This annex has been developed by Dalberg Advisors, and represents their independent interpretation and analysis of the team's visit to Indonesia.

Section I EXECUTIVE SUMMARY

1. For Australia to engage more strategically in the Association of Southeast Asian Nations (ASEAN) region, Indonesia remains the most important partner. To date, however, Australian financial activity in the country has been relatively limited.

Indonesia is the fourth most populous nation in the world, with a population of 270 million, is Australia's largest neighbour by area, and the largest country in ASEAN, wielding considerable geopolitical influence in the region. The country is politically stable and has established itself as a democratic model for other ASEAN fledgling democracies. With an annual GDP growth rate of 5.2%, Indonesia is also the fastest growing economy in Southeast Asia. However, Australia's annual development assistance budget for Indonesia has seen a decline over the last five years. The 2018–19 budget of US\$ 228 million may be insufficient to enable the development of a mature economic partnership. This is especially likely considering the scale of demand for economic and social infrastructure in Indonesia, and the envelope sizes of competing donors.

2. Adopting a broader suite of development finance tools will enable Australia to more effectively influence, and contribute more to the region's growth, stability and prosperity.

There is both a political and a developmental rationale for adopting these tools. Participating in Indonesia's growth as an investor will entitle Australia to a seat at a broader range of tables and represent a better way of exerting influence over specific projects in which Australia and Indonesia may have common goals. Given Indonesia's size, even vast sums of money will not translate to influence on overall policy—according to estimates, the combined aid flows from all donors constitute less than 2% of the overall national budget.

3. However, NGFs and grants (especially when structured efficiently—e.g., made returnable) can make a difference in very specific sectors, regions or sets of challenges, and in so doing, can position Australia as a trusted strategic partner.

For instance, by participating selectively in infrastructure financing, Australia will have the opportunity to partake in critical economic projects that may not be currently available through traditional grant financing alone, and thereby play a role in guiding the direction of development in the country. Doing so not only would promote Australia's economic objectives, but would also respond to strong development needs—if Australia can provide sustained, high quality support through NGF and accompanying TA, it can contribute to the country's continued prosperity, growth and stability.

4. Within the current financial envelope, NGF and catalytic grants may be useful for a number of opportunities.

We have identified a non-exhaustive list of these opportunities as (a) impact investing in promising social enterprises through impact funds in order to create sustainable business models, (b) assisting the funding of well-functioning credit cooperatives in order to improve overall access to finance, (c) deepening capital markets to mobilise domestic and institutional capital across economic sectors; (d) mobilising private capital from institutional investors toward financing infrastructure projects, (e) financing impactful infrastructure and related projects at the provincial level through the use of municipal bonds, (f) helping establish methods such as aggregation platforms to improve the domestic financing of local-level infrastructure and (g) supporting private-sector providers of technical training willing to benchmark with Australian standards.

5. Grants continue to be important for social and economic development while Indonesians also appreciate bundled technical assistance (TA) packages. An example is the US\$ 27.2 million Provincial Road Improvement and Maintenance (PRIM) initiative, an output-based grant program through which Australia provides incentives for Indonesian subnational governments to implement road maintenance and rehabilitation works. Grants structured in this innovative manner help ensure project accountability and sustainability by installing M&E processes and employing strict performance criteria, as well as by working through and bolstering existing government systems. Another example is the AUD 37 million grant component in the Eastern Indonesia National Roads Improvement program (EINRIP), extended in combination with an AUD 276 million loan. The combination of both loans and grants in this project enabled funds to be used effectively—in fact, government agencies have credited EINRIP with producing among the best quality roads recently achieved in Indonesia. Additionally, Indonesia has found it extremely useful to have access to a skilled workforce deputed in key ministries through the support of Australia. Based on limited consultations, we believe that many of the stakeholders occupying key positions across the government and private sector in Indonesia have completed parts of their education in Australia, many with the support of scholarships provided by Australia.

6. Indonesia's rapid development requires a broader range of support than Australia can provide with grants alone. Given the limited size of Australia's development assistance budget compared to other funders in the region, the ability to make use of a suite of financial instruments that can be tailored to the specific needs of the Indonesian public sector and the desired profiles of prospective private sector investors is critical to ensuring that Australia's development finance will be able to meet the country's rapidly shifting needs. Our field research has revealed strong demand for NGF from the Indonesian public sector—as public debt mounts, an estimated US\$ 83.5 billion will be sought from the private and developmental sectors for the government's ambitious National Medium-Term Development Plan 2015–2019⁵⁷—and has also revealed that engaging the private sector can lead to a profound magnification of impact. For instance, our consultations indicate that the ADB targets a mobilisation multiple of 6x from private sector alone for its investments in Indonesia.

Section II ANALYSIS OF STRATEGIC DIMENSIONS

7. Despite Indonesia's close proximity to Australia and its immense economic potential, Australian financial activity in the country has thus far been relatively limited in recent years. While Indonesia was historically one of Australia's largest development assistance programs, the program has shrunk significantly in the last decade. Australia's annual development assistance budget for Indonesia has declined by 12% from 2017–18 to 2018–19, to US\$ 228 million—a small sum considering the scale of demand in Indonesia and the envelope sizes of competing donors.⁵⁸ This decline in relative terms is compounded by Australia's inability to offer NGF, placing it at a disadvantage compared to the majority of bilateral and multilateral organisations that can offer a more diverse range of financing options. According to Indonesia's Investment Coordinating Board (BKPM), the top sources of foreign direct investment in 2017

⁵⁷ Karlis Salna, 'Indonesia Needs \$157 Billion for Infrastructure Plan,' *Bloomberg*, 25 January 2018. <https://www.bloomberg.com/news/articles/2018-01-25/indonesia-seeks-to-plug-157-billion-gap-in-nation-building-plan>.

⁵⁸ DFAT, *Indonesia—Australia Aid Factsheet*, October 2018.

were Singapore, Japan, China, South Korea, the United States and the Netherlands.⁵⁹ In terms of private sector engagement, opaque regulations and high levels of perceived risk make Indonesia a difficult environment in which to operate for Australian businesses.

8. Given Indonesia's strategic economic importance, Australia should engage with the country on more equal terms. Indonesia has the potential to be one of Australia's most important economic and development partners. Indonesia is the fourth most populous nation in the world, with a population of 270 million, is Australia's largest neighbour by landmass and the largest country in ASEAN, wielding considerable geopolitical influence in the region. Recently, Australia has opened two new posts in Makassar and Surabaya to better engage with Indonesia's economically dynamic regions. In other instances, Australia has provided US\$ 108 million in funding for the 2012–2020 Empowering Indonesian Women for Poverty Reduction program⁶⁰ and, with Patamar Capital, has supported an accelerator for women-led businesses addressing food security challenges. We see a potential for Australia to capitalise on extant development assistance relations and deepen support. With a GDP growth rate of 5.2%, Indonesia is also the fastest growing economy in Southeast Asia. It is expected to become the region's fourth largest economy by 2050, and is currently the largest in ASEAN. Foreign direct investment flows have been growing steadily and stand at 31.2% of overseas resource flows into Indonesia.⁶¹ Socially, the country is politically stable and has established itself as a democratic model for other ASEAN fledgling democracies.

9. Australia should broaden the suite of financial instruments available for deployment in order to engage more deeply in Indonesia given the potential for (a) increased development impact and (b) an improved relationship as a trusted partner. For instance, growth in Indonesia could be more inclusive than it currently is. Ensuring that economic growth translates into equitable outcomes is a stated objective of the government. As of July 2017, the number of Indonesians living below the poverty line entered single digits (9.82%) for the first time since the monetary crisis of 1999;⁶² however, 40% of Indonesians are still vulnerable to poverty.⁶³ Employment and investment have been concentrated in urbanised hubs—Java and Sumatra account for 80% of the nation's total economic activity. Meanwhile, eastern Indonesia (notably Sulawesi and Papua) has higher rates of poverty due to its relative remoteness and lack of connectivity with growth centres, indicating that for development activity to be meaningful, it must take place at the district and provincial levels.⁶⁴ The scale of these challenges is mammoth—significant impact is beyond the scope of Australia's limited, grant-based financial envelope. NGF, accompanied by a strong push for regulatory change (including policy reforms such as improving transparency in the management of SOEs and easing the path for private sector entry), can mobilise much higher sums of capital and improve the lives of many more Indonesians.

10. The investment and economic climate in Indonesia is ripe for the deployment of NGF. Much of Indonesia's growth has been propelled by the services sector, which accounts for 46% of the nation's GDP. Transport and communication have also been growing at a fast pace, indicating a sizeable market: as of 2017, mobile penetration in Indonesia stood at 74% (195

⁵⁹ Erwida Maulia, 'China becomes Indonesia's No. 2 investor with infrastructure drive', *Nikkei Asian Review*, 1 February 2018. <https://asia.nikkei.com/Politics/International-Relations/China-becomes-Indonesia-s-No.-2-investor-with-infrastructure-drive>

⁶⁰ Australian Government, *Foreign Policy Whitepaper*, 2017.

⁶¹ OECD, *FDI Flows*. Database. <https://data.oecd.org/fdi/fdi-flows.htm>

⁶² *The Jakarta Post*, 'Poverty rate falls to lowest ever: BPS', 16 July 2018.

<http://www.thejakartapost.com/news/2018/07/16/poverty-rate-falls-to-lowest-level-ever.html>

⁶³ DFAT, *Country Information Report Indonesia*, 2017.

⁶⁴ *Ibid.*

million users).⁶⁵ The government will be seeking an estimated US\$ 83.5 billion from the private and developmental sector for the ambitious National Medium-Term Development Plan 2015—2019.⁶⁶ The impact investing ecosystem is the most mature in the region, with private impact investors deploying US\$ 148.8 million across 58 deals over the past decade, and DFIs deploying US\$ 3.6 billion through 67 deals over the same period.⁶⁷ The private equity market is similarly booming—Indonesia has seen several “unicorns” over the past few years. GoJek, a ridesharing app, raised US\$ 1.2 billion while Tokopedia, a sales platform for small and medium-sized retailers, raised US\$ 1.1 billion.⁶⁸ Companies such as Tencent, Softbank, Sequoia and Northstar are active investors in the start-up ecosystem; the climate is widely perceived as favourable, with 80% of foreign investors expressing the intention of increasing their investment size by 10% or more.⁶⁹ These indicators point to a market landscape that is ripe for new investment.

11. Participating in Indonesia's growth as an investor will provide Australia with greater influence in a range of specific projects that serve the two countries' common goals. Over the next few years, as the current National Medium-Term Development Plan draws to a close, the GoI will be seeking external funding for its various infrastructure projects. In practice, funding these projects on a consistent basis will require NGF; if Australia continues to use a “business as usual” approach, it is likely that Australia's influence within and its importance to Indonesia will decline relative to newer players emerging with the potential to dominate the financing landscape. But, by participating selectively in infrastructure financing, Australia will have the opportunity to partake in critical economic projects and guide the direction of development in the country. In addition, by continuing to focus on social sectors such as healthcare and education, Australia can continue to support equitable Indonesian public policy. Moreover, as the Indonesian market matures, opportunities are opening up in sectors traditionally reserved for grants, such as healthcare, education and technology-enabled services.

12. However, deepening strategic ties with Indonesia will require considerable effort and attention on Australia's part. Any strategy going forward will require buy-in from stakeholders across the political spectrum and at multiple levels of the Indonesian government. Australia must also consider other players; consultations suggest that the Asian Infrastructure Investment Bank and the United States are likely to ramp up activity and the United Kingdom is starting to enter the market more meaningfully. In an increasingly crowded field, Australia will need to emphasise what distinguishes it as a partner and what benefits it can uniquely provide.

Section III DEMAND ANALYSIS

Detailed Findings

13. The size of Indonesia's economy and its growth trajectory all point to immense demand for investment, reiterating the importance of applying Australian capital efficiently to financing infrastructure and, where feasible, obtaining returns and leveraging other finance. To fuel this growth, Indonesia will need to make significant investment in both economic and social infrastructure. Global Infrastructure Hub, a G20-affiliated database, estimates that

⁶⁵ Statista Database. <https://www.statista.com/statistics/257046/smartphone-user-penetration-in-indonesia/>

⁶⁶ Karlis Salna, ‘Indonesia Needs \$157 Billion for Infrastructure Plan’, *Bloomberg*, 25 January 2018. <https://www.bloomberg.com/news/articles/2018-01-25/indonesia-seeks-to-plug-157-billion-gap-in-nation-building-plan>

⁶⁷ GIIN, Intelicap, *The Landscape for Impact Investing in Southeast Asia: Indonesia*, 2018.

⁶⁸ Hogan Lovells, ‘PE in Indonesia—a vibrant market’, 16 October 2017. <https://www.hoganlovells.com/en/blogs/the-buyout-board/pe-in-indonesia-a-vibrant-market>

⁶⁹ AT Kearney, Google, *Indonesia Venture Capital Outlook*, 2017.

Indonesia will need US\$ 1.7 trillion in investment between now and 2040, and will face an overall shortfall of US\$ 70 billion.⁷⁰ While estimates from various sources (e.g., PricewaterhouseCoopers, World Bank) differ and are largely incomparable, there is consensus that social sectors like water will face higher funding gaps than economic sectors.⁷¹

14. The scale and pace of Indonesia's growth have invited large flows of capital from other bilateral donors and DFIs. For example, AIIB has disbursed US\$ 6.3 billion in the nation since 2016,⁷² the World Bank Group is slated to extend US\$ 7.5 billion from 2016 to 2020 and the ADB has committed US\$ 6.95 billion for 2019–2021.⁷³ To maximise its impact in a market crowded with developmental capital—featuring operation budgets significantly larger than Australia's 2018–2019 estimated development assistance budget of US\$ 228 million (a decline from last year's US\$ 259 million)—Australia needs to approach Indonesia in a focused manner.⁷⁴

15. For instance, Indonesia's Ministry of Finance has released a preliminary project list concerning the achievement of Indonesia's UN Sustainable Development Goals.⁷⁵ Project costs are estimated to exceed US\$ 18.2 billion over the next 12 years, with the largest shares of financing allocated to urban transport (US\$ 6.48 billion), ports (US\$ 5.91 billion) and renewable energy (US\$ 2.48 billion). Given Australia's annual development assistance budget to Indonesia, Australia can effectively target small- to medium-sized-ticket deals⁷⁶ to support Indonesia's 2030 Agenda through a mix of NGF and grants.

Table 7—Indicative list of small & medium-sized Sustainable Development Goals projects

	Project Name	Project Type	Estimated Cost (US\$ million)
1.	Kuala Tanjung Industrial Gateway	Port	140.92
2.	West Semarang Water Supply	Water supply	88.9
3.	Kulon Progo New Yogyakarta Airport Access Railway	Urban transport	88.8

⁷⁰ This shortfall figure is calculated by projecting current investment trends and subtracting the same from an investment needs estimate. It does not explicitly take into account commitments by organisations like MDBs, such as those listed in the subsequent paragraph.

⁷¹ PricewaterhouseCoopers, *Indonesian Infrastructure: Stable Foundations for Growth*, 2017; World Bank, *Infrastructure Sector Assessment Program: Indonesia*, 2018.

⁷² Asian Infrastructure Investment Bank (AIIB), *Investor Brief*, 2018.

⁷³ World Bank, *2016-2020 Country Partnership Framework*, 2016; ADB, *2019–2021 Country Operations Business Plan*, 2018.

⁷⁴ DFAT, *Indonesia—Australia Aid Factsheet*, October 2018.

⁷⁵ Ministry of Finance, *SDG Indonesia One*, 2018.

⁷⁶ Benchmarked here as projects with an estimated cost less than USD 200 million.

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4.	Green Bond of PT SMI	Renewable energy	75
5.	Drinking Water Supply System Lampung	Water supply	49.86
6.	Dharmais Cancer Hospital	Healthcare	45.6
7.	Pirngadi Public Hospital	Healthcare	40.7
8.	Pekanbaru Water Supply	Water supply	33.8
9.	GEUDP Waesano Geothermal Exploration Project	Renewable energy	30.3
10.	Sidoarjo Public Hospital	Healthcare	26.2

16. Within the current financial envelope, NGF may be useful for a number of opportunities.

A non-exhaustive list of these opportunities includes the following:

- a. *Impact investing in promising social enterprises:* An estimated 70% of social enterprises in Indonesia are in the seed or early stages⁷⁷ and do not attract many investors beyond high-net-worth individuals (HNWIs). Given the maturity of the impact investing ecosystem, the potential exists for Australia to target capital deployments in these enterprises through regional or sectoral impact investment funds. In the current landscape, private impact investors favour equity, while DFIs favour debt; this appears to be related to the scalability of opportunities, with DFIs investing in projects that offer steady returns but limited horizons to scale. Some emerging sectors where impact investors are most active include education, healthcare and other smaller units that can spur employment growth.⁷⁸

Many of the emerging business models (largely in the workforce development and education sectors) tend to be ICT enabled, presenting potential scalability. Australia has already supported initiatives such as an accelerator for women-led businesses

⁷⁷ Angel Investment Network Indonesia (ANGIN), *Social Finance and Social Enterprises*, 2017.

⁷⁸ Global Impact Investing Network (GIIN), Intellectap, *The Landscape for Impact Investing in Southeast Asia: Indonesia*, 2018.

addressing food security challenges, set up by Patamar Capital.⁷⁹ However, the potential exists to co-invest with other established impact investors, accelerators and incubators, particularly as gender-lens investing gains traction. For instance, the ANGIN Women Fund has provided training to more than 100 women-led businesses; similar funds could be good potential target investments for Australia.⁸⁰ Other potential collaborators in the space include OPIC, which recently unveiled a “2X Women’s Initiative” to mobilise US\$ 1 billion in gender-lens investing;⁸¹ Insignia Ventures, which co-invested with Patamar Capital in a women-focused SME fund;⁸² Aavishkar, a private impact investor with a local presence, which co-invested with the RaboBank Rural Fund, a Dutch social impact fund without a full-time local presence, in P.T Bali Seafood; and Aqua-Spark, a fund based in the Netherlands, which co-invested with Ideosource in an aquaculture company.

- b. *Assisting the funding of well-functioning credit cooperatives:* There are more than 200,000 cooperatives in Indonesia, enrolling about 15% of the workforce. From 2010 to 2015, the quantity of cooperative capital grew from US\$ 4.3 billion to US\$ 16.2 billion. Over the same period, turnover and profits increased by 5–7%⁸³—suggesting that credit cooperatives are ripe for investment. By targeting well-run cooperatives, Australia could improve credit access for smallholder farmers and struggling enterprises, making a lasting impact on their income levels and productivity.

Consultations with Mekar, an Indonesian fintech company that deals in peer-to-peer and other direct lending, suggest that among the most suitable instruments for Australia to extend would be term deposits and credit insurance. Further, they noted that credit cooperatives have a trust problem due to instances of mismanagement and corruption. Australia’s involvement could boost reputation and credibility, thereby helping to bring more businesses on board.

- c. *Deepening capital markets to mobilise domestic and institutional capital:* Forecasts for 2019 estimate that the Indonesian equity market’s role will increase from 0.9% to 1.4%, and that the role of bond markets will similarly rise from 1.0% to 1.4%. These figures paint a pessimistic picture for private sector actors turning to capital markets in the medium term.⁸⁴

Indonesia’s Committee for the Acceleration of Priority Infrastructure Delivery (KPPIP) is working with various federal stakeholders to deepen the capital market. Instruments implemented by KPPIP on which Australia potentially could focus its efforts include asset-backed securities such as those issued by PT Indonesia Power, IDR-denominated bonds issued by Indonesian construction and toll-maintenance companies and sector-specific investment funds such as the Infrastructure Investment Fund (DINFRA).⁸⁵

⁷⁹ Ibid.

⁸⁰ Ibid.

⁸¹ OPIC Press Release, 7 March 2018. <https://www.opic.gov/press-releases/2018/opic-unveils-2x-womens-initiative-mobilize-more-1-billion-invest-worlds-women>

⁸² Aastha Maheshwari, ‘Impact investor Patamar makes first investment from women-focused fund in SayurBox’, *Deal Street Asia*, 22 January 2018. <https://www.dealstreetasia.com/stories/exclusive-patamar-capital-strikes-maiden-investment-in-indonesias-sayurbox-90748/>

⁸³ Azhari Gito et al., ‘The Role of Cooperative in the Indonesian Economy’, *International Journal of Humanities and Social Science Invention*, October 2017.

⁸⁴ Nomura Foundation, *Indonesian Capital Market: Developments and Challenges*, 2016.

⁸⁵ Committee for Acceleration of Priority Infrastructure Delivery (KPPIP), *Recent Progress in Indonesia Infrastructure Financing Development*, 2018.

Broader needs point to the importance of attracting large institutional investors, encouraging a long-term approach to financing and building stakeholder capacity, all of which Australia could potentially play a part in accomplishing through equity financing, first-loss facilities, interest subsidies and guarantee premium subsidies. Such support could mobilise otherwise unwilling capital and help finance underserved sections of the Indonesian market.

- d. *Helping pitch revenue-earning infrastructure assets to institutional investors:* Institutional investors in Indonesia command about US\$ 105.8 billion in assets,⁸⁶ the bulk of which are managed by insurance and social security funds. Although these investors are not heavily active in infrastructure investing, trends indicate that continued growth could direct them toward different kinds of assets. The recent national social security system (SJSN), implemented in 2015, mandates a social safety net for all Indonesians. In the coming years, this reform will likely generate significant growth in **social security funds**, particularly in the old-age and pension savings segment. Further, portfolio allocation for **pension funds** skews heavily toward government bonds (23.3%), as well as equity (12.3%) and corporate bonds (21%); this indicates possible mobilisation potential for long-term infrastructure financing. In contrast to the general insurance segment, which shows preference for short-term investments, the **life insurance industry** is likely to be interested in infrastructure investments, given its long-term liabilities. The **mutual fund industry** has been growing at a rate of 15% over the last five years, and is an important vehicle for mobilising private Indonesian savings.⁸⁷

By nature, these funds must invest conservatively to ensure preservation of committed disburseable capital, and most infrastructure investment opportunities must be de-risked in order to be seen by institutional investors as viable prospects. Structuring these opportunities in ways that present attractive risk profiles to these investors usually requires NGF—common approaches include guarantees, debt and equity securitization and loan syndication, for which our consultations suggest there is demand. While it is possible to accomplish the same through innovative grants, possibly in the form of convertible grants or some form of conditional risk coverage that is delivered in grant form, using only grants would likely restrict Australia's ability to attract institutional investors in Indonesia. Australia could encourage pension and insurance funds to participate in infrastructure financing (i) by supporting government agencies like KPPIP that seek to mobilise institutional investors as part of their agenda to deepen financial markets, and (ii) with a strong focus on linking finance to reforms associated with sector policy, transparency, and ease of private sector participation.

- e. *Financing impactful infrastructure and related projects at the provincial level through the use of municipal bonds:* Indonesia has an established regulatory framework for municipal bonds, but there is no precedent for a bond issuance. According to the World Bank, efforts to issue bonds by DKI Jakarta (between 2011 and 2013) and West Java (2014 and 2015) did not yield results, due to the overly complicated and lengthy processes involved.⁸⁸ This constraint also explains the lack of emergence of a bond market more broadly—bond issuances face a complicated approval process and a lack of any standardised procedure.

However, there is cause for optimism—a recent regulation, passed in 2017, simplifies the auditing process in issuing municipal bonds for subnational governments. Further,

⁸⁶ Ibid.

⁸⁷ World Bank, *Infrastructure Sector Assessment Program: Indonesia*, 2018.

⁸⁸ Ibid.

KPPIP believes that bonds are ready for issuance in Central Jakarta, West Jakarta and DKI Jakarta. These developments signal the potential revival of the stalled municipal bond projects mentioned above, which involve large infrastructure projects such as airport construction.⁸⁹

- f. *Helping establish methods such as aggregation platforms to improve the domestic financing of local-level infrastructure:* One of the most pressing cost considerations for potential investors is the identification of viable investment pipelines. Most investors are deterred by a lack of local knowledge or partnership with local networks.

Currently, one prominent digital platform fulfilling this purpose is the G20-affiliated Global Infrastructure Project Pipeline, where the Indonesian government promotes public infrastructure projects. The other source is the “Blue Book” produced by the Indonesian Ministry of National Development Planning (Bappenas), which includes a list of planned external loans in the medium term, some of which are used for infrastructure and related purposes. A competitive market of aggregation platforms that identify upcoming public and private projects in the pipeline, emphasise information transparency and build a rating system for metrics that investors care about (e.g., rate of return, local regulatory complexity, etc.) could dramatically decrease the cost of finding investments—and open the floodgates for domestic financing.

- g. *Supporting private-sector providers of technical and vocational education and training (TVET) willing to work with Australian intellectual property and standards:* Access to skilled labour is a serious challenge in parts of Indonesia. By some estimates, 20% of the workforce does not reach the minimum threshold of educational qualification beyond which formal sector employers are willing to train and hire.⁹⁰ Only 5% of Indonesian firms provide formal training to their employees.⁹¹

At OECD's “Fourth Regional Policy Dialogue on TVET”, Indonesian companies noted that “good technical mentors with sound pedagogical skills enhance the outcomes” for in-company training. Our stakeholder consultations clearly indicated that given Australia's strong know-how in TVET and robust benchmarking standards, it has the potential to bolster existing processes by training or providing such mentors, sharing world-class training modules and training software and systems and further encouraging the adoption of skill-building programs in the private sector with the promise of similar TA.

Australia also has the opportunity to participate in PPPs. The Ministry of Education has expressed that private participation will be crucial in setting up more and better quality TVET institutes—Indonesia's vocational or non-formal education sector is currently open to foreign investments of up to 49%.⁹² However, to ascertain concrete opportunities based on impact and feasibility, processes like sizing the nature of Indonesia's TVET need and conducting due diligence will be required.

This recommendation reflects a repeated theme heard across consultations; however, this is not to suggest that Australia's current priorities in the education sector (in particular, its focus on primary education) are incompatible with a focus on TVET,

⁸⁹Ibid.

⁹⁰ USAID, FHI 360, *Analysis of Skills Demand in Indonesia*, 2015.

⁹¹ OECD, *SME and Entrepreneurship Policy in Indonesia*, 2018.

⁹² Global Business Guide Indonesia, *Vocational Education in Indonesia: Crucial to Compete in the ASEAN*, 2016.

although it may be necessary to weigh the merits of this new focus against the current strategy in order to prioritise development assistance spending.

17. However, a key factor in Australia's ability to be truly impactful in Indonesia will be the potential for NGF to mobilise private sector investment. For instance, our consultations indicate that the ADB targets a mobilisation multiple of 6x from the private sector alone for its investments in Indonesia. According to the OECD, of the US\$ 81 billion in private resources mobilised by public development finance between 2012 and 2015, 77% were mobilised in middle-income countries such as Indonesia. Given Australia's limited development assistance budget earmarked for Indonesia, higher mobilisation ratios in the country will help Australia leverage its investments to support larger-ticket projects.

18. Meanwhile, grants continue to be important for social and economic development, and Indonesia continues to appreciate bundled TA packages. Powerful examples include the education scholarships that have, for decades, given Indonesians an opportunity to study in Australia. Many of the past beneficiaries have returned to Indonesia and served in important roles in top government and private organisations, building local institutional capacity. Implementing agencies have also found it extremely useful in the past to have Australian expertise involved in building and maintaining high-quality roads and other infrastructure. An example is the US\$ 27.2 million Provincial Road Improvement and Maintenance (PRIM) initiative—a results-based grant program through which Australia provides incentives for Indonesian subnational governments to implement road maintenance and rehabilitation works. Another example is the AUD 37 million grant component in the Eastern Indonesia National Roads Improvement Program (EINRIP), extended in combination with an AUD 276 million loan; the combination of both loans and grants in this project enabled effective utilisation of funds, with government agencies crediting EINRIP with producing among the best quality roads recently achieved in Indonesia. The grant package in particular helped manage major risks facing the project.⁹³ Grants used in this innovative manner help ensure accountability and sustainability, both by instituting M&E processes that employ strict performance criteria and by working with and bolstering existing government systems.⁹⁴

19. Australia's TA is widely viewed as high quality and relevant, and is a critical component of Australia's demonstrated commitment to the long-term development of its partner countries. Grants with a results-based structure, such as that mentioned above, can potentially be extremely effective and should be bundled with TA, including technology transfers and institutional and human capacity building. A relevant example is the Water and Sanitation Hibah (WSH) Phases 1 & 2, implemented by DFAT in partnership with various federal ministries across 128 district governments. The project had a strong TA component provided by DFAT through the Indonesia Infrastructure Facility; by 2016, it had achieved 250,000 household water connections. An independent review in 2017 rated this results-based program as highly sustainable and replicable. Australia's financing, as well as its demonstration of new approaches, led Indonesia to scale WSH using its own financial resources—to date, this is the only results-based program that has been reproduced by the government. Further, an IMF assessment shows that the provision of grants is effective when accompanied by policies to strengthen domestic institutions; e.g., IMF's funding for the Heavily Indebted Poor Countries Initiative (HICP) is tied to poverty reduction programs. A similar requirement could be considered for revenue spending, or the establishment of better accountability and transparency mechanisms.⁹⁵

⁹³ DFAT, *Investing in Roads: Lessons from EINRIP*, 2017.

⁹⁴ DFAT, *Pilot program for Provincial Road Improvement and Maintenance (PRIM): program Design Document*, 2013.

⁹⁵ IMF, *Foreign Aid: Grants versus Loans*, 2004.

Key Challenges and Constraints

20. **Australia's modest financial envelope compared to other players in the space implies that the transition to NGF would be useful, but necessarily on a small scale.** As an illustrative example, if the current proportion of bilateral aid allocated for infrastructure could be deployed as NGF, with repayments worth 80% of the principal in real terms, Australia could possibly then finance a new, substantial loan every two years. However, the clearest opportunities for stepping up engagement would require offering substantially larger amounts of assistance that lead to the creation of either larger-sized infrastructure projects or longer-term programs that demonstrate important improvements in policies or systems. At the moment, the Australian development assistance budget for Indonesia is simply not large enough to finance these opportunities.

21. **The mobilisation ratios for Australian capital could likely be dampened by legal and regulatory challenges faced by the private sector,⁹⁶ including:**

- **Legal challenges**

- *The legal framework is fragmented, and complex..* Indonesia has 158 national laws governing infrastructure projects, many of which do not appear to be consistent with each other, leading to the dissolution of ventures
- *Private and foreign participation is restricted.* While the current negative investment list is slowly being liberalised, foreign operators have little choice in local partners due to the domestic dominance of SOEs
- *The approvals process is heavily bureaucratic.* Government contracting authorities are mandated to secure and disburse multiple permits, including environmental and site approval licenses, which are often delayed by uncertain procedures or slow responses
 - This is heightened by provisions related to “state loss”, where civil servants may be subject to an investigation for decision-making leading to a loss to the government exchequer, and therefore make cautious, time-consuming decisions
- *Present regulations do not encourage cost recovery.* Revenues provided by tariffs often do not permit cost recovery, making service delivery dependent on direct or indirect government subsidies—75% of PDAMs⁹⁷ run at a loss, with some 50% classified as financially unhealthy or sick
- *Environmental and social safeguards are improving but inconsistently applied.* In the absence of well-managed compliance frameworks that reduce risk and liability, leading financiers are less likely to assist in the creation of large-scale infrastructure financing platforms

- **Regulatory risks**

- *Risk allocation is not consistent with international standards.* This is especially true of land acquisition risk, termination and a general lack of contractual standardisation. For example, within the toll road sector—the only sector evolving toward model

⁹⁶ World Bank, *Infrastructure Sector Assessment Program: Indonesia*, 2018.

⁹⁷ A PDAM is a regional water supply utility owned by the local government.

agreements consistent with global standards—concession agreements still require the private investor to take on land acquisition risk. Recent regulations on power purchase agreements (PPAs) have also significantly changed the risk allocation structure to the detriment of the private investor

- *Land acquisition is a critical risk.* Land acquisition is the responsibility of the state, but more recent regulations have allowed private parties to use their own funding to acquire land, sometimes backstopped by a government guarantee. This has created ambiguities in ownership.
- *Identifying a commercially viable pipeline of projects is a risk.* Many of the state SOEs and other players with deep local roots are usually the first to invest in commercially viable projects, leaving a pipeline of riskier and not-so-lucrative projects for other investors.

22. To address such problems, MDBs such as ADB have considered establishing a sustained advocacy program to secure buy-in from political and bureaucratic leadership on the effectiveness and impact of their projects. To date, the ADB has conducted international forums, workshops and high-level discussions with Indonesian leadership to promote business climate reforms and the role of PPPs in surmounting the country's infrastructure deficit.⁹⁸

Section IV DEVELOPMENT IMPACT

23. Indonesia will benefit greatly from mobilisation of private capital for both economic and social infrastructure. One promising source of private capital is the impact investing market, which has grown and matured in recent years—over 90% of private impact investor deals in Indonesia have been made since 2013. Indonesia has also seen a gradual transition from debt deals in the financial services and agricultural sectors to equity investments in a more diverse range of sectors.⁹⁹ This shift presents more opportunities for Australia to step up spending and mobilise impactful capital through locally focused intermediaries.

24. The domestic capital markets can also be used to mobilise private investments. As of recent estimates, only 440,000 of Indonesia's total population of 260 million can be classified as retail investors.¹⁰⁰ Many securities are traded over the counter, resulting to opacity around pricing and market depth. By supporting the development of capital markets, Australia can help position securities as a viable investment option and persuade more retail investors to invest in the secondary market. This should help drive more household savings into the formal economy and result in more productive capital deployment, including for economic and social infrastructure.

25. Australia can meaningfully contribute to improving the quality of infrastructure and the labour force in Indonesia. For instance, the expertise of Australia's infrastructure developers can be used to build better quality roads in Indonesia and help reduce continued maintenance expenditure. Similarly, the Australian private sector's expertise in TVET can be utilised through a combination of classroom trainings, on-the job apprenticeships and work-related exchange programs. These programs offer benefits both in terms of upskilling individuals and in providing

⁹⁸ Asian Development Bank, *Special Evaluation Study on ADB Assistance for PPPs in Infrastructure Development: Potential for More Success*, 2009; ADB, *Indonesia: Activities*.
<https://www.adb.org/countries/indonesia/activities>

⁹⁹ GIIN, Intelicap, *The Landscape for Impact Investing in Southeast Asia: Indonesia*, 2018.

¹⁰⁰ Nomura Foundation, *Indonesian Capital Market: Developments and Challenges*, 2016.

local firms with a pipeline of skilled labour. Cost recovery is often possible since employers are willing to pay for the skilling services and NGF can be used to finance these ventures. The Australian model, with its well-established industry-based competencies and modular course design, can meaningfully contribute to building local human and institutional capacity in the country.

26. TA will continue to build capacity for Indonesia, creating institutions that can serve the country over the longer term. Thus far, GoI has found it extremely useful to have access to skilled workforce deputed in key ministries through the support of Australia. For instance, Australia's Prospera program supports the GoI in developing more effective institutions and policies that contribute to strong, sustainable and inclusive economic growth and improved public sector performance. This form of support is notable, as many other donors and MDBs focus exclusively on project-by-project financing, often leaving unaddressed the need for systemic changes.

27. Based on limited consultations, we also believe that many of the stakeholders occupying key positions across the government and private sector in Indonesia have completed parts of their education in Australia, many with the support of scholarships provided by Australia. Continued use of such TA will help build robust local institutions.

Section V INSTITUTIONAL, CAPACITY AND FINANCING REQUIREMENTS

28. To successfully deploy NGF in Indonesia, any institutional arrangements would need to allow for the following capabilities:

- a. Ability to tie in TA with financing instruments to enhance the value proposition of the financial offering
- b. Ability to source and identify bankable projects since many of the more lucrative projects with established cost recovery models are financed by SOEs or other bilateral or multilateral players
- c. Ability to make larger-ticket investments, monitor and evaluate progress and course correct as required
- d. Ability to work with multiple partners, including impact investing funds and Australia Inc., with a focus on mobilising private capital.

ANNEX 4—Country Report: Papua New Guinea

This annex has been developed by Dalberg Advisors, and represents their independent interpretation and analysis of the team's visit to Papua New Guinea.

Section I EXECUTIVE SUMMARY

1. **Papua New Guinea (PNG) presents a unique opportunity for Australia to deploy non-grant finance (NGF). There is healthy demand for NGF in sectors that would further the shared objectives of Australia and the Government of PNG (GoPNG).** PNG's recently released Medium Term Development Plan III 2018—2022 (MTDP) sets out an agenda of inclusive economic growth with a strong emphasis on enabling infrastructure—notably, improved transport, power and telecommunications—as well as broader economic diversification with a particular focus on agriculture.¹⁰¹ If designed and implemented well, this plan has the potential to address some of PNG's most critical constraints to economic growth and progress in standards of living.¹⁰²

2. **Concessional financing will be in strong demand in PNG.** Under the MTDP III, the estimated annual demand for concessional finance from external sources will more than triple over the next five years, reaching US\$ 601 million by 2022.¹⁰³ While other public donors and MDBs, including Japan, the US, the ADB and the World Bank Group, have been increasing their activity in PNG, realising this level of external finance will require a step change by all actors, and likely the entrance of new ones.

3. **Our review of the feasibility of meeting this demand found that there are a number of opportunities to deploy NGF over the next 3—5 years across a range of sectors.** The sectors with the strongest near-term demand for the feasible use of NGF include transportation (notably airports and wharves), energy, telecommunications and water. While sectors such as health, education and small business finance are critical to PNG's growth, they demonstrate less demand for NGF—in these sectors, for the foreseeable future, grant-based mechanisms will remain the most important form of aid.

4. **Australia already has successful track record in PNG of financing smaller infrastructure, such as hospitals and university buildings.** Australia also has an active set of TA programs across multiple sectors to advise GoPNG on how to better prioritise, plan and advance the development of high-impact infrastructure projects. Many of the prerequisites for Australia to move into the role of an investor—for example, deep relationships, strong technical knowledge of the sectors, project procurement experience, a long-term view and a command of the complexities of the operational challenges in PNG—are already in place.

5. **Introducing the ability to deploy NGF will be important for Australia's relationship with PNG to evolve into a mature economic partnership.** PNG officials express a desire to move away from a donor-beneficiary relationship toward one of partners in development. NGF would enable Australia to participate in PNG's growth at a scale that is commensurate with the level of opportunity. Participating as an investment principal through the use NGF will also ensure

¹⁰¹ Government of Papua New Guinea, *Medium Term Development Plan III 2018—2022*, 2018.

¹⁰² Antonio Estache, and Grégoire Garous, *The Impact of Infrastructure on growth in Developing Countries*, IFC Economics Note, 2012.

¹⁰³ Exchange rate: PGK 1 = USD 0.3.

Australia a “seat at the table” to positively influence project design, transparency, governance and ongoing implementation efforts.

6. **Introducing NGF in PNG will have both capacity and institutional implications.** The highly dynamic nature of the demand for NGF, as well as the complexity of project development, suggest the need for a flexible pool of capital that Australia can deploy as opportunities arise. As the recent experience with the Coral Sea Cable project illustrates, while it is possible to participate in larger-scale projects using a grant-based modality, there are constraints on the number of times that Australia is able to do so. To be a strategic partner, Australia will likely need at its disposal a full range of instruments—including debt, equity and guarantees—as well as the expertise and capacity to deploy them quickly and efficiently. Australia has the capabilities to deliver NGF in the near term; however, these skills will need to be augmented as the project portfolio expands in size and scope. Developing capabilities to co-invest alongside others, especially commercial banks and local super funds, is one way to position Australia as distinct from other bilateral and multilateral funders. A robust function for ensuring environmental and social safeguards, especially gender analysis, will also be a critical capacity to further develop. Similarly, it will also be necessary to bolster Australia's existing capabilities for monitoring and evaluating the development impact of these projects in order to ensure that development outcomes are being realised.

Section II ANALYSIS OF THE STRATEGIC DIMENSIONS

7. **The geopolitical context in PNG is rapidly evolving.** A broader range of instruments and a more innovative use of grant financing will be important for Australia to achieve PNG's stated goal of realising a mature economic partnership with PNG.

8. **Australia's Foreign Policy White Paper has identified the stability and prosperity of PNG as one of Australia's most important foreign policy goals.**¹⁰⁴ The underlying premise of Australia's engagement with PNG is that vibrant and inclusive economic growth within PNG is in the strategic interest of both countries. The goal of engaging with PNG as a mature partner with shared economic growth objectives naturally raises the question of whether or not Australia's traditional means of engagement align with a contemporary approach.

9. **A more mature bilateral partnership recognises PNG's tremendous potential for economic growth and prosperity, as well as the importance of addressing key constraints to achieving this growth.** PNG is endowed with vast natural resources. Its mineral and other resource deposits—including copper, gold and oil—account for nearly two-thirds of export earnings while its massive natural gas reserves (estimated to be over 140 billion cubic meters,¹⁰⁵ the 48th largest in the world and among the largest for a country of its size). However, lack of core economic infrastructure—including for transport, communication and energy—constrains PNG's ability to translate this natural wealth into economic growth. Existing infrastructure remains poor in quality and concentrated in centres of economic activity. The nation's unique topography and widely distributed population create challenges in designing and realising high-impact, economically feasible projects. A further constraint on all aspects of development work is PNG's overall lack of human capacity, reflected in the country's poor ranking on the Human Development Index (154—higher than only Timor-Leste and Afghanistan in the Asia-Pacific region). Finally, there are concerns about governance and the strength of public institutions.

¹⁰⁴ Australian Government, *2017 Foreign Policy White Paper*, 2017.

¹⁰⁵ Central Intelligence Agency, *The World Factbook, Country Comparison: Natural Gas, proved reserves*, 2018.

Despite these issues, however, PNG presents tremendous opportunity for economic activity and growth.

10. PNG's recently released MTDP calls for an ambitious agenda of inclusive economic growth with a strong emphasis both on developing economic enablers—notably, improved transport, power and telecommunications—and on increasing economic diversification, with a particular focus on agriculture.¹⁰⁶ The plan lays out infrastructure investment priorities including major road construction, the development of national ports and wharves and the rehabilitation and upgrade of airports. The plan also calls for a dramatic improvement in the reliability and affordability of electricity through investments in power generation, including renewable sources, as well as improvements in transmission and distribution. Telecommunications are also a key priority—in particular, expanding cellular networks into the interior of the country. The development of the agricultural sector is also seen as a critical lever for fostering inclusive economic growth and opportunities for the significant majority of people in PNG who live in rural areas, as well as a strategy for replacing imports.

11. GoPNG's plans to finance the MTDP call for a dramatic increase in concessional lending, from US\$ 177 million in 2018 to US\$ 601 million in 2022. GoPNG's internal revenues are already the single largest source of financing, but that share is forecast to grow to 54.3% of all financing by 2022. Grants are forecast to decrease as a share of total financing, shrinking from 22.1% at present to 14.5% in 2022. According to IMF data from 2016, Asian countries and regions now comprise seven of PNG's top ten trading partners, with Singapore second, China third, Japan fourth, Taiwan sixth, Malaysia seventh, India eighth and Thailand tenth. Much of the aid is currently committed or disbursed in the form of grants and ODA loans that are almost exclusively provided by China and the multilaterals. Simply put, if Australia continues to offer only grants, its strategic influence will decline as grant funding becomes less integral to financing GoPNG's growth priorities. In some cases, more creative uses of grants may address some constraints. For instance, grants can be used to buy down the blended rate of interest in case of multilateral loans, increasing their offtake. However, it is likely that NGF will be required.

12. Australia is seen by many actors, including GoPNG, as having distinctive capabilities that could translate into the ability to make catalytic investments with positive influence. As a longstanding source of advisors to GoPNG, as well as a provider of TA across a range of sectors, Australia is seen to have rich market insights, strong relationships within GoPNG, technical expertise in key sectors and a successful track record of collaborating with GoPNG on advancing reforms. Often Australia has done the hard work of advancing sectoral reforms that have allowed other investors to transact (e.g., ADB). While this is a positive outcome from a resource mobilisation perspective, it is a missed opportunity for Australia to continue to influence the operations and implementation of these projects in a potentially greater capacity—for example, by introducing credible international private sector operators, with a healthy representation of Australian corporations.

13. While there are promising signs of increased funding from bilateral and multilateral funders in PNG, their efforts are not likely to close the financing gap. For instance, the United States' recent announcement of US\$ 113 million in financing for projects in the Indo-Pacific region was met with criticism, even within the US itself, of the relative modesty of the sum compared to the billions of financing that China is offering.¹⁰⁷ While the establishment of the United States International Development Finance Corporation will offer greater opportunities for Australia to work with the US on scaling up opportunities, it is unlikely that this option alone

¹⁰⁶ Government of Papua New Guinea, *Medium Term Development Plan III 2018—2022*, 2018.

¹⁰⁷ Katrina Manson and Shawn Donnan, 'Mike Pompeo's plans to counter China found wanting', *Financial Times*, 20 July 2018. <https://www.ft.com/content/e8dbe9be-940f-11e8-b67b-b8205561c3fe>

will be sufficient to close the financing gap. The recently announced trilateral partnership between Australia, Japan and the United States to invest in infrastructure projects is also a promising avenue for catalysing the flow of more finance for infrastructure into the country; in a similar vein, Australia could take the lead in shared financing agreements with other partner countries while driving policy and development goals.

14. Participating as an investment principal (i.e., taking an ownership stake as a provider of equity or acting as a creditor) would enable Australia to participate in more significant ways in major strategic initiatives and projects. The rights afforded to creditors and equity holders would offer Australia a greater ability to maintain an ongoing positive influence on transparency, governance and safeguards, as well as an opportunity to ensure that projects are well designed and are likely to translate into actual development outcomes for the people of PNG. Ownership and creditor investment positions involve regular contact over the long term, with free access to the accounts, all of which are critical to modelling and establishing standards for governance and transparency. Inhabiting these positions is also a way of improving the operations of SOEs that are critical to the delivery of essential services. A recent example that demonstrates this strategic participation was the launch of the 4,000-kilometer undersea cable linking PNG, Solomon Islands and Australia, costing US\$ 96 million.¹⁰⁸ that is expected to boost international connectivity and provide high-speed telecommunications capacity to both PNG and Solomon Islands. Australia financed the project with grant-based modalities. With the ability to deploy NGF, Australia would have been able to better leverage its very scarce grant finance with concessional capital, and, as a creditor or part owner, would have been positioned to have a greater say in ongoing operations.

15. This point was reinforced by private investors—in particular, by domestic superannuation funds and commercial banks such as ANZ. They noted that Australia has credibility within the PNG context to provide high-quality technical advice to the government in order to improve the design and operation of major projects and initiatives. NGF would enable Australia to have that much more influence on a specific project as well as mitigate risk for private investors, allowing them to participate in projects that otherwise would not meet their standards for creditworthiness. Interviews with private investors revealed a strong appetite for Australia to play the role of setting up funds and investment structures that can provide other investors with the confidence to co-invest. Australian Super appears to be a promising superannuation fund for the effort—however, no firm proposals have been submitted, and no financial opportunities have been concretely identified.

16. The need for capable partners for the financing and delivery of major projects is particularly important in light of the fiscal situation in PNG. Debt-to-GDP ratios are approaching legislative caps established in the Fiscal Responsibility Act and are likely to increase if accounting rules are enforced that would recognise the debt on the balance sheets of the SOEs.¹⁰⁹ Australia's strategic interests may be best served by exercising greater influence to ensure that projects involving new debt in PNG are of high quality and likely to succeed.

17. MDBs are critical partners, yet there are limitations to Australia's ability to advance its strategic interests by working through them. MDBs play an important role in realising development outcomes in the region, and Australia should continue to strengthen and deepen these partnerships to achieve maximum impact. However, while Australia collaborates frequently and effectively with MDBs within PNG, these institutions are independently governed and pursue projects according to strategic priorities and incentives that do not always

¹⁰⁸ Exchange rate: AUD 1 = 0.7 USD.

¹⁰⁹ Rosalyn Albanil, 'PNG Debt to Surpass Legal Limits Set Under the Fiscal Responsibility Act', *Pacific Islands Report*, 3 August 2016. <http://www.pireport.org/articles/2016/08/02/png-debt-surpass-legal-limits-set-under-fiscal-responsibility-act>

align with those of Australia. MDBs have also been the target of criticism for being overly bureaucratic, risk-averse, and slow to act.¹¹⁰ In some circumstances, MDBs follow procurement processes that do not meet appropriate due diligence standards and therefore enable poor contracting and monitoring. When projects involving collaboration with MDBs go well, Australia does not benefit reputationally, despite providing funding and project support. When projects go poorly, Australia retains a reputational risk.

Section III DEMAND ANALYSIS

Overall Commentary

18. There is evidence of strong demand for NGF and more innovative use of NGF alongside the capability to design and deliver effective projects that translate into strong development outcomes.

19. While there is strong demand for NGF, PNG faces a larger constraint related to the government's capacity to develop and implement projects that will translate into tangible development outcomes. The MTDP III notes that draw downs on existing loans reached a low of US\$ 88 million in 2017, down from US\$ 447 million in 2015. The MTDP highlights two constraints that are driving this slowdown: 1) the shortage of GoPNG counterpart funding to launch and finance new projects and 2) implementation challenges for existing projects. Indeed, US\$ 2.4 billion in loans remain undisbursed due to these key issues.¹¹¹

20. Implementation risks abound when working in PNG, requiring highly capable operating partners with strong track records of delivering results in this or a similar business environment. Australia's ability to introduce credible international private sector operators, with a heavy representation of Australian corporations, will assist greatly. Companies face difficulties in starting a business, enforcing contracts, trading across borders and resolving insolvency. For instance, it can often take over a year and a half to enforce a contract through PNG's court system, at the cost of up to 110% of a company's damage claims—a clear disincentive to push for legal remedy.¹¹² Other challenges include a regulatory ecosystem characterised by low levels of transparency, poor governance, and a lack of supporting basic infrastructure including transport, electricity and communication, all resulting in high transaction costs for private players.

21. Accordingly, the demand for NGF in PNG is not just for new forms of finance, but also for partners with a proven, comprehensive set of capabilities—including project development, financing and contracting with highly capable firms to implement projects. Stakeholders across the private and public sectors alike indicated that the key constraint in the market is not financing per se, nor is it the scale of opportunities to work in sectors that deliver both strong financial and development impact. One of the critical constraints in the market is the actual pipeline of viable, bankable projects—due to a lack of in-country actors who have the necessary long-term time horizons, risk appetite and capability to originate, develop and deliver major investment opportunities. In contrast to a number of major bilateral donors, certain stakeholders we consulted in PNG are looking to partner with financiers who will prioritise working with institutions and employees that are committed to transferring knowledge and capacity to local PNG employees. There is also a strong demand for the kind of partner that can

¹¹⁰ Center for Global Development, *Why Multilateral Development Bank Practices Are So Far from Their Potential*, 2009; Center for Global Development, *Billions to Trillions? Issues on the Role of Development Banks in Mobilizing Private Finance*, 2017.

¹¹¹ Government of Papua New Guinea, *Medium Term Development Plan III 2018—2022*, 2018.

¹¹² World Bank Group, *Doing Business 2018—Reforming to create jobs*, 2018.

help support accompanying regulatory reform efforts alongside investment, so as to enhance the chances of success of the investments.

22. Australia is already working to address some of these challenges through the Economic and Social Infrastructure program (ESIP). This eight-year effort seeks to close the infrastructure gap in PNG through addressing shortcomings in public sector capacity, lack of maintenance of existing infrastructure, a challenging overall business environment and the lack of capacity for ensuring that environmental and social safeguards for infrastructure projects are in place. ESIP builds capacity and provides TA at the project, sector and national levels to deliver regulatory reforms, high-quality sectoral plans and an increase in the number of capital projects being designed, financed and completed. Above and beyond sectoral reform and planning, ESIP aims to support project preparation and is equipped to directly design and implement capital projects, essentially providing a standalone vehicle to support the use of NGF. This deep involvement in a variety of projects across PNG can serve as a foundation for Australia to become the investor that brings a full suite of capacities to make high-impact contributions to PNG's economic and social development.

23. Also in high demand are NGF that can help address the foreign exchange shortage. Foreign exchange restrictions are in place as part of measures to stabilise the value of the kina.¹¹³ There are now substantial backlogs in processing foreign exchange orders, with wait times estimated between six and 16 weeks.¹¹⁴ In a recent survey, 60% of CEOs indicated that this shortage is “the major obstacle, more than double any other challenge.”¹¹⁵ Currency swaps that would enable improved access to foreign reserves are among the instruments that Australia could consider as part of its NGF offerings for PNG.

Sector Analysis

24. With this context in mind, the analysis that follows provides an overview of expected demand for NGF over the next 3—5 years, by instrument and by sector, with particular emphasis on the opportunities in which Australia could feasibly participate over this time period should it introduce NGF. This analysis is informed by GoPNG's stated priorities, the current priorities of Australia's engagement with PNG and consultations with a range of public and private sector leaders. However, it is important to note that demand for NGF in PNG is likely to be highly dynamic over time. **This analysis is purely representative in nature and should not, in any way, be interpreted as investment advice on the suitability of specific transactions.**

25. The key finding of this analysis is that, over the next 3—5 years, across a range of sectors, a suite of feasible opportunities exists for Australia to deploy NGF that—if successfully implemented—would deliver outcomes that are in the shared interests of GoPNG and Australia. While the time frame of 3–5 years also accounts for project delivery, there are opportunities that are actionable in the nearer term and could be financed much sooner if Australia were to have access to NGF. These opportunities would, of course, also involve a range of financial, governance and operational risks that would need to be carefully managed. This demand should also be tempered by the limited revenue potential of some projects, and by the government's and SOEs' limited ability to service existing debt obligations.

¹¹³Tom Westbrook, 'Coke's coffers crammed with kina as dollar crunch hits Papua New Guinea', *Reuters*, 8 November 2018. <https://in.reuters.com/article/us-apec-summit-currency/cokes-coffers-crammed-with-kina-as-dollar-crunch-hits-papua-new-guinea-idINKCN1ND39U> ; Liam Cochrane, 'PNG Central Bank moves to stabilise the kina with foreign currency trading bands', *ABC News*, 5 June 2014. <https://www.abc.net.au/news/2014-06-06/an-png-kina-trading-band/5504716>

¹¹⁴ DevPolicy, *Foreign Exchange Restrictions in PNG: Costs and Remedies*, 2017.

¹¹⁵ Ibid.

26. The strongest near-term demand for NGF is in the sectors of transportation (notably airports and wharves), energy, telecommunications and water. Three of these sectors—energy, telecommunications and water—are the focus of Australia's Economic and Social Infrastructure Program.¹¹⁶ While health, education and small business finance are critical to PNG's growth, these sectors demonstrate less demand for NGF in the near term; for these sectors, grant-based mechanisms will continue to play an important role. Moreover, working in these sectors would require a cross-cutting approach that meets Australia's rigorous development impact guidelines.

27. It is important to note that Australia is already active in financing or providing TA to projects in many of these sectors. Australia has a long track record of providing TA and financing for infrastructure projects in each of these sectors in PNG. In the transport sector, for example, Australia is financing an AUD 350 million Australia Transport Sector support program using grants. In telecommunications, the Australian telecommunication company Vocus Group Limited will deliver the Coral Sea underwater cable project, with majority financing from Australia and financial co-contribution from PNG and Solomon Islands.¹¹⁷ In health and education, Australia has financed the construction of facilities such as the ANGAU hospital and buildings at the University of PNG. Australia has also provided technical advisory services to the GoPNG on key sectoral planning and specific projects in the energy, water and telecommunications sectors.

28. Accordingly, the demand for NGF is premised on the imperative for Australia to play a much more catalytic role in each of these sectors as part of a broader effort to modernise and mature its relationship with the GoPNG. NGF—particularly concessional finance and risk-sharing instruments—would enable Australia to amplify the scale of its financial contributions to a level that is commensurate with the opportunities and needs within PNG. In this context, positioning itself as a financial principal, rather than just an advisor, would also afford Australia greater rights and privileges to influence the transparency, governance and quality of project design and implementation efforts—especially when compared to a context wherein grants cannot holistically address PNG's needs, and therefore cannot provide Australia the same level of influence.

Demand for NGF in the Transport Sector¹¹⁸

29. Advancing transportation infrastructure is a key priority of GoPNG. Through the MTDP III, the GoPNG has laid out ambitious targets for the transport sector that will require significant investment. The MDTP aims to increase the share of national priority roads in good condition from the baseline of 34% to 80% by 2022 and increase the number of bridges on national roads in good condition from 15 to 80 within the same time frame. For water transport, the government aims to increase the number of new/improved wharves and ports from the existing 16 to 22 in addition to increasing the capacity of existing ports and improving the efficiency of cargo handling. In the aviation sector, the government aims to upgrade seven more airports by 2022 to handle larger jets and rehabilitate up to 290 rural airstrips to basic safety standards. While GoPNG's transportation budget has grown rapidly in recent years, distribution has been largely skewed in favour of road transport.¹¹⁹ The country's 2014 transportation budget of

¹¹⁶ Australia Department of Foreign Affairs and Trade (DFAT), *PNG Economic and Social Infrastructure program Design Document*, 2018.

¹¹⁷ Corinne Reichert, 'Vocus scores AU\$137m subsea cable contract with Australian government', *ZD Net*, 19 June 2018. <https://www.zdnet.com/article/vocus-scores-au137m-subsea-cable-contract-with-australian-government/>

¹¹⁸ Craig Lawrence, *Infrastructure Challenges for Papua New Guinea*, 6 December 2017

¹¹⁹ Asian Development Bank (ADB), *Papua New Guinea: Country Partnership Strategy (2016-2020): Transport Sector*, 2015.

approximately US\$ 1 billion was nearly triple the transportation budget for 2011; of that figure, roads accounted for 82% of the allocation while maritime and civil aviation budget allocations each represented approximately 9% of the total.¹²⁰

30. NGF have a critical role to play in achieving high-priority GoPNG goals. Our analysis highlights two sub-sectors with strong potential for the deployment of NGF: aviation and maritime. Projects in both of these sectors are likely to have the potential to generate sufficient revenue to merit NGF. Roads are clearly a major priority for the Government and an area where concessional financing will be important in the case of sub-commercial opportunities, but several of these proposed efforts may not be bankable due to their limited revenue potential.

- *Aviation:* The air transport sector presents opportunities for deploying a mix of concessional lending and equity to finance the contracting of capable operating partners to upgrade airports throughout PNG—particularly in rural and provincial locations. There may also be opportunities to co-invest alongside other multilaterally funded efforts—for example, the ADB is active in this sector through its Civil Aviation Development Investment Program, which includes efforts to overhaul aging navigation aids and flight management systems, as well as to improve the nation's air transport safety. A co-investment by Australia could amplify the impact of this effort.
- *Maritime:* Maritime transport plays a particularly important role in an island nation where topography makes road travel difficult. There are several opportunities to deploy concessional finance in the maritime sector, including financing the upgrade and improvement 15 wharves managed by PNG Ports Limited or contracting capable port operators to secure long-term leases on port facilities. NGF have been deployed successfully in this sector—for example, ADB extended a US\$ 20 million loan to PNG for improving waterway access for marginalised and remote maritime and river-based communities and established a Community Water Transport Trust Fund (CWTF). This project positively impacted commuter safety and was assessed to be financially sustainable.¹²¹
- *Roads:* The Transport Sector Support program (TSSP)¹²² and the National Road Network Strategy 2018—2037 will require significant levels of financing¹²³ and will provide several opportunities for Australia to finance portions of the many expected upgrades to roads and bridges, as well as opportunities to bid for long-term maintenance contracts. However, in weighing its participation in the TSSP, Australia should take into consideration the limited potential for generating revenues from financing roads, as well as the challenges that the GoPNG has faced in servicing existing debts and financing the ongoing construction and rehabilitation of its road networks.

31. ADB has an innovative, results-based grant for building roads in the Solomon Islands that provides lower transaction costs, a strong incentive to achieve development goals and greater accountability for achieving them—leading to more efficient public spending in the sector. The grant also relies on country systems to deliver a well-defined and monitored program and

¹²⁰ Ibid.

¹²¹ ADB, *Papua New Guinea: Community Water Transport Project*, 2015.

¹²² Australia's current level of involvement is limited to technical assistance.

¹²³ PNG TSSP, *Annual Sector Performance Report*, 2015; Freddy Mou, 'Cabinet approves upgrade of national roads,' *Loop News*, 28 May 2018. <http://www.looppng.com/png-news/cabinet-approves-upgrade-national-roads-76876>

encourages larger government contributions to finance asset maintenance.¹²⁴ There should be scope to introduce results-based grants in the transport sector in PNG.

32. Consultations indicate that there may also be scope to finance the rehabilitation and maintenance of roads in Morobe's economic corridor, in cooperation with the national and provincial governments.

Demand for NGF in the Power Sector

33. **The power sector in PNG presents significant opportunities for realising both economic and development impact.** Only 12% of the population has access to electricity. Where power is available (generally in the main urban centres), supply is often unreliable. However, the country is close to achieving fossil fuel self-sufficiency and has the potential to harness 15,000 megawatts of hydropower. PNG also has extensive resources for geothermal generation. Despite these advantages, PNG is the least energy-intensive economy in the Asia Pacific region due to ageing, fragmented, and inadequate plant and distribution systems. Planning has not sufficiently addressed growing energy needs as household incomes and population continue to rise.

34. **Government targets for improving local energy access are ambitious; PNG is now looking to encourage private sector participation in the energy sector through a series of policy-related reforms.**¹²⁵ The MTDP III aims to double the household electrification rate from 17% to 33% by 2022. The Electricity Industry Policy (EIP) of 2011 aims to facilitate competition, develop a clearly defined access regime, transfer a range of regulation functions from the power authority PNG Power Limited (PPL) to the government and increase rural electrification through government assistance. The government has also passed the Public–Private Partnership Policy, which will support the development of private sector participation in the energy sector. There is also potential for PNG to bring more of its considerable petroleum and natural gas deposits to the export market by expanding the nation's extraction and processing capabilities. The government plans to increase its proven petroleum reserves by 60% and establish at least three liquefied natural gas (LNG) projects by 2030, which should generate new revenues of at least US\$ 1.65 billion per year.

35. **NGF enable much more catalytic approaches to expanding access to energy than do traditional grant instruments.** Our analysis found several ways that NGF could be strategically deployed—where grant instruments alone cannot—to finance the development of the power sector. These opportunities include:

- *Providing PNG SOEs or companies under contract with concession or PPP arrangements backed by Australian guarantees* to allow them to access lower-cost capital for financing utility projects (e.g., grid extensions, power plant rehabilitations) with diminished commercial viability
- *Providing a combination of instruments including debt and TA, or equity and TA, to set up renewable energy investment plans, partial-risk guarantees, letters of credit and pre-purchase agreements* in order to ensure short-term liquidity and secure operations for an initial period of 2–3 years. For instance, ADB's Pacific Renewable Offtake Guarantee program proposes a similar structure for its solar independent power project facility

¹²⁴ ADB, *Sustainable Transport Infrastructure Improvement Program: Report and Recommendation of the President*, 2016.

¹²⁵ ADB, *Papua New Guinea: Country Partnership Strategy (2016–2020): Energy Sector*, 2015.

- *Providing equity (where possible) and loans to participate in PPPs that build out distributed power generation technologies, such as small gas turbines and renewables (solar, biogas, etc.)*
- *Providing financing or co-financing for government equity in LNG II or other extractive / utility projects*

Demand for NGF in the Telecommunications Sector

36. GoPNG is prioritising improving mobile and internet penetration in the near term through financing the expansion of networks throughout the interior of the country.

Telecommunication infrastructure is largely concentrated in central regions of economic activity, away from rural and isolated pockets of population. Overall penetration rates are low and affordability is a key challenge, yet PNG is beginning to face bandwidth pressures. Demand is expected to grow rapidly in the coming years; given current investment flows, stock of infrastructure and frequency of outages due to natural phenomena, attaining a level of connectivity on par with the rest of the world appears to be a steep challenge. Moreover, access to power is impacting the availability of mobile coverage, as handsets cannot be easily recharged in many regions of the country.

37. The telecommunications sector presents several opportunities for the high-impact deployment of NGF:

- *Providing concessional financing for expanding the reach of broadband networks to underserved communities.* For example, over the past decade, both ADB and OPIC have assisted Digicel, the country's largest mobile network, in expanding its network capacity and coverage. OPIC's US\$ 10 million investment guarantee in 2012 helped the company introduce telecommunications services to underserved markets in PNG, including rural areas. Digicel also continued to invest in solar-powered telecom towers, thus reducing pollution and fossil fuel usage.
- *Facilitating restructuring of the existing players Bmobile and Citifon to improve the transparency and operational capabilities of both companies.* As an example of what might be possible in the PNG context, IFC advised the government of Kenya on the privatisation of Telkom Kenya Limited (TKL) in 2007. IFC was able to assist the Kenyan government with a restructuring package that demanded transparency and balanced the interests of several public and private players. A consortium led by France Telecom won the bid, paying US\$ 390 million for 51% of TKL. IFC also helped to unbundle TKL's 60% stake in Safaricom and vest it back to the government. The unbundling of this stake led to the flotation of 25 per cent of Safaricom in June 2008. The initial public offering was the largest ever in East Africa and raised over US\$ 800 million for the government.
- *Facilitating spinoff businesses following the arrival of the undersea fibre optic cable.* The cable should stimulate significant demand for spinoff business opportunities in a segment where, with DFAT's assistance, Australian tech companies could play a meaningful role.

Demand for NGF in the Agricultural and Fisheries Sector

38. The relatively undeveloped agriculture and fisheries sector is critical to the livelihoods of millions in PNG. Agriculture constitutes between 25% to 40% of the nation's GDP and more than 85% of the population—overwhelmingly indigenous—is employed in subsistence farming and fishing. However, less than 2% of the national budget is allocated for agriculture. PNG has extensive and valuable fishery resources, including inland river fisheries. The Pacific Tuna Forum estimates that the value of the annual tuna catch in PNG's waters could double to US\$ 2.7 billion if the industry explored more value-added activities. However, large ocean territories

have made it difficult to prevent unlicensed fishing boats from encroaching on PNG's exclusive economic zone (EEZ), while climate change has had further adverse effects on fish stock. Poor infrastructure and fragmented supply chains, combined with high production costs and infrequent use of modern inputs, have essentially shut PNG out of the broader global agriculture market. With the exception of commodities such as rice, palm oil and sugar cane, which are supported for political reasons, the government does not invest in research and development for most other commodities. Few financial institutions are willing to lend to smallholder farmers under the best circumstances; in PNG, climate vulnerability, land tenure uncertainty and transaction costs add to the high level of perceived risk.

39. Further developing the productivity and commercial viability of the agricultural sector will be critical for PNG to realise a more inclusive and diversified economy. As per the MTDP III, the state is focused on developing agriculture and agribusinesses in the medium term. To this end, the state has committed itself to enacting land reforms, developing road networks to link rural areas to trade hubs, improving extension services, assisting farmers in replanting high-yield varieties of certain commodities and implementing food safety standards to boost PNG's exports.¹²⁶

40. The agricultural sector in PNG offers Australia opportunities to deploy NGF in ways that can have strong development impact through spurring more inclusive market development; however, given the relatively underdeveloped state of the sector, significant effort will likely be required in project development phases in order to create bankable opportunities. Promising opportunities include:

- *Providing finance (concessional, where opportunities have been evaluated as sub-commercial) to intermediaries (banks, funds, etc.) to finance the formalisation and growth of agribusinesses that have inclusive business models*
- *Providing financing (concessional, where opportunities have been evaluated as sub-commercial) to larger-scale projects to develop agricultural zones and corridors*
- *Financing projects to further develop fisheries in PNG.* For example, the EU-financed Rural Coastal Fisheries Development program (RCFDP) has managed a revolving fund for paying off boat loans since 2002. In addition, private players such as PNG Microfinance Limited have collaborated with the National Fishery Authority to extend microfinance facilities to buy fishing equipment or start wholesaling stock.¹²⁷

Demand for NGF in the Water Sector

41. PNG has strong demand for water supply and sanitation upgrades. An estimated 4.2 million Papua New Guineans, representing roughly 61% of the population, do not have access to safe water, while 3.8 million people, or 55% of the population, do not have access to improved sanitation. Due to high population growth and declining coverage rates, over the last two decades the absolute number of people without access to safe water has grown by 67% and improved sanitation by 73%, with wide disparity in access between urban and rural populations.¹²⁸ By 2020, the MTDP III aims to increase the proportions of the rural population

¹²⁶ New Agriculturist, *Papua New Guinea Country Profile*, March 2013. <http://www.new-ag.info/en/country/profile.php?a=2924>

¹²⁷ ADB, *Papua New Guinea Microfinance Expansion Project*, 2016; SPC Fisheries, *Coastal Fishery Management and Development Projects in Papua New Guinea*, 2004.

¹²⁸ Department of National Planning and Monitoring, Department of Health, WaterAid, Water and Sanitation Program, The World Bank, Water PNG, EDA Ranu, *Water Supply and Sanitation in Papua New Guinea: Turning Finance into Services for the Future*, 2013.

using an improved source of drinking water and sanitation facilities from 33% and 13%, respectively, to 50% and 20%, respectively.

42. The Water, Sanitation and Hygiene (WASH) sector presents opportunities to deploy NGF, largely for building supporting infrastructure to facilitate service delivery. These opportunities include:

- *Contributing finance (concessional, where opportunities have been evaluated as sub-commercial) to one or more WASH funds proposed by the National Water, Sanitation and Hygiene Authority (NWSHA) to finance the extension, rehabilitation and maintenance of WASH service delivery, particularly in rural and peri-urban settlement areas.*
- *Providing finance (concessional, where opportunities have been evaluated as sub-commercial) to GoPNG and SOEs to ensure the availability of safe and reliable water supply in remote areas of the country.* For instance, World Bank has recently approved credit of US\$ 70 million to support the GoPNG's WASH policy to oversee policy implementation, regulation, training and monitoring at the national level. In addition, the project will assist state-owned water institutions in expanding and improving services in provincial and district towns across PNG that currently do not have water supply systems.
- *Financing potential PPPs that would support the development of additional water treatment plans in Port Moresby.*

43. Innovative grants could also have relevance here. Australia could look to Tajikistan, where Oxfam is funding a social impact bond designed to improve access to safe drinking water by providing individual water connections to 50,000 households; local governments are carrying out the implementation.¹²⁹

Demand for NGF in the Health and Education Sector

44. There is an urgent and clear need for significant upgrades to the nation's health and education systems. PNG performs poorly on most health and education indicators, specifically for vulnerable populations such as the rural poor and women, largely due to inadequate state expenditure. The MDTP III highlights both of these areas as very high priorities for GoPNG and aims to improve the quality of healthcare in both rural and urban areas through strategic investments in secondary health services and improved health systems. As part of the plan, Level 4 District Hospitals will be established in every district of the country. A deliberate quality-of-education initiative is also underway that will upgrade the four National High Schools to Schools of Excellence.

45. However, in the near term it is likely that grants, including those with innovative structures, will continue to be the most effective way to continue supporting health and education. There may be some opportunities to more efficiently finance school and hospital construction—e.g., mobilising local pension funds, such as Nasfund, to finance the construction of schools or providing sovereign loans for the construction of hospitals (as EXIM did to finance hospitals for which Australia provided TA). There may also be opportunities to use grant-based modalities more innovatively—for instance, Palladium Group recently sponsored a development impact bond (DIB) in PNG that will help spread awareness about gender-based violence and HIV/AIDS. However, experience would suggest that unless these efforts are incorporated within well-designed, broader system-strengthening efforts, financing the construction of new facilities alone is unlikely to translate into improved health or education outcomes. In addition, given of the weakness of each of these systems, it is unclear that there

¹²⁹ Brookings Institute, *Impact Bonds in Developing Countries*, 2017.

are projects that would be sufficiently creditworthy, even with very concessional forms of finance.

Demand for NGF to Finance the Growth of Micro, Small and Medium-sized Enterprises (MSMEs)

46. MSMEs in PNG have limited access to finance. The MSME sector also faces other challenges, not least of which are the cultural community rights to assets and a lack of entrepreneurial role models. MTDP III calls for a diversification of the economy away from reliance on extractives and toward inclusive growth in key sectors such as tourism and agriculture through the development of small and medium-sized businesses. The SME Policy aims to promote the development of small to medium-sized enterprises—in particular, through strengthening linkages between SMEs and larger industries and investors, as well as regional and international markets, and through the transfer and adoption of appropriate technology to boost the efficiency and productivity of domestic producers.

47. However, the overall lack of bankable SMEs in PNG presents a deeper challenge. Given this broad limitation, Australia could consider deploying grant-based TA programs. While IFC's investment in Bank South Pacific did translate into greater finance for SMEs, there are currently few other viable opportunities (ANZ, for example, recently sold its retail banking business to the PNG-based Kina Bank¹³⁰). Potential options for the more effective use of grant-based mechanisms could include:

- *Financing small business accelerator programs* that help companies become ready to receive external finance (formalisation, building management capacity, etc.). Consultations suggest that the Bank of South Pacific and IFC could be potential project leaders for incubators such as these.
- *Providing challenge grants* to the banks and financial technology companies (fintechs) that are starting to use agent banking models to increase the reach and quality of usage among a wider swath of the population.
- *Providing technical assistance* to help small businesses that are part of the value chains of some of the higher-priority sectors to access more and better finance (e.g., small businesses in PNG's agriculture, water and energy sectors).

Key Challenges and Constraints

48. Providers of development finance face significant barriers in PNG due to a lack of investable opportunities and difficulties in provision. These issues can be attributed to the following drivers:¹³¹

- *Lack of viable deal pipeline:* A well-developed private sector creates a virtuous cycle of investment and consumption, having positive externalities on associated demand for infrastructure and other services. The private sector in PNG is fairly nascent, and hence limits the number of commercially viable projects that may require funding. For intermediaries, restricted deal flow does not allow them to reach a minimum viable scale of investments. This, coupled with uncertainties around exit opportunities owing to an almost non-existent equity market, may be a key challenge

¹³⁰ Radio New Zealand, 'ANZ selling Papua New Guinea assets,' 26 June 2018.

<https://www.radionz.co.nz/international/pacific-news/360420/anz-selling-papua-new-guinea-assets>

¹³¹ Deryck R. Brown, 'Institutional Development in Small States: Evidence from the Commonwealth Caribbean,' *Halduskultuur—Administrative Culture*, 2010; ADB and the Institute of National Affairs, *The Challenges of Doing Business in Papua New Guinea*, 2014.

- *Nepotism, corruption and mismanagement in governance:* Transparency International ranks PNG at 136th least corrupt out of 172 nations. Independent institutions face the significant threat of politicisation or marginalisation. Many institutions are also not being held accountable for their mandated responsibilities, or have overlapping and unclear responsibilities
- *Fiscal health:* PNG is facing a revenue crisis. Adjusting for inflation, the country's 2017 revenues were back at 2006 levels. Imports have fallen by 57% from their 2013 peak and are back at 2005 levels. Imports in the machinery and equipment category have fallen by 58% since 2010, including by 20% in 2016 alone. This might result in the public sector's inability to repay debts, and hence deter development actors from deploying NGF
- *Vulnerability to disasters:* PNG is extremely vulnerable to natural disasters such as volcanic eruptions, floods, cyclones, landslides and tsunamis. The scale of infrastructure reconstruction needed in the aftermaths of these disasters can exceed what the government can afford. Development actors may be reluctant to provide NGF for infrastructure projects that do not account for climate change resiliency
- *Lack of supporting ecosystem:* Not many private equity investors, venture funds or impact investors are present in the market, owing largely to the lack of investable opportunities. This problem compounds misfortune since large donors, many of whom may want to enter the market and offer concessional NGF, cannot invest due to a lack of market information. Further, the lack of a banking, financial services and insurance (BFSI) ecosystem leads to high transaction costs for private players
- *Diversity:* PNG is an extremely diverse country in which more than 800 languages are spoken. For social infrastructure and service provision, scaling becomes complex and resource-intensive, as it is difficult to produce standardised schemes and programs
- *Security:* Many actors point to the pressing physical security risk of investing and doing business in PNG, and list security expenses as one of their chief overheads. The main security threats include urban crime, gender-based violence, corruption, arms trafficking, border protection, resource poaching, climate change, natural disasters, and transnational crime.¹³²

Section IV DEVELOPMENT IMPACT

49. PNG's development needs, particularly viewed through a gender lens, are closely related to the need for better infrastructure. Financing critical infrastructure upgrades frequently results in stimulation of inclusive economic growth. For instance:

- *Improved and affordable electricity access.* PNG's energy deprivation disproportionately affects women, who are primarily responsible for collecting firewood and other fuel materials for lighting and cooking, and also suffer from indoor pollution due to the lack of clean energy appliances. Stable power access allows women to meaningfully utilise timesaving energy appliances such as cooking stoves and solar lamps. Evidence from South Africa shows that rural electrification raised female labour force participation by 9.95%, likely because increased use of such appliances freed the time and effort previously required for a number of household obligations, and

¹³² Sinclair Dinnen, *Internal Security in Papua New Guinea: Trends and Prospects*, 6 December 2017.

effectively enabled micro-entrepreneurship; similar studies from Brazil and Nicaragua affirm this relationship between energy access and female employment.¹³³ Further, increases in purchasing power can create a virtuous cycle wherein women can work their way up to other effective timesaving appliances such as washing machines and gain even more autonomy. Reliable access to energy also empowers self-employed women who run small businesses from their homes, and can have an outsized impact on girls whose household learning environment and education outcomes suffer from electricity disruption at night.¹³⁴

- *Greater and safer access to drinking water and sanitation facilities.* More extensive and better maintained WASH infrastructure can free up time to be used productively in income-generating activities, improve education outcomes, and lower safety risks for women. Women and girls are the primary collectors of water in PNG. Without water piped to their doorstep, women lose productive and leisure time to the drudgery of water hauling and other WASH-related domestic labour, while school attendance rates drop for girls. Female participation in schools also diminishes due to a lack of separate and usable sanitation facilities on the premises.¹³⁵ When toilets are few and far between, the threat of sexual assault increases; in provinces like Bialla, women use sanitation facilities at night for privacy.¹³⁶ This is especially dangerous given how widespread gender-based violence is: two out of every three Papua New Guinean women are estimated to have experienced rape or assault in their lifetimes.¹³⁷
- *Improved transport access.* Lack of access to urban healthcare facilities has significant consequences for rural women—professional health staff assist in only 47% of rural pregnancy deliveries in PNG.¹³⁸ Poor connectivity to healthcare facilities also leads to reduced treatment and reporting of violent injuries caused by domestic abuse; more than half of married women experience rape in their marriage, and 68% are beaten at home.¹³⁹ In addition to bettering health outcomes, improved roads could make schools less remote and education more accessible to girls (one in six teenage girls never attends school in PNG, compared to one in fourteen teenage boys),¹⁴⁰ and also connect women entrepreneurs to market centres at lower costs and with greater reliability.
- *Improved agricultural infrastructure.* As in many developing countries where the agriculture workforce is highly feminised, women carry out 70% of agricultural work in PNG. Extending concessional finance to agribusinesses to improve irrigation infrastructure and access other technological inputs could lead to greater income earnings for women, allowing them to invest in their own training and skill-

¹³³ Sophia Kathleen O'Dell, Sophia Peters and Kate Wharton, 'Women, Energy and Economic Empowerment', *Deloitte*, 18 September 2014. <https://www2.deloitte.com/insights/us/en/topics/social-impact/women-empowerment-energy-access.html>

¹³⁴ Ibid.

¹³⁵ JMP, WHO, UNICEF, *Annual Progress Report, 2017*; UNICEF, *Strategy for WASH (2016-30)*, 2016.

¹³⁶ World Bank, 'Papua New Guinea: Clean Water Access to End the Walk for Water for Women and Girls', 20 March 2018. <https://www.worldbank.org/en/news/feature/2018/03/20/papua-new-guinea-clean-water-access-to-end-the-walk-for-water-for-women-and-girls>

¹³⁷ Human Rights Watch, *World Report: Papua New Guinea*, 2016.

¹³⁸ ADB, *Sector Assessment (Summary): Health*, 2015.

¹³⁹ Liam Cochrane, 'Papua New Guinea's rates of violence at 'pandemic' levels, Australian Federal Police officer says', ABC News, 19 February 2015. <https://www.abc.net.au/news/2015-02-19/png-facing-a-domestic-violence-pandemic,-afp-officer-says/6150064>

¹⁴⁰ Jonathan Pryke and Paul Barker, *A Bumpy Road: Societal Trends in Papua New Guinea*, 6 December 2017.

development, participate in cooperatives and even shift from subsistence farming to more lucrative employment opportunities that are currently male-dominated.¹⁴¹

- *Greater ICT connectivity.* Increased mobile penetration and internet usage have also been shown to lead to beneficial outcomes for women, particularly in terms of the development of marketable skills and an increase in financial inclusion through mobile banking services. Women-owned businesses in PNG have testified that ICT infrastructure is driving economic benefits by allowing them to reach a wider consumer base.¹⁴²

50. Australia's investment in infrastructure should be seen as consistent with the objectives of its development assistance program as well as its strategic interests. Improvements in the top priority areas—including power, energy and water—have generally been perceived as tangible, transformative and clearly attributable to Australia's interventions.

51. The key sectors that are most associated with PNG's development constraints—power, transport and telecommunications—require far more than just grants. Australia is a credible partner to GoPNG, but more frequent involvement in larger infrastructure projects will bolster this credibility. While grant-based funding efforts are important (e.g., funding sector analysis, feasibility studies, technical advisory work and institutional strengthening), there are limits to what these programs can achieve. Influence in Melanesia is strongly relationship-based. In contrast to the up-front, one-off benefits of grants, investments typically involve longer-term partnerships for the life of the project—which, for infrastructure projects, may mean decades of close collaboration.

52. For instance, ADB has a solid track record in financing investment programs that support the government's target of electrifying 70% of all households by 2030.¹⁴³ The US\$ 238 million investment programs prioritise renewable energy generation, improving transmission and distribution efficiencies and expansion to peri-urban areas. The investments are expected to respond to the government's national development and sector strategies by promoting sustainable development in peri-urban and rural areas and by increasing the grid penetration from 12% to approximately 19% by 2028, as well as by replacing diesel generation with renewable energy sources in provincial centres. The investment programs are also likely to enhance the operational efficiency of PPL and address institutional capacities and policy framework, as well as facilitate private sector mobilisation in off-grid areas.

53. However, the decision to deploy NGF in the PNG context must also take into consideration the impact of these instruments on the country's fiscal situation. The IMF Debt Sustainability Analysis classifies PNG's public and external debt burden as moderate and its debt-to-GDP ratio as low, at 33.4%.¹⁴⁴ However, it is worth noting a lack of consistent data and

¹⁴¹ World Bank, 'Women in Papua New Guinea to Play Stronger Role in Agriculture', 16 September 2013. <http://www.worldbank.org/en/news/feature/2013/09/16/women-in-papua-new-guinea-to-play-stronger-role-in-agriculture> ; Katja Mikhailovich et al., 'Exploring the lives of women smallholder farmers in Papua New Guinea through a collaborative mixed methods approach', *Cogent Social Sciences*, 22 February 2016.

¹⁴² Food and Agriculture Organization of the United Nations (FAO), 'FAO shares the "7 success factors to empowering rural women through ICTs"'. <http://www.fao.org/e-agriculture/news/fao-shares-7-success-factors-empowering-rural-women-through-icts> ; Sarah Byrne, 'Women entrepreneurs say ICT infrastructure and expertise delivering economic benefits', *Business Advantage PNG*, 2018. <https://www.businessadvantagepng.com/women-entrepreneurs-say-ict-infrastructure-and-expertise-delivering-economic-benefits/>

¹⁴³ ADB Press Release, 'New Energy Grid, Transmission Investments are Lighting up Papua New Guinea', 2018. <https://www.adb.org/news/videos/new-energy-grid-transmission-investments-are-lighting-papua-new-guinea>

¹⁴⁴ IMF, *Papua New Guinea: Staff Report for the 2017 Article IV Consultation—Debt Sustainability Analysis*, 2017.

the fact that the IMF's analysis does not recognise the debt on the balance sheets of SOEs. Any sovereign-based lending over the next 3–5 years should be undertaken with significant prudence. Australia's current efforts to support GoPNG's priorities around improving revenue generation will be key. Commercial banks operating in PNG are very cautious about increasing their exposure to GoPNG, citing concerns about debt sustainability. While public borrowing to support productive investment continues to drive growth in emerging economies—and is central to building infrastructure that cannot be funded by taxpayers—there is also considerable evidence indicating significant negative impacts on countries and their people when governments incur too much debt. However, instruments such as equity investments provide a means of project financing through NGF without necessarily adversely impacting overall fiscal health, underscoring the need for Australia to adopt a full suite of finance tools.

54. Ensuring that these investments translate into sustainable development outcomes will require robust efforts to establish and monitor good governance practices as well as investments in sound and transparent data systems that can measure relevant development outcomes. For instance, ADB recognises that some of the challenges faced in the country include:

- Lengthy contract approval procedures within GoPNG that affect timely delivery of the projects
- Outstanding contractual obligations that affect project implementation
- Lack of capacity, such as existing road contractors with poor expertise and construction capability
- Inadequate government counterpart funding due to project cost overruns and additional costs borne by the projects
- The commonplace occurrence of land disputes and compensation claims when working in various targeted provinces¹⁴⁵

55. These are all challenges that DFAT is likely accustomed to dealing with, and may not pose any new difficulties.

Section V INSTITUTIONAL, CAPACITY AND FINANCING REQUIREMENT

56. To successfully deploy NGF in a PNG context, any institutional arrangements would need to allow for the following capabilities:

- Flexible financing that can be deployed with significant discretion as to the timing and nature of specific activities financed
- The ability to move quickly with financing decisions and contracting processes
- A whole-of-government approach to ensure that investment decisions benefit from a full range of perspectives including development, trade and security perspectives
- The alignment of staff incentives (i.e., a strong focus not on *volume* of financing but rather on the *quality* of projects and delivery of outcomes).

¹⁴⁵ Gorethy Kenneth, 'ADB faces challenges to roll out programs', *Papua New Guinea Post-Courier*, 9 December 2016. <https://postcourier.com.pg/adb-face-challenges-to-roll-out-programs/>

57. There are significant capabilities already in place in the PNG HiComm to deliver projects in the near term; over time, these capabilities would need to be augmented as the project portfolio grew in order to fully realise the opportunity of deploying NGF. Australia already has some relevant capabilities including a track record of financing infrastructure projects (although on a smaller scale) and ongoing advisory work in key infrastructure sectors (such as energy, power, etc.). Australia's environmental, social and governance (ESG) expertise is widely recognised, particularly in the areas of community safeguards and gender analysis. Although significant internal resources are dedicated to these safeguards currently, they would need to be more effectively translated into practical elements of project implementation. Australia also has many existing relationships across key stakeholders, including within GoPNG, which would likely prove helpful as Australia expanded its development assistance program. However, Australia would need to add further capacity, including additional technical expertise in project financing and flexible access to sector experts.

58. There will also be potential opportunities to use Australia's industry expertise and reputation. Australian corporations enjoy a reputation both for high-quality services and products and for "clean" business practices, including a willingness to employ, train and promote local workers, transfer technology to local partner businesses, utilise best practice procurement processes and deploy world-class systems and sector-specific technologies. Australia's development assistance program would benefit from forming deeper relationships with Australia's major companies by using NGF judiciously to attract them into commercial opportunities in PNG.

ANNEX 5—Country Report: Vanuatu

This annex has been developed by Dalberg Advisors, and represents their independent interpretation and analysis of the team's visit to Vanuatu.

Section I EXECUTIVE SUMMARY

1. **Significant demand for infrastructure investments, across multiple sectors, is expected as the Government of Vanuatu (GoV) implements the ambitious vision for the country's society, environment and economy outlined in the National Sustainable Development Plan (NSDP) (2016—2030).** The demand will be supported by ongoing recovery efforts and the implementation of national plans in the aftermath of Cyclone Pam. Three years since the cyclone hit, Vanuatu is still rebuilding much of its infrastructure and will require considerable financial investment over the next decade.
2. **NGFs may have limited applicability in the context of Vanuatu under present conditions and circumstances.** Bilateral donors in the past have focused on grant provision in the country, as opposed to ODA loans, owing to concerns around debt sustainability, poor governance practices, perceived preference among domestic politicians for grants instead of NGF, a limited domestic market size, absence of a thriving private sector and few bankable projects. Given that many of these constraints remain in place, Vanuatu may not yet be ready for intensive deployment of NGF.
3. **For the present, the continued use of grant financing complemented by dedicated TA will be most impactful.** Grant financing can continue to be used to provide TA and build institutional and human capacity to support infrastructure projects. In addition, these grants should continue to be designed with the aim of transferring technical knowledge and expertise to the local Vanuatu workforce.
4. **However, the ability to deploy NGF in select circumstances will be valuable for both Australia and Vanuatu.** We believe that four use cases emerge for the applicability of NGF in the Vanuatu context: (1) financing large, strategic infrastructure projects, specifically in the sectors of ports, airports and power; (2) playing the role of a market maker through smaller-sized investments in private sector players such as MSMEs and social enterprises; (3) committing highly concessional debt or guarantees to finance disaster relief; and (4) creating parallel co-financing arrangements with MDBs to take more ownership of project implementation.

Section II ANALYSIS OF STRATEGIC DIMENSIONS

5. **As the largest bilateral partner of Vanuatu, Australia's assistance has been key to the country's development. The socioeconomic context in Vanuatu is evolving; by 2020, the country is expected to transition out of its least developed country (LDC) status. At the same time, other bilateral actors are increasing their efforts in the region. Given these variables, there is potential for Australia to introduce NGF selectively over time in order to remain strategically relevant. In the more immediate term, given Vanuatu's limited market size and the concerns around its ability to repay, Australia should continue providing grants.**
6. **Vanuatu is an important strategic partner for Australia given its historical ties, geographic location and broader geopolitical implications.** Australia has a direct interest in a prosperous and stable Vanuatu given the country's proximity and a long history of aid and trade. Australia is Vanuatu's largest development partner, providing approximately 40% of total ODA to the

country.¹⁴⁶ Australia is also an important economic partner of Vanuatu, providing the country with the majority of its foreign direct investments. In addition, Australians comprise the majority of tourists to Vanuatu.

7. In comparison to other Pacific islands, Vanuatu does not have rich natural resources and is at high risk of suffering from natural disasters; aid remains a critical source of financing for national infrastructure and social services. According to the UN University World Risk Index, Vanuatu is the world's most "at-risk" country for natural hazards. In addition, economic growth in Vanuatu is constrained by a lack of natural resources, the country's distance to major markets, infrastructure needs, limited access to financial services and a narrow market base. Aid has remained a critical source of revenue under public finance, constituting, in some years, as much as 15% of the total government revenue.¹⁴⁷ Despite these challenges, Vanuatu's economic growth over recent years has been in line with the countries in the region, with forecasts suggesting GDP growth of around 4% in 2018.¹⁴⁸ Economic and social stability have, in turn, helped attract investment and tourism.

8. In carrying out its NSDP, and as part of ongoing post-Cyclone Pam and post-Volcano Manaro Voui recovery efforts, Vanuatu will continue to require considerable financing to rebuild, build and maintain its infrastructure. In 2015, Cyclone Pam hit Vanuatu, resulting in damages to infrastructure and other losses estimated at over 64% of GDP.¹⁴⁹ While reconstruction efforts have been greatly supported by donors through grants,¹⁵⁰ the GoV was still required to borrow from external sources and run a significant fiscal deficit in order to access the sheer volume of funding required.¹⁵¹ Three years since, the country is still rebuilding some of its infrastructure, with some MDBs yet to commence their programs: the World Bank's US\$ 50 million Vanuatu Reconstruction and Improvement Project is still in the procurement planning stages as of November 2018, and the EU recently announced an EUR 10 million grant recovery package.¹⁵²

9. Following Cyclone Pam, the eruption of the volcano Manaro Voui in July 2018 presented another major natural disaster, resulting in the evacuation of the entire island of Ambae.¹⁵³ Infrastructure financing will be required for the construction of housing and public buildings to accommodate evacuees on the islands of Santo and Maewo.

10. Vanuatu has just two urban centres (Port Vila and Luganville); over 70% of the population lives in rural areas that lack infrastructure even for basic services such as electricity and water supply. The absence of other essential infrastructure such as roads is also a huge bottleneck for the growth of the tourism sector.

11. In 2016, GoV committed itself to the NSDP (2016—2030), laying out a fifteen-year vision for the society, environment and economy of Vanuatu. While the plan does not present any specific targets, the vision is ambitious, and Vanuatu will require considerable financial investment over the next decade to deliver on its national plans.

¹⁴⁶ Estimates based on data from OECD and reports on China's aid.

¹⁴⁷ Government of Vanuatu, *Select Budget Statements*.

¹⁴⁸ DFAT, *Vanuatu country brief*, 2018.

¹⁴⁹ Government of Vanuatu, *Vanuatu Post-Disaster Needs Assessment*, 2015.

¹⁵⁰ GoV received grants worth USD 4.7 million and insurance payouts worth USD 2 million for cyclone recovery operations; exchange rate: USD 1 = VUV 100.

¹⁵¹ Accounting for donor financing, the combined net borrowing (or fiscal deficit) for Vanuatu was estimated at USD 113 million in 2015, USD 149 million in 2016 and USD 140 million in 2017.

¹⁵² World Bank, *Vanuatu Infrastructure Reconstruction and Improvement Project—Procurement Plan*, 2018.

¹⁵³ BBC News, 'Vanuatu: Ambae island evacuated again over volcano eruption', 27 July 2018.

<https://www.bbc.com/news/world-asia-44978132>

12. While the aid inflows into Vanuatu are presently dominated by Australia, other players are making significant inroads into the country and are financing strategic infrastructure. Most of the disbursements, however, have been in the form of grants and the offtake of loans has been less common. According to the OECD database, Australia is the largest donor of aid to Vanuatu. Other significant players include Japan, New Zealand and the United States, along with EU institutions, the IMF and the Global Environmental Facility. Much of the aid is currently committed or disbursed in the form of grants and technical cooperation, with ODA loans constituting only 2.6% of overall aid.¹⁵⁴ Most aid focuses on the social infrastructure sector (approximately US\$ 1.5 billion over 2007–2016), which includes education and healthcare. In comparison, aid for economic infrastructure—including for transport, energy and communication—amounted to a little over US\$ 699 million for the same period.

13. However, other players are increasing their presence in the region. For instance, while official figures are not available, estimates from the Lowy Institute indicate that China has disbursed US\$ 243 million in aid since 2006. If true, this makes China the second largest donor behind Australia. Chinese companies have been contracted for strategic assets, including the upgrade of the Bauerfield Airport runway in Port Vila, which remains the only international airport in the country until the upgrade of the Luganville airport is completed. The China Civil Engineering Construction Corporation (CCECC) is the main contractor for the World Bank-funded US\$ 47 million Vanuatu Aviation Investment Project.¹⁵⁵ In addition, the Chinese have built an exhibition centre and a stadium in Port Vila and are in charge of the Tanna-Malekula Road rehabilitation and the construction of the Luganville wharf. In education, proposed projects valued at US\$ 282 million are almost entirely being funded by Chinese aid.¹⁵⁶ While some projects such as the exhibition centre and the stadium are funded through grants, others such as the construction of roads and wharfs have been structured as loans. The Lapetasi wharf in Port Vila, meanwhile, has been financed by Japan and offers another example of bilateral donor investment.

14. The tendency of countries leading some of these development projects to bring in their own labour has given rise to concerns around the lack of technical and knowledge transfer to Vanuatu workers. The Bauerfield runway upgrade project, for instance, largely uses non-local labour at almost all levels. This is in stark contrast to some of the other projects in the region, such as the development of the Lapetasi wharf by JICA, which largely used local labour and, in the process, upskilled ni-Vanuatu workers.

15. While implementers often face difficulties in sourcing local labour due to low skill levels, past projects have attempted to bridge this gap by providing training opportunities to local workers. Australia, for example, has intentionally submitted its major projects, such as the Port Vila Urban Development Project, through GoV systems to demonstrate trust and build local capacity.

16. Australia's development assistance has supported Vanuatu's efforts to build resilient urban infrastructure, recover from Cyclone Pam and achieve better health and education outcomes. However, that aid has been spent with mixed results. Australia was one of the first responders post-Cyclone Pam in Vanuatu and provided both humanitarian support and funds for immediate and long-term recovery. Some of the immediate efforts helped in providing food security, healthcare, education and rehabilitation support, while the long-term support is

¹⁵⁴ ODA loan share may be underestimated given that the data do not include disbursements from China, which is likely to have provided a higher share of loans than other donors.

¹⁵⁵ *The Blue Swan Daily*, 'Vanuatu Govt confirm Port Vila Bauerfield Airport's USD47m runway rehabilitation project is underway', 3 November 2017. <https://blueswandaily.com/vanuatu-govt-confirm-port-vila-bauerfield-airports-usd47m-runway-rehabilitation-project-is-underway/>

¹⁵⁶ Government of Vanuatu, *Vanuatu Infrastructure Strategic Investment Plan 2015-2040*, 2015.

continuing to rebuild much of the physical infrastructure in the country—program works are scheduled to be completed in June 2019.

17. In another instance, Australia announced the US\$ 25 million Port Vila Urban Development Project to build urban infrastructure to be co-financed with ADB. Funds were committed to resurface 21 kilometres of roads in the Vanuatu capital as well as build 33 kilometres of roadside drainage. However, an assessment undertaken by the Australian National Audit Office in June 2015 rated the project poorly across a number of criteria. While the project has since continued, the 2015 assessment found that the project had not followed standard processes and planning had not been efficient.¹⁵⁷

18. For Vanuatu, the centrepiece of Australian engagement will likely continue to be grant financing, complemented by dedicated TA with the ability and capacity to exercise active engagement in project implementation. Many development projects, infrastructure or otherwise, are of smaller size and may be sub-commercial for development players looking to invest in the region. There are also concerns about rising debt levels of the country, pointing to a looming sovereign risk. Grant financing can continue to be used to provide TA and build institutional and human capacity to support infrastructure projects. For instance, the supply of project planning and management software, computer systems and training of staff provided through grants will be beneficial for a host of infrastructure projects. Past examples that have worked well include the use of grants for management software purposes during the construction of the Ifira Port Development Company.

19. However, the ability to deploy NGF in select circumstances will be important for funding strategic and high-impact projects. The financing needs in Vanuatu are large and recur on a regular basis, meaning that a grant-only model is not likely to be sufficient for Australia to remain a key strategic partner. The following section highlights some of the clear cases in which deployment of NGF will be most useful.

Section III DEMAND ANALYSIS

Detailed Findings

20. Our demand-side analysis reveals four NGF use cases in the Vanuatu context that demonstrate the value to Australia of having access to NGF. As incomes rise and Vanuatu transitions from being an LDC in 2020, Australia's strategy should reflect these underlying economic changes. The four use cases for NGF in Vanuatu are as follows: (i) providing finance for large, strategic infrastructure projects; (ii) providing financing for smaller-sized investment deals; (iii) providing finance for disaster relief; and (iv) creating parallel co-financing arrangements with MDBs.

21. First, NGF will be valuable for financing larger-sized national infrastructure projects with important geopolitical implications. Grants, by nature, are constrained by size and more suited for projects that may not have the potential to generate profit over extended periods of time. Given their ability to attract and repay investments, large, revenue-generating projects are principally funded through loan and equity investments.¹⁵⁸ As such, aid may be best reserved for other sub-commercial non-revenue generating projects and sectors.

22. Adding NGF to the current set of offerings can enable Australia to make investments multiple times larger than current grant investment sizes, and hence fund larger projects. Some

¹⁵⁷ *XinhuaNet*, 'Australian roads project in Vanuatu rated poor by audit office', 1 February 2018.

http://www.xinhuanet.com/english/2018-02/01/c_136941798.htm

¹⁵⁸ McKinsey & Company, *Making the most of a wealth of infrastructure finance*, 2015.

of the other players' investments in individual infrastructure projects surpass Australia's entire annual development assistance budget for Vanuatu. Instruments such as loans can, within the same financial envelope, be offered responsibly in much larger sums than grants in order to help finance larger and costlier developments projects. Risk aside, a US\$ 100 million zero-interest loan for a period of three years represents the same expenditure as a US\$ 19 million one-year grant,¹⁵⁹ yet larger envelopes can go further toward funding much larger projects. For instance, JICA invested in the Lapetasi wharf to the tune of US\$ 70 million—almost equal to the total annual development assistance budget that Australia allocates for Vanuatu.¹⁶⁰

23. Opportunities to deploy NGF may not surface in the near term due to a number of factors. The constrained market size, sparse private sector activity and institutional weaknesses can all deter private players, while investors like JICA are already actively meeting many of the existing major opportunities to deploy NGF. Moreover, many of the opportunities that have surfaced—such as lending through green bonds or supporting company-led projects to improve and expand telecommunication, electricity, water and transport infrastructure—are still theoretical at this stage; none are actually underway or in the pipeline. Taken together, these factors do not paint an encouraging picture for bankable opportunities right now. However, having access to NGF would be valuable should opportunities for larger-sized infrastructure projects with geopolitical advantages present themselves in the future. As such opportunities reached readiness, investments could be made either directly or through institutional investors such as the Vanuatu National Provident Fund, a joint investment platform of the pension funds of various Pacific islands, or the Australian High Commission's developments in new areas. Examples of potential larger-profile infrastructure projects include the following:

- **Ports.** As trade improves, there is potential to increase the capacity of existing ports and wharfs or build new ones. These projects can be funded through long-term concessional loans with repayment ensured by the revenue stream generated by the project.
 - For instance, JICA funded the construction of the new Lapetasi wharf, container yard and facilities in Port Vila to alleviate the high berth occupancy at the existing International Wharf. The project aimed to improve efficiency, mitigate the high cost of stevedoring and reduce delays and congestion that were causing poor delivery capacity of containers and cargo to consignees. The facility was funded through long-term concessional loans in the range of US\$ 70 million with ten years of grace period. Loans were awarded to a private entity, Ifira Trust Limited, which expects the project to generate a steady flow of cash—currently being used to repay the loan.
 - Similarly, China is funding the construction of a wharf in Luganville at the cost of US\$ 114 million, which is now the largest in the South Pacific and strategically located in the same harbour in which the US based many of its troops during World War II. The terms of the construction between China and the Vanuatu government are unknown.
- **Airports.** As mentioned above, CCECC is currently conducting a runway upgrade of the Bauerfield Airport in Port Vila through a World Bank-funded project.
 - There are also plans to upgrade the Pekoa and Whitegrass International Airports with World Bank funding, but construction has not yet commenced. There may

¹⁵⁹ Assuming a 6% rate of interest compounded annually; conservative estimates not discounting for time value of accrued interest yields.

¹⁶⁰ Department of Foreign Affairs and Trade, *Overview of Australia's aid program to Vanuatu*, 2018. Accessed on 16 October 2018.

exist scope for Australia to provide technical support and additional funding for some of the airport upgrade projects.

- PPP models such as “build-own-operate” have the potential to be used in Vanuatu as well, given the increasing number of tourists over the years, which should positively impact airport traffic;¹⁶¹ IFC is exploring such models for airports in East Timor, which may prove relevant for Vanuatu.
- **Power.** Electricity penetration rates remain extremely low. The two private utilities, Union Electrique du Vanuatu (UNELCO) and Vanuatu Utilities and Infrastructure (VUI), capture all of the market; UNELCO has a concessional pricing agreement with the GoV in several islands, in which the price is driven by cost of production, which is opaque.
 - Australia can explore the opportunity to work with the Vanuatu National Provident Fund through concessional loans to finance some of the equity investments it is currently making in UNELCO. Taking a more active position in electricity companies may also help Australia reduce the opacity around price setting and foster a more rules-based environment.
 - There has been some traction in the mini-grid market from the private sector, and Vanuatu recently received US\$ 15 million from the World Bank for the Rural Electrification Project Stage II, which seeks to construct five mini-grids in the nation's rural areas. Australia's concessional loan support or guarantees through minimum purchase agreements could catalyse the market.
 - JICA is funding the construction of a downstream hydropower station in Louganville with an additional capacity of 1.2 megawatts. However, this facility might be funded wholly through grants. There might be scope for Australia to consider providing concessional finance to other upcoming facilities. By leveraging its influence, Australia could catalyse the electricity market in the islands that lie outside of the UNELCO/ GoV electricity concession, thereby improving access to energy in the nation's remotest locations.

25. Second, market-making NGF that target smaller-sized investments to support MSMEs and social enterprises across a broad range of sectors are likely to be additional. Consultations with stakeholders including banks and private players suggest that the MSMEs and social enterprises in Vanuatu are likely to benefit from an infusion of financing in smaller-sized investment items, helping them access working capital with minimal collateral requirements, create business plans, understand the market landscape, put their existing finances in order and establish new financial reporting mechanisms. Such ecosystem creation will, in time, make the firms market ready and allow for NGF such as small-sized equity to be gradually deployed.

26. There is much demand for smaller-sized investment items in Vanuatu—not many players are actively catering to this segment. The IFC estimates that ni-Vanuatu MSMEs face a financing gap of US\$ 135 million.¹⁶² Banks reveal that most of the smaller enterprises, especially in the tourism and fishery industries, are constrained by access to finance, given the high levels of risks associated with lending to them. Many of the loan applications are rejected due to lack of experience among the founding team, lack of any collateral or deposit and the country's poor law enforcement standards in case of defaults. At the same time, our consultations also suggested that there may exist supply-side issues with local banks being unable to provide loans to small business owners at competitive interest rates. Players such as the IFC are not able to meaningfully cater to these enterprises, given that they define an SME investment as ~US\$ 5

¹⁶¹ Indexamundi, *Vanuatu International Tourism*, 2016.

¹⁶² Miriam Bruhn et al., *MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small, and Medium Enterprises in Emerging Markets*, 2017

million, which is extremely high for Vanuatu. Demand exists among MSMEs and social enterprises for smaller-sized investments combined with guidance and mentorship. One potential way in which Australia can cater to this segment is by contributing to a fund focused on enabling smaller enterprises to improve their processes, build sustainable businesses and access more commercial capital.

27. Third, commitments for disaster relief, in the form of guarantees or highly concessional loans, will be extremely valuable for Vanuatu. Australia has been one of the key supporters of recovery and rebuilding efforts in Vanuatu after Cyclone Pam, having invested upwards of US\$ 36 million and rebuilt over 200 buildings since 2015. However, given the ongoing risk of disasters in Vanuatu and the underdeveloped insurance landscape, commitments for disaster relief in the form of loans can help Australia invest considerably larger sums of money. Similarly, given that insurance provision is considered to be an extremely risky business in Vanuatu, consultations suggest that guarantees to insurance players are likely to help crowd in private players and reduce insurance premiums, enhancing overall readiness to deal with the aftermath of future disasters.

28. A disaster relief fund could help enhance Australia's relationship with Vanuatu, given its reputation for being the first responder in times of crisis. After Cyclone Pam, the single largest provider of insurance in Vanuatu—Tower Insurance, with a market share over 80%—reduced its exposure to disaster insurance. This points to a gap in the market and highlights the demand for de-risking instruments to insure the insurer and reduce premiums. One way in which Australia can satisfy the demand is by committing concessional or zero-interest debt in the case of future disasters—helping to rebuild of infrastructure at a much faster pace than is possible with fully grant-based aid.

29. Fourth, in order to ensure the quality of processes and mitigate any risks to its reputation, Australia could consider actively participating in the procurement and delivery processes for co-investments made with MDBs. Some donors in the past have run into issues in the process of vendor selection when investing with an MDB. Our consultation with JICA revealed that in one instance, the Lapetasi wharf project ran into difficulties at the planning stage due to consultants' inaccurate project designs, increasing the project implementation cost by almost 100%. In other instances, donors have had no ability to ensure appropriate skill levels of locally sourced labour, but have had to potentially bear the reputation risk for faulty project implementation practices.

30. Working more closely with the MDBs—and ensuring that Australia is party to financing arrangements that provide greater control over procurement and delivery processes—would also help improve the effectiveness of Australian aid. New Zealand's Ministry of Foreign Affairs and Trade, for example, has had challenges with an ADB-led project implementation due to ADB's lack of a strong local presence in Vanuatu. Similarly, an MDB's vendor selection and procurement processes may not always align well with those of the donor, negatively impacting the project implementation. Securing a seat at the table through parallel co-financing arrangements can afford Australia greater ownership of project implementation and help ensure better development outcomes. This is by no means a benefit flowing exclusively from NGF, and will equally be available through grant financing—which, as emphasised earlier, should remain the core of Australia's engagement with Vanuatu. Innovative grant structures that could allow Australia a seat at the table include results-based aid, such as the US\$ 4.85 million agreement between the World Bank and GoV in 2014 to bring electricity to low-income households, which was facilitated by Australia's contribution to Global Partnership on Output-Based Aid.

31. Finally, outside of these four use cases, Australia's approach in the country should continue to focus on grant provision, with an added focus on technical advisory, knowledge

sharing and quality control and maintenance. For instance, IFC and other actors investing in private players believe that there is an absence of credible players able to provide TA such as incubation support to improve the readiness of smaller enterprises to take on finance.

32. Australia can also look closely at innovative forms of grant deployment, such as allowing the grantee to use a single grant fund to create a sustainable stream of revenue through investments in a social business venture—effectively ensuring that the grant is used as a revolving fund. Consultations with New Zealand's Ministry of Foreign Affairs and Trade suggest that the agency used grants to fund a facility for loan provision in Vietnam. The facility saw almost 100% repayment and the initial grant by the agency became the principal fund. Such an approach can also be used in Vanuatu. In addition, Australia can use its development assistance to improve transparency in Vanuatu through helping to create more rules-based standards that can influence the quality of the country's regulation and legislation.

- **Roads.** Australia has long been a key financier of roads in Vanuatu and currently runs the Vanuatu Roads for Development program with an allocation of US\$ 18 million over 2017–2021.¹⁶³ Many stakeholders believe that Australia has, over the years, gained a competitive advantage in the roads sector and is a key partner of choice for road construction and rehabilitation. Given concerns around debt sustainability, and the consideration that road infrastructure often cannot be monetised, especially on small Pacific Island countries such as Vanuatu that may not have need for toll roads, it may be prudent to continue funding the construction and restoration of roads through the use of grants.
- **Telecommunication.** Due to high telecommunication coverage in Vanuatu—upwards of 97%—along with constrained market size and the presence of dominant players such as UNELCO and VUI, there is little entry motivation for additional players. The market for faster broadband is also likely to be limited, both due to market size and household purchasing power considerations—once again making unlikely the prospects of wide-ranging commercial activity for Australia to support. The sector does, however, have a dearth of qualified personnel. Australia is well suited to use grants to build the sector's human capacity.
- **WASH.** Australia has supported the establishment of community sanitation facilities and a new sewage treatment facility through its US\$ 21 million Port Vila Urban Development Project, and is currently supporting water supply systems through its US\$ 3.2 million basic water infrastructure project—part of its Tropical Cyclone Pam long-term recovery strategy.¹⁶⁴ While there is demand for water purification systems in rural areas, these facilities would be best funded through grants, given that they are usually perceived as public goods with significant positive externalities around disease prevention—an area of pressing concern, giving the high incidence of communicable diseases and other adverse health trends in Vanuatu.

Key Challenges and Constraints

33. It is important to note that these NGF opportunities exist within broader contextual concerns around limited domestic market size, a minimal number of bankable projects, an opaque understanding of debt sustainability, corruption within some levels of government, a pronounced desire amongst government decision makers for expediency in project design and delivery and the preference among some politicians for grants instead of NGF. Given

¹⁶³ Department of Foreign Affairs and Trade, *Building resilient infrastructure and an environment for economic opportunity in Vanuatu*, 2018.

¹⁶⁴ Ibid.; DFAT, *Aid program Performance Report 2016–17: Vanuatu*, 2017.

these present circumstances, we believe that, with the exception of select instances outlined above, NGF currently have limited applicability in the context of Vanuatu.

34. There are concerns around rising levels of debt in the country. Officially, the Vanuatu government has current debt levels of over 30% of GDP, but these are highly contestable. For this reason, and due to the relatively easy availability of grant money from other donors, many politicians also prefer grants to other financial instruments. The general perception of the political landscape is that it is saddled with corruption and constrained by the short-term vision of some politicians—factors that negatively affect the investment appeal of longer-term projects. Moreover, our consultations revealed that recent legislation empowers individual Members of Parliament to take on sovereign debt for projects; many of these loans are likely not reflected on the official balance sheet.

35. In addition, the domestic market and export capabilities of local players are limited, severely constraining the potential for revenue and thus the bankability of many development projects. Almost all institutions are affected by perceived corruption—Transparency International ranks Vanuatu as 71st least corrupt out of 180 nations.

Section IV DEVELOPMENT IMPACT

36. Vanuatu may benefit greatly from improved infrastructure and a thriving private sector that focuses on smaller enterprises.

- Financing critical upgrades of infrastructure frequently results in stimulation of economic development and growth. For instance,
 - improved electricity enables education and healthcare upgrades, as well as consistent telecommunications services
 - improved transport enables lower-cost and more reliable market access
 - greater access to low-cost telecommunications and internet has positive impacts on education, healthcare, business development and access to financial services
- Australia's investment in infrastructure should be seen as consistent with the objectives of its development assistance program, as well as with its strategic interests.
- Smaller enterprises have the potential to move the needle in Vanuatu by generating employment and creating demand for additional investments, likely having a positive impact on the overall economy.

37. Key sectors such as power, transport, and smaller enterprises can benefit greatly from larger NGF investments. By funding larger infrastructure projects such as ports and airports, as well as smaller enterprises, Australia can act as a credible partner to the GoV in areas of high strategic and development priority. While grant-based funding efforts are important and should be continued (e.g., funding sector analysis, feasibility studies, technical advisory work and institutional strengthening), greater impact can be created through the use of NGF.

- For instance, development of the Lapetasi wharf has opened up new avenues for trade and tourism. Bigger cruise ships, with the capacity of up to 6,000 people, can now disembark at the wharf, creating local tourism opportunities. Similarly, the port can handle up to 30,000 container boxes over a seven-day cycle, enabling greater trade in the region.

38. Ensuring that these investments translate into development outcomes will require solid project management as well as working closely with the GoV and other stakeholders to participate in on-the-ground implementation.

Section V INSTITUTIONAL, CAPACITY AND FINANCING REQUIREMENTS

39. To successfully deploy NGF in Vanuatu, any institutional arrangements would need to allow for the following capabilities:

- Resources and expertise to actively participate across all stages of project implementation
- Comfort with smaller-sized investment deals and the ability to provide handholding support to smaller enterprises
- Flexible financing that can be deployed with significant discretion as to the timing and nature of specific activities financed
- The ability to move quickly with financing decisions and contracting processes

ANNEX 6—stakeholder consultation lists

DFAT Functional Unit/Post Consulted
DFAT Development Economics Unit, PXB/MDD
DFAT International Economy Section, OEA/IVD
DFAT Budget Branch, FSB/CMG
DFAT ODA Reporting and Statistics Section, FSB/CMG
DFAT Financial Systems Section, FSB/CMG
DFAT Infrastructure Policy Section, BFB/MDD
DFAT AMD
DFAT Indo-Pacific Strategy and Geo-Economics Section, IMB/AMD
DFAT RGB/PAD
DFAT PNB/PAD
DFAT UCTF/PAD
DFAT Pacific Economic Growth Section, RGB/PAD
DFAT PNG Economic and Private Sector Section, PNB/PAD
DFAT Trade Finance Section, IVB/IVD
DFAT BFB/MDD
DFAT Indonesia Trade and Economic Section, INB/SED
DFAT—Beijing Post
DFAT—Lae Post
DFAT—Honiara
DFAT—Hanoi Post
DFAT—Manila Post
DFAT—New Delhi
DFAT—Yangon Post
DFAT—Vientiane Post
DFAT—Dhaka Post
DFAT—Suva Post
DFAT—Apia Post
DFAT—Nauru Post
DFAT—Colombo Post
DFAT—Hanoi Post
DFAT—Port Vila Post
DFAT—Port Moresby Post
DFAT—Jakarta Post

Feasibility Study into Expanding the Australian Aid Program's Development Finance Options

Organisation Consulted	Name of Individual
AECOM	Simon Quail
Agence Francaise de Development—Jakarta	Emmanuel Baudran
Agence Francaise de Development	Bruno Bosley
Angel investment Network	David Soukhasing
Asia Pacific Project Preparation Facility	Takeo Koike
Asian Development Bank	David Hill
Asian Development Bank	Winfried F. Wicklein
Asian Development Bank	Anthony Gill
Asian Development Bank	Amr Jalil Qari
Asian Development Bank, Pacific Liaison and Coordination Office	David Lloyd
Asian Development Bank, Pacific Liaison and Coordination Office	Matthew Hodge
Asian Development Bank—Vanuatu	Nancy Wells
Asian Infrastructure Investment Bank	Darren Stipe
Austrade—Jakarta	Andrew Barnes
Austrade—Pacific & Timor-Leste	Adrian Weeks
Australia and New Zealand Banking Group Limited	Paul Richards
Australia and New Zealand Banking Group Limited	Ian Matthew
Australia and New Zealand Banking Group Limited	Vishnu Shahaney
Australia and New Zealand Banking Group Limited	Mark Fitzgerald
Australia and New Zealand Banking Group Limited	Ronny FRM
Australia and New Zealand Banking Group Limited—Port Vila	Sheng Lee
Australian Council for International Development	Bridi Rice
Australian Council for International Development	Amrita Rice
Australian Council for International Development	Marc Purcell
Australian Department of Finance	Joseph Borgese
Australian Department of Finance	Robert Lam
Australian Department of Finance	Ceinwen Hiscock
Australian Department of Finance	Melissa Pan
Australian Department of Finance	Marina Kim
Australian Department of Finance	Daniel Featherston
Australian Department of Finance	Alex Chu
Australian Department of Finance	Shaun Bagley
Australian Department of the Prime Minister and Cabinet	Michael Carnahan
Australian Department of the Treasury	Megan Hardy
Australian Department of the Treasury	Peter Depta
Australian Department of the Treasury	Jane Gordon

Feasibility Study into Expanding the Australian Aid Program's Development Finance Options

Organisation Consulted	Name of Individual
Australian Embassy—Washington D.C.	Tyler Jensen
Australian Super	Nik Kemp
Australia-PNG Business Council	Materua Tamerua
Bank Central Asia	Jahja Setia
Bank Central Asia	Armand Hartono
Bank of PNG	Loi Bakani
Bank of South Pacific	Jonathan Prince
Bank Rakyat Indonesia	Yuli Norita Sari Putri
Bank Rakyat Indonesia	Mikke Mahamita R
Bank Rakyat Indonesia	Achmad Royadi
Bappenas	Amalia Widyasanti
Bappenas	Teni Widuriyanti
Bappenas	Kurniawan Ariadi
Bappenas	Belinda Costin
Bluescope	Natalie Dawson
Bred Bank Vanuatu Ltd	James Hudson
Brightlight	Tim MacReady
Brightlight	Matthew Zschech
Brightlight	Samuel Richards
Brookings Institute	George Ingram
Business Council PNG	Douveri Henao
Center for Global Development	Todd Moss
Cook Islands National Superannuation Fund	Damien Beddoes
The Australian National University, Crawford School	Stephen Howes
The Australian National University, Crawford School	Matt Dornan
Deloitte—Jakarta	Patrick Lee Weide
Deloitte—Jakarta	Patrick Bryski
Economic Governance and Inclusive Growth Partnership (Abt Associates)	Nik Soni
Economic Governance and Inclusive Growth Partnership (Abt Associates)	Bill Rowell
Economic Governance and Inclusive Growth Partnership (Abt Associates)	Lady Aivu Tauvasa
Economic Governance and Inclusive Growth Partnership (Abt Associates)	David Kavanamur
European Investment Bank, Pacific Regional Office	Adam Bruun
European Investment Bank, Pacific Regional Office	Ella Drake
Export Development Canada	Etienne Grall
Export Finance and Insurance Corporation	Stuart Neilson
Export Finance and Insurance Corporation	John Hopkins
Export Finance and Insurance Corporation	Swati Dave

Feasibility Study into Expanding the Australian Aid Program's Development Finance Options

Organisation Consulted	Name of Individual
Export Finance and Insurance Corporation	Stuart Neilson
Export Finance and Insurance Corporation	John Hopkins
Export Finance and Insurance Corporation	Stephen Farmer
Export Finance and Insurance Corporation	Dougal Crawford
ExxonMobil	Lee Dula
Fiji Development Bank	Mark Clough
Fiji Development Bank	Robert Lyon
Global Impact Investing Network	Abhilash Mudaliar
Global Infrastructure Facility	Towfiqua Hoque
Global Infrastructure Facility	Jason Zhengrong
Global Infrastructure Facility	Kirti Devi
Ifira Ports Development Services Company Limited	Russell Mitchell
Indonesia Australia Infrastructure Partnership (KIAT)	David Hawes
Indonesia Australia Infrastructure Partnership (KIAT)	Gizelle Herrera
Indonesia Australian Business Council	Peter Fanning
Indonesia Exim Bank	Sinthya Roesly
Indonesia Exim Bank	Tito Elvano
Indonesia Infrastructure Finance	Wito Tantra
Indonesia Infrastructure Finance	Irman Boyle
Indonesia Infrastructure Finance	Harold Tjiptadjaja
Indonesia Infrastructure Guarantee Fund	Ahmad Zaki Arifin
Indonesia Infrastructure Guarantee Fund	Rizka Anandita Ramses
Indonesian Ministry of Finance	Arif Kelana Putra
Indonesia Public Works	Agita Widjayanto
InfraCo Asia	Allard Nooy
InfraCo Asia	Claudine Lim
InfraCo Asia	Karen Tsang-Hounsell
InfraCo Asia	Karen Mantell
Infrastructure and Project Financing Agency	Leilani Frew
Infrastructure and Project Financing Agency	Bill Brummitt
Infrastructure and Project Financing Agency	Margaret Makeham-Kirchner
Infrastructure and Project Financing Agency	Nikolas Yiannakopoulos
Innovative Agro	Ilan Weiss
Institute of National Affairs	Paul Barker
International Finance Corporation	John Vivian
International Finance Corporation	Johanna Klein
International Finance Corporation	Laird Reed
International Finance Corporation	Michael Chae
International Finance Corporation	Milissa Day
International Finance Corporation	Thomas Jacobs

Feasibility Study into Expanding the Australian Aid Program's Development Finance Options

Organisation Consulted	Name of Individual
International Finance Corporation	Daniel Street
Japan International Cooperation Agency—Jakarta	Tomoyuki Kawabata
Japan International Cooperation Agency—Jakarta	Mariko Toyoda
Japan International Cooperation Agency—Vanuatu	Ohara Katsuhiko
KfW Group—Jakarta	Jens Wirth
Kina Bank	Greg Pawson
Komite Percepatan Penyediaan Infrastruktur Prioritas (KPPIP)	Nanda Erian
Komite Percepatan Penyediaan Infrastruktur Prioritas (KPPIP)	Putera Utama
Komite Percepatan Penyediaan Infrastruktur Prioritas (KPPIP)	Joseph Tobing
Korea International Cooperation Agency	Jeong Hoejin
Kumul Consolidated Holdings	Darren Young
Lowy Institute	Jonathon Pryke
Lowy Institute	Roland Rajah
Manufacturers Council	Chey Scovell
Nambawan Super	Anthony Smare
National Australia Bank	Simone Constant
National Australia Bank	James Waddell
National Australia Bank	Connie Sokaris
National Australia Bank	Anna Rintoul
National Superannuation Fund (NASFUND)	David Brown
New Zealand High Commission—Vanuatu	Kathryn Beckett
New Zealand High Commission—Papua New Guinea	Kathleen Pearce
Newcrest	Ian Kemish
Norton Rose Fulbright	Diane Jungman
OilSearch	Wayne Kasou
OilSearch	Julian Fowles
Otoritas Jasa Keuangan	Alvin Taulu
Overseas Private Investment Corporation	Edward Burrier
Pacific Island Forum Secretariat	Paki Ormsby
Pacific Island Forum Secretariat	Raymond Prasad
Pacific Region Infrastructure Facility	Jack Whelan
Partnership for Indonesia's Sustainable Agriculture	Zul Martini Indrawati
Partnership for Indonesia's Sustainable Agriculture	Anastasia Ika Wulandari
PIFS Working Group	Andrew Anton
PNG Chamber of Mines	Julian Storm
PNG Department of Finance	Ken Ngangan
PNG Department of Prime Minister and National Executive Council	Ephraim Sukbat
PNG Department of Treasury	Dairi Vele

Feasibility Study into Expanding the Australian Aid Program's Development Finance Options

Organisation Consulted	Name of Individual
PNG Department of Treasury	Nama Polum
PNG Department of Treasury	Manu Momo
PNG Department of Works	David Werah
PNG Power Limited	Carolyn Blacklock
Port Moresby Chamber of Commerce	Rio Fiocco
Private Financing Advisory Network	Peter Storey
Private Financing Advisory Network	Patrick Nussbaumer
Prospera	David Nellor
Public-Private Infrastructure Advisory Facility	Jemima Sy
Public-Private Infrastructure Advisory Facility	Ludovic Deplanque
RBC Capital Markets	Tim Foy
RBC Capital Markets	Kay Stuart
Samoa National Provident Fund	Prince Suhren
Sampoerna Foundation	Thierry Sanders
Sampoerna Foundation	Pandu Aditya Kristy
Sarana Multi Infrastructure	Edwin Syahrudat
Save the Children	Marion Stanton
Second Muse	David Ball
Tetra Tech—Jakarta	Bill Meade
Trade and Investment Victoria	Anthony Baker
United States Agency for International Development— Jakarta	Retno Setianingsih
United States Agency for International Development— Jakarta	Rosana Pribadi
United States Agency for International Development, Development Credit Authority	Beth Addler
United States Agency for International Development, Development Credit Authority	Jason Fleming
Vanuatu Department of Strategic Planning, Policy and Aid Coordination	John Ezra
Vanuatu National Provident Fund	Alain Lew
Vanuatu National Provident Fund	Parmod Achary
Vanuatu Telecommunications and Radio Communications and Broadcasting Regulator	Dalsie Baniata
Vanuatu Telecommunications and Radio Communications and Broadcasting Regulator	Brad Partridge
Vanuatu Utilities Regulatory Authority	John Obed Alilee
Westpac	Jason Duarte
Westpac	Adrian Pin
Westpac	Cathy Hayne-Smith
World Bank—Jakarta	Alex Webber
World Bank—Jakarta	Andrew Rowsano

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Organisation Consulted	Name of Individual
World Bank—Singapore	Jenny Chao
World Bank—Singapore	Jeffrey Delmon
World Bank	Patricia Veevers Carter
World Bank	Stephen Claude Frederic Garnier
World Bank—Jakarta	Marcus Lee
World Bank—Jakarta	Francesca De Paolis
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ANNEX 8—Debt distress assessments

Table 1—Level of debt distress in the Pacific region, by country that receives Australian aid

Country	Level of debt distress	Year of assessment
Cook Islands	Low*	2017
Fiji	Low*	2016
Nauru	Low*	2017
Palau	Low*	2016
Papua New Guinea	Moderate	2017
Solomon Islands	Moderate	2018
Vanuatu	Moderate	2018
Kiribati	High	2017
Marshall Islands	High	2018
Micronesia	High	2017
Samoa	High	2018
Tonga	High	2018
Tuvalu	High	2018
Niue	<i>Data unavailable</i>	
Tokelau	<i>Data unavailable</i>	

*The IMF Article IV reports for these countries did not state the level of overall debt distress. The source used here is DevPolicy's analysis of the IMF data: <http://www.devpolicy.org/is-china-engaged-in-debt-trap-diplomacy-20181108/>.

^Data unavailable for these countries as no IMF Article IV reports are available.

Table 2—Level of debt distress in the Southeast and East Asia region, by country that receives Australian aid

Country	Level of debt distress	Year of assessment
Cambodia	Low	2017
Myanmar	Low	2017
Vietnam	Low to Moderate	2018
Timor Leste	Moderate	2017
Laos	High	2017
Indonesia	Unstated*	2017
Mongolia	Unstated*	2018
Philippines	Unstated*	2018

*The IMF Article IV reports for these countries did not state the level of overall debt distress. For Philippines, government reliance on external financing is a 'moderate risk'. For Mongolia, the most recent report (2015) that specifies debt distress characterizes the risk as moderate.

Table 3—Level of debt distress in the South and West Asia region, by country that receives Australian aid

Country	Level of debt distress	Year of assessment
Nepal	Low	2017
Bangladesh	Low	2018
Bhutan	Moderate	2018
Maldives	High	2017
Afghanistan	High	2017
Pakistan	Unstated*	2017
Sri Lanka	Unstated*	2018

*The IMF Article IV reports for these countries did not state the level of overall debt distress. For Pakistan, the projected path for external debt was termed 'sustainable'. For Sri Lanka, there was a 'high risk' to public debt sustainability, and the external debt path was termed 'sustainable'.

ANNEX 9—PIDG indicators of development results

Result Level	Development Result Indicator	Components
Input	<i>Finance</i>	<ul style="list-style-type: none"> • PIDG company investments • Technical assistance funding
	<i>Additional support</i>	<ul style="list-style-type: none"> • Strategic role of company in securing a deal - this includes financial additionality, i.e. PIDG only funds when others would not • Better design and efficiency • Improved regulatory and policy environment
	<i>Investment mobilised from commercial entities</i>	<ul style="list-style-type: none"> • Domestic commercial finance (equity and/or debt) • Foreign commercial finance (equity and/or debt)
	<i>Investment mobilised from DFIs</i>	<ul style="list-style-type: none"> • DFI finance (equity and/or debt)
Output	<i>Viable infrastructure</i>	<ul style="list-style-type: none"> • Projects reaching financial close • Operational projects
	<i>Access to infrastructure</i>	<ul style="list-style-type: none"> • Number of people expected to have access to new infrastructure • Number of people expected to have access to improved infrastructure
	<i>Employment</i>	<ul style="list-style-type: none"> • Direct short-term jobs created during construction • Direct short-term jobs created during operations
	<i>Supply chain</i>	<ul style="list-style-type: none"> • Description of value and opportunities generated for local businesses
Outcomes	<i>Wider economic impact</i>	<ul style="list-style-type: none"> • Fees and taxes paid to the government and government subsidies avoided • Description of other economic impacts resulting from PIDG infrastructure
	<i>Demonstration effect</i>	<ul style="list-style-type: none"> • Capital mobilisation through greater private participation in infrastructure

ANNEX 10—Table of DFI benchmarks in the region

Donor country	Overview of governance arrangement	Target recipient countries and regions (excluding EU recipients)	Sectors with greatest aid spend	Instruments	Average project size (ex-grant)
Korea: KOICA & KEXIM (including EDCF)	Committee for International Development Cooperation (CIDC, headed by the PM) has final approval over activities undertaken by Korean International Cooperation Agency (KOICA - for grant aid) and KEXIM (which administers the Economic Development Cooperation Fund [EDCF] for concessional loans). Ministry of Strategy and Finance (MOSF) supervises KEXIM and EDCF; Ministry of Foreign Affairs (MOFA) supervises KOICA.	ASIA: Bangladesh, Cambodia, Indonesia, Lao PDR, Mongolia, Myanmar, Nepal, Pakistan, Philippines, Sri Lanka, Vietnam; MIDDLE EAST & CIS: Azerbaijan, Uzbekistan; AFRICA: Ethiopia, Ghana, Mozambique, Rwanda, Senegal, Tanzania, Uganda; LATIN AMERICA: Bolivia, Colombia, Paraguay, Peru. ¹⁶⁵	Transport (22.5%), Health (11.8%), WASH (11.6%), Education (11%), Governance (9.2%). ¹⁶⁶	PPP loans, concessional loans, export credit, guarantees.	N/A ¹⁶⁷

¹⁶⁵ ODA Korea, *ODA White Paper*, 2017. Not a historic list: as per Korea's newly formulated 24 Country Partnership Strategy, which will concentrate resources in 24 countries to maximise aid effectiveness.

¹⁶⁶ OECD database; calculated across 2011-15.

¹⁶⁷ Project list detailing disbursements and number of projects was unavailable.

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Donor country	Overview of governance arrangement	Target recipient countries and regions (excluding EU recipients)	Sectors with greatest aid spend	Instruments	Average project size (ex-grant)
Germany: KfW Development Bank (including DEG)	Federal Ministry for Economic Cooperation and Development (BMZ) oversees German Agency for International Cooperation (or GIZ, for technical cooperation) and KfW Development Bank (including German Investment and Development Corporation [or DEG, the private sector financing arm], for financial cooperation). DEG operates as a Limited Liability Company, wholly owned by KfW. ^{168,169}	ASIA: Afghanistan, Bangladesh, Cambodia, China, India, Indonesia, Kazakhstan, Kyrgyzstan, Lao PDR, Mongolia, Myanmar, Malaysia, Nepal, Pakistan, Philippines, Sri Lanka, Tajikistan, Timor-Leste, Thailand, Uzbekistan, Vietnam; MIDDLE EAST & NORTH AFRICA: Egypt, Iraq, Jordan, Lebanon, Morocco, Palestinian territories, Syria, Tunisia, Yemen; AFRICA: AU, Benin, Burkina Faso, Burundi, Cameroon, CAR, Congo, Ghana, Guinea, Liberia, Madagascar, Malawi, Mozambique, Namibia, Niger, Rwanda, Senegal, Sierra Leone, South Sudan, Togo, Uganda, Zambia, Ethiopia, Ivory Coast, Kenya, Mali, Nigeria, SA, Tanzania; LATIN AMERICA: Argentina, Bolivia, Brazil, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru. ¹⁷⁰	Industry/manufacturing (33%), Financial sector (35%), Power (13%), Agribusiness (11%). ¹⁷¹	Promotional loans (100% extended by KfW), development loans (extended jointly by KfW and the German federal government), grants, equity.	US\$ 19.89m ¹⁷²

¹⁶⁸ Donor Tracker: Germany donor profile.

¹⁶⁹ EDFI member profile: DEG.

¹⁷⁰ Countries highlighted in blue text are only recipients of KfW Development Bank's programs, and not DEG's.

¹⁷¹ EDFI member profile: DEG. Figures as of 2017.

¹⁷² Charles Kenny, Jared Kalow, Ben Leo, and Vijaya Ramachandran, *Comparing Five Bilateral Development Finance Institutions and the IFC*, CGD Policy Paper, 2018. Figure is specific to DEG, calculated across 2012-16.

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Donor country	Overview of governance arrangement	Target recipient countries and regions (excluding EU recipients)	Sectors with greatest aid spend	Instruments	Average project size (ex-grant)
Japan: JICA	The Ministry of Finance and the Ministry of Foreign Affairs (MOFA - includes the International Cooperation Bureau, which designs the development policy) jointly supervise JICA. JICA implements grant, loan, and technical cooperation programs, while in recent years MOFA has taken the lead in steering direction. ¹⁷³	SOUTH EAST ASIA: Cambodia, Indonesia, Lao PDR, Thailand, Malaysia, Myanmar, Philippines, Timor-Leste, Vietnam, Singapore; PACIFIC: PNG, Vanuatu, Tonga, Kiribati, Samoa, Marshall Islands, Solomon Islands, Fiji, Palau, Micronesia; CENTRAL/EAST ASIA & CIS: Mongolia, China, Uzbekistan, Azerbaijan, Tajikistan, Kyrgyzstan, Armenia, Georgia, Turkmenistan, Kazakhstan; SOUTH ASIA: India, Bangladesh, Sri Lanka, Pakistan, Nepal, Afghanistan, Maldives, Bhutan; MIDDLE EAST & NORTH AFRICA: Egypt, Iraq, Jordan, Lebanon, Morocco, Palestinian territories, Syria, Tunisia, Algeria, Iran; AFRICA: Angola, Burkina Faso, Cameroon, CAR, Congo, Ghana, Guinea, Liberia, Madagascar, Malawi, Mozambique, Niger, Rwanda, Senegal, Sierra Leone, South Sudan, Uganda, Zambia, Ethiopia, Ivory Coast, Kenya, Nigeria, SA, Tanzania; LATIN AMERICA: Argentina, Bolivia, Brazil, Belize, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Haiti, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela. ¹⁷⁴	Transport (31.7%), Electric Power & Gas (21.3%), Social services (14.8%), Mining & manufacturing (6.6%). ¹⁷⁵	Loans, grants.	US\$ 264m ¹⁷⁶

¹⁷³ Donor Tracker: Japan donor profile.

¹⁷⁴ JICA, *Annual Report*, 2018.

¹⁷⁵ *Overview of JICA ODA Loans*, 2018. Figures are as of 2016.

¹⁷⁶ JICA, *Annual Report: Data Book*, 2017. Calculated by dividing the total JPY amount of ODA loan disbursements for 2016 by the number of disbursements. 1 JPY = 0.0092 USD

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Donor country	Overview of governance arrangement	Target recipient countries and regions (excluding EU recipients)	Sectors with greatest aid spend	Instruments	Average project size (ex-grant)
U.S.A: OPIC	Operates under the foreign policy guidance of the Secretary of State. The U.S. Congress authorises and oversees OPIC's activities.	ASIA & PACIFIC: Afghanistan, Bangladesh, Burma, Cambodia, Cook Islands, Fiji, India, Indonesia, Kiribati, Laos, Malaysia, Maldives, Marshall Islands, Micronesia, Mongolia, Nepal, Pakistan, Palau, Papua New Guinea, Philippines, Samoa, Singapore, South Korea, Sri Lanka, Taiwan, Thailand, Timor-Leste, Tonga, Vietnam; LATIN AMERICA: Anguilla, Antigua and Barbuda, Argentina, Aruba, Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Costa Rica, Curacao, Dominica, Dominican Republic, Ecuador, El Salvador, French Guiana, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Saint Kitts and Nevi, Saint Lucia, Saint Vincent and the Grenadines, St. Maarten, Suriname, Trinidad and Tobago, Uruguay, Venezuela; EURASIA: Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Kosovo, Kyrgyzstan, Macedonia, Malta, Moldova, Montenegro, Serbia, Tajikistan, Turkey, Turkmenistan, Ukraine, Uzbekistan; AFRICA & MIDDLE EAST: Algeria, Angola, Bahrain, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Congo, Côte d'Ivoire, Djibouti, Egypt, Equatorial Guinea, Eritrea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Iraq, Israel, Jordan, Kenya, Kuwait, Lebanon, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Mozambique, Namibia, Niger, Nigeria, Oman, Rwanda, São Tomé and Príncipe, Senegal, Seychelles, Sierra Leone, Somalia, South Africa, South Sudan, Swaziland, Tanzania, Togo, Tunisia, Uganda, West Bank and Gaza, Yemen, Zambia, Zimbabwe.	Financial sector (42%), Utilities (34%), Manufacturing (6%). ¹⁷⁷	Loans, guarantees, political risk insurance, funding for other equity funds.	US\$ 12.63m ¹⁷⁸

¹⁷⁷ Charles Kenney et al., 2018. Figures calculated across 2012-16.

¹⁷⁸ *Ibid.*

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Donor country	Overview of governance arrangement	Target recipient countries and regions (excluding EU recipients)	Sectors with greatest aid spend	Instruments	Average project size (ex-grant)
China: Ministry of Commerce (MOFCOM), China Export-Import Bank (Chexim), China Development Bank (CDB) and many other governmental, state-owned, and state-controlled entities.	China's development finance regime encompasses an enormous variety of organizations that distribute mostly-unreported financial flows thorough a range of official and unofficial channels.	At least 142 countries across six continents. ¹⁷⁹	Diversified but concentrated in infrastructure and extractive industry. ¹⁸⁰	Grants, loans, equity, export finance, insurance.	US\$ 558m ¹⁸¹

¹⁷⁹ Dalberg analysis (China does not provide comprehensive official data on its development finance program).

¹⁸⁰ *Ibid.*

¹⁸¹ *Ibid.* Calculated across 2000-2014. Caveats: the database source, AidData, compiles figures solely from media reports. Further, these reports tend not to report smaller loan disbursements. Hence, this figure is likely heavily skewed upwards.

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Donor country	Overview of governance arrangement	Target recipient countries and regions (excluding EU recipients)	Sectors with greatest aid spend	Instruments	Average project size (ex-grant)
France: AFD (including Proparco)	The Interministerial Committee for International Cooperation and Development (CICID) approves the long-term strategic priorities, while the Finance Ministry and Ministry of Europe and Foreign Affairs jointly manage the development policy. All three bodies exercise some level of supervision over the French Development Agency (AFD), which includes Proparco, the private sector financing arm of AFD Group. AFD is the majority shareholder (64%) of Proparco, which operates with a banking license. Other shareholders include public and private financial institutions, service companies and ethical funds and foundations across Africa & Latin America.	ASIA & PACIFIC: China, India, Bangladesh, Cambodia, Indonesia, Lao PDR, Pakistan, Philippines, Thailand, Vietnam, Sri Lanka , Malaysia , Myanmar , Mongolia ; AFRICA: Cameroon, Kenya, Morocco, Senegal, Tunisia, Madagascar, Niger, Ivory Coast, Mozambique, Ghana, Benin, Nigeria, Chad, Togo, Egypt, Algeria, Congo, Mali, Ethiopia, Djibouti, Gabon, Guinea, Tanzania, Uganda, Burkina Faso, Burundi, Zambia, Angola, Namibia, Senegal, Sierra Leone, Zimbabwe, CAR, Mauritania, Malawi , Reunion , Cape Verde , Rwanda , Swaziland ; LATIN AMERICA & THE CARIBBEAN: Brazil, Peru, Colombia, Haiti, Mexico, Suriname, Ecuador , Nicaragua , Panama , Costa Rica , Jamaica , Chile , Dominican Republic , Guatemala , Honduras , Uruguay , Salvador , Bolivia , Paraguay , Argentina , Belize ; MEDITERRANEAN & MIDDLE EAST: Jordan, Lebanon, Palestine, Turkey, Iraq, Georgia , Montenegro , Armenia , Moldova , Palestinian autonomous areas , Ukraine , Tajikistan . ¹⁸²	Financial sector (36%), Power (22%), Industry/manufacturing (11%). ¹⁸³	Loans, grants, guarantees	US\$ 18.46m ¹⁸⁴

¹⁸² Countries highlighted in blue text are recipients only of Proparco's programs, and not AFD Group's.

¹⁸³ EDFI member profile: Proparco. Figures as of 2017.

¹⁸⁴ Charles Kenney et al., 2018. Figure is specific to Proparco, calculated across 2012-16.

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Donor country	Overview of governance arrangement	Target recipient countries and regions (excluding EU recipients)	Sectors with greatest aid spend	Instruments	Average project size (ex-grant)
UK: CDC Group	CDC Group is entirely owned by the UK government. UK's Department for International Development (DFID) sets the investment policy, appoints the members of the board, and practises other accountability measures, but otherwise practises 'arm's length' governance.	ASIA & CIS: India, China, Myanmar, Pakistan, Bangladesh, Vietnam, Indonesia, Malaysia, Cambodia, Philippines, Thailand, Mauritius, Kazakhstan; AFRICA: Nigeria, South Africa, Kenya, Ivory Coast, Cameroon, Zambia, Ghana, Uganda, Tanzania, Congo, Ethiopia, Algeria, Malawi, Mozambique, Morocco, Egypt, Zimbabwe, Tunisia, Gabon, Sierra Leone, Senegal, Madagascar, Burkina Faso, Rwanda, Mali, Niger, Liberia; LATIN AMERICA: Brazil, Costa Rica, Peru, Colombia, Mexico	Financial sector (24%), Funds (36%), Power (19%), Industry/manufacturing (15%). ¹⁸⁵	Equity, loans, guarantees.	US\$ 32.7m ¹⁸⁶

¹⁸⁵ EDFI member profile: CDC Group. Figures as of 2017.

¹⁸⁶ Charles Kenney et al., 2018. Figures calculated across 2012-16.

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ANNEX 11—Skills matrix for support unit

		Skills Common to All Infrastructure							Related DFAT Core Skills					
		Legal	Financial Analysis & Modeling	Economic & Political Risk Assessment	Financial Structuring	Negotiation	Quality Control	Sector-Specific Expertise	Impact on Aid Program & Country Strategy	Rule of Law and Transparency Risks	Environmental & Renewables	Gender	Social Inclusiveness	Design of Concessionality
Stage of Infra Project	Notes													
Feasibility	+ Pre-Feasibility	X	X	X	X	X		X	X	X		X	X	X
Concessioning	Approvals	X	X	X	X	X	X	X	X	X		X	X	X
Financing		X	X		X	X		X	X				X	X
Procurement		X		X		X	X	X	X	X		X	X	X
Project Management		X	X	X		X	X	X	X	X		X	X	X
Commissioning							X	X				X		
Rectification		X				X	X	X				X		
Operations	Monitoring and Reporting			X			X	X		X		X	X	
Transfer	Sale or Transfer to Concessionaire	X	X	X		X		X	X	X		X	X	X
		Skills Common to Economic Development							Related DFAT Core Skills					
		Legal	Financial Analysis & Modeling	Economic & Political Risk Assessment	Business Mentoring	Financial Markets	Business Stage-specific Expertise	Sector-specific Expertise	Impact on Aid Program & Country Strategy	Rule of Law and Transparency Risks	Environmental Impact	Gender	Social Inclusiveness	Design of Concessionality
Economic Development	Notes													
Local Business Building														
Entrepreneurship Training	School programs, Prize Programs	X	X				X		X	X	X	X	X	X
Early Stage Incubation	Third Party funds, programs	X	X		X		X	X	X			X	X	X
Investment Capital	Through local banks, funds	X	X	X	X	X	X	X	X					X
Management Capacity	Mentoring, training, exchanges	X			X	X	X	X	X	X		X	X	
Value Capture	Local processing before export	X	X	X	X	X	X	X	X	X	X	X	X	
International Business														
Skills Transfer	Apprenticeship, employment	X	X	X	X			X	X	X	X	X	X	X
Broader Ecosystem	+ regulation, transparency	X		X	X	X	X	X	X	X		X	X	
Supply Chain	Reduce costs, improve quality	X	X	X	X	X	X	X	X		X	X	X	
Market Access	Export revenues	X	X	X	X	X	X	X	X	X				
Financial Markets Access	Competitive capital	X	X	X	X	X	X	X	X	X		X	X	X
Type of Infrastructure									Examples of Economic Sectoral Development					
1. Hard:									Agriculture	Cropping, Grazing, Aquaculture				
Transport	Ports, Roads, Airports, Rail								Natural Resources	Logging Mining, Oil & Gas, Fishing				
Energy	Traditional & Renewable								Primary Processing	Timber, Refining, Canning, Preserving				
	Generation & Transmission								Financial Services	Banking, Insurance, Savings, Pensions, Remittances, M-money				
	Oil & Gas Refining & Pipelines								Tourism	Guides, Accommodation, Services, Security				
Water	Dam, Pipeline, Potable, Sewerage								Technology	Telco, Internet Access, Distribution				
Telco	Poles and Transponders								Infrastructure services	Maintenance, Operations, Ecosystems				
2. Soft:									MNC Partnerships	Local supply hubs, tech and skills transfer				
Telco														
Financial Services	Funds, Pensions, Insurance													

ANNEX 12—Summary of AGS advice prepared by Legal Division, DFAT

Summary of overall advice/recommendation

Authority for the full range of instruments is likely to require primary legislation. A single standalone Act could potentially be made which could also address the issues raised, i.e. the ability to use funds received under the instruments for further foreign aid, and any other applicable legislative requirements.

	Constitutional Authority	Legislative Authority	Legislative Compliance
Loan	External Affairs power (s 51 (xxix))	<p>Medium level of risk if DFAT were to rely on Sch 1AA of the FF(SP) Regs (items 413.001 to 413.006) (para 41).</p> <p>Legislative authority required, recommend amend Sch 1AB or primary legislation, or amend the <i>Export Finance and insurance Corporation Act 1992</i> (EFIC Act) (para 44).</p> <p>In limited circumstances, loans to foreign countries may be supported by ss 8C or 8CA of the <i>International Monetary Agreements Act 1947</i> (para 43).</p> <p>AGS recommends amendments are made in broad terms, along the lines of the Sch 1AA items above, but that clearly encompass the making of loan (para 44).</p>	<p>None, s 58 of the PGPA Act may apply if the loan is regarded as an 'investment' but this is unlikely given that the loans are likely to be concessional (paras 46—47).</p>
Guarantees	External Affairs power (s 51 (xxix))	<p>Medium level of risk if DFAT were to rely on s 60 of the PGPA Act, because s 60 is extremely broad, and there is the possibility that a court could find that more specific legislative authority is required (paras 52 and 58).</p> <p>AGS advises <u>not</u> to rely on the FF(SP) framework, including</p>	<p>If DFAT were to rely on s 60 of the PGPA Act, as legislative authority, there are 2 relevant restrictions:</p> <p>(i) The delegate cannot grant a guarantee for the payment of any</p>

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	Constitutional Authority	Legislative Authority	Legislative Compliance
		<p>making amendments to it, as regulations made under the framework authorising guarantees might detract from, and be inconsistent with s 60 of the PGPA Act. This is because s 60 confers power specifically on the Finance Minister to grant guarantees on behalf of the Commonwealth, and by implication prevents other persons from doing this (para 59).</p> <p>To avoid medium level of risk, AGS recommends enacting primary legislation, or amending primary legislation, such as the EFIC Act (para 59).</p>	<p>amount or principal or interest due on a loan (cl 6.1(2)),¹⁸⁷ and</p> <p>(ii) A delegate can only grant a guarantee if the delegate considers the likelihood of its being enlivened is remote (less than 5% chance) and the most probable expenditure under it is not significant (less than US\$ 30 million)</p> <p>Notwithstanding these restrictions, the delegate may grant such a guarantee in certain circumstances, e.g. if the guarantee has been explicitly agreed in a decision of Cabinet or Prime Minister (cl 6.4) or, in the case of the restriction in cl 6.3(1), if the Finance Minister has approved the grant of the guarantee in writing (cl 6.3(2)).¹⁸⁸</p>

¹⁸⁷ ([Public Governance, Performance and Accountability \(Finance Minister to Accountable Authorities of Non-Corporate Commonwealth Entities\) Delegation 2014](#) Part 6, cl 6.1 (2))

¹⁸⁸ ([Public Governance, Performance and Accountability \(Finance Minister to Accountable Authorities of Non-Corporate Commonwealth Entities\) Delegation 2014](#))

	Constitutional Authority	Legislative Authority	Legislative Compliance
Equity Investments	External Affairs power (s 51 (xxix))	<p>Limitations associated with reliance on Schedule 1AA of the FF(SP) Regulations (paras 70—75), s 58 of the PGPA Act (paras 76—79), s 85 of the PGPA Act, s 39B of the FF(SP) Act, and s 32B of the FF(SP) Act (paras 70—75). It would be reasonable to rely on a new item in Schedule 1AB of the FF(SP) Regulations, however this attracts a medium level of risk (paras 81—82).</p> <p>Legislative authority required (paras 81—83). AGS recommends enacting primary legislation (para 83) or amending the EFIC Act (para 105).</p>	<p>money is paid not with the main purpose of obtaining a profitable return, but rather for the purpose of furthering some other policy objective of the Commonwealth, then the transaction is not an 'investment' for the purposes of s 58. In AGS' view, equity investment could not properly be regarded as 'investment' for the purposes of s 58 of the PGPA Act (paras 78—79).</p>
Insurance products	<p>External Affairs power (s 51 (xxix))</p> <p>Also, the insurance power in s 51(xiv)</p>	<p>Considerable level of risk if DFAT were to rely on an existing item in Schedule 1AA the FF(SP) Regs (items 413.001 to 413.006) or amend s 60 of the PGPA Act (guarantees) (paras 86—87).</p> <p>Legislative authority required. AGS recommends amending Sch 1AB, enacting primary legislation or amending primary legislation, such as the EFIC Act (paras 88—90).</p>	<p>The <i>Insurance Contracts Act 1984</i> may not apply, particularly overseas. There is a general statutory presumption that legislation is not intended to have extra-territorial effect (para 94).</p>