EFIC REFORMS AND LEGISLATION:

SUBMISSION TO THE SENATE FOREIGN AFFAIRS, DEFENCE AND TRADE LEGISLATION COMMITTEE

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Executive summary

This submission raises six issues with the proposed Efic reforms and legislation:

1. Efic does hardly any business with the Pacific, few Pacific countries will qualify for Efic support, and there is a risk that in a few years' time this part of the Pacific step-up will be seen to have failed.

2. There is a risk that that the Efic reforms will undermine governance in the Pacific by encouraging a supply-side, project-proponent-led, non-competitive approach to infrastructure. This is widely perceived to be a problem with Chinese export credit to the Pacific.

3. Efic projects, even if commercially viable, may be against the national interest of the recipient country in a poor policy environment. But Efic lacks both the capacity to make policy assessments and the mandate to promote policy dialogue and reform.

4. Efic will be mandated to pursue infrastructure projects that are in Australia's interests, and to maximise Australian participation. In other words, it is required to put Australia first, which is bad for the Pacific, and inconsistent with our official position of backing openness and competition.

5. The relationship between Efic and the other new government initiative in this area, the Australia Infrastructure Financing Facility for the Pacific (AIFFP) is unclear and may be unduly complex, for example, with both entities engaging in transactions with both the public and private sectors of recipient countries.

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6. Efic reform may be a substitute for other more desirable initiatives to promote Pacific economic growth. Creation of a Development Finance Institution (DFI) is a higher priority, and would be more consistent with the approach of other OECD countries.

On this basis, the submission makes four recommendations:

1. **A higher priority than reforming Efic in the way envisaged would be to establish a DFI.** Efic can already lend to support Australian businesses engaged in infrastructure, but this should not become a major part of the Australian effort to support infrastructure in the Pacific. Instead, an Australian Development Finance Institution should be established. This would make for a much clearer division of labour, with the DFI supporting the private sector, in infrastructure and other sectors, and AIFFP lending to government for infrastructure. Canada provides an interesting example. Canada recently asked its ECA to establish a DFI, FinDev Canada, to "support the growth and sustainability of businesses in developing markets."

2. **If, however, the government decides to continue going down the track of Efic reforms, then the Committee should recommend the parallel establishment of a DFI or at least further study of the issue. Further, the proposed legislation should be amended in the following two ways to take account of the issues mentioned above.**

3. **First, Efic should be required to certify that the policy framework for any infrastructure project it supports is satisfactory.** If it is able to do this, and if the project is commercially viable, then we know that the project must be in the interests of the recipient. Absent a satisfactory policy framework, even commercially viable projects may not be in the interests of the recipient. Possibly, Efic could be allowed to certify that the policy framework would be satisfactory if a number of agreed policy reforms are made. Such an approach adds the risk that the policy reforms won't actually be made, but is consistent with the practices of the multilateral banks.

4. **Second, the requirement that Efic maximise Australian participation should be dropped.** This initiative is meant to be about helping the Pacific. To benefit the Pacific, to be consistent with our stand in multilateral fora in favour of free trade and open competition, to avoid having to bargain with governments to increase Australian content, and to distinguish ourselves from Chinese export credit (which maximises Chinese participation), the requirement of maximising Australian participation should be waived. Such an approach would be consistent with recognising that this infrastructure initiative would be different from Efic's other work. The message would be that the rest of Efic's work is for Australian business, but this initiative is for the Pacific.

Introduction

Prime Minister Scott Morrison's 8 November 2018 Townsville speech "Australia and the Pacific: a new chapter" outlined two new infrastructure initiatives for the Pacific.

The speech, delivered in response to a perception that Australia was being out-muscled by China in the Pacific, announced two major new initiatives. The first was the creation of the Australian

Infrastructure Financing Facility for the Pacific (AIFFP), costed at $2 billion, which will "use grant funding combined with long term loans to support high priority infrastructure development." The second was an increased role for Efic, Australia's export credit agency: "an extra $1 billion in callable capital and a new more flexible infrastructure financing power."

"Australia and the Pacific: a new chapter"
Morrison's 8 November 2108 Townsville speech

The Pacific region is estimated to need US$3.1 billion in investment per year to 2030. So today I'm pleased to announce two major new initiatives that will help address the infrastructure needs of the Pacific region.

The first is the creation of an Australian Infrastructure Financing Facility for the Pacific (AIFFP).

This $2 billion infrastructure initiative will significantly boost Australia's support for infrastructure development in Pacific countries and Timor Leste.

It will use grant funding combined with long term loans to support high priority infrastructure development.

This will also enable these projects to leverage broader support. It will invest in essential infrastructure such as telecommunications, energy, transport, water and will stretch our aid dollars even further.

The second major announcement I'm making today is the Government will ask Parliament to give Efic, Australia's export financing agency, an extra $1 billion in callable capital and a new more flexible infrastructure financing power to support investments in the region which have broad national benefit for Australia. It's in our interest that's why we need to do it.

These new measures will enhance Efic's ability to support Australian SMEs to be active in their region. Working with the support and aid that we are putting into the region. Private capital, entrepreneurialism, open markets are crucial to our mutual prosperity. These are our beliefs, these are values, they are shared with the Pacific and we stand with those who share our beliefs and values.

This submission draws on a larger report by the author and Dr Matthew Dornan which investigates this announcement and the subsequent Efic legislation.

The Efic reforms and legislation

Every developed country has an export credit agency (ECA) which provides loans, guarantees and insurance to help national businesses export. Efic is Australia's. The government's decision to increase Efic's callable capital is dramatic: its callable capital is currently $200 million; this will be increased to $1.2 billion.

Callable capital are funds that are not paid up but are available if needed. Essentially, the government undertakes to bail Efic out to the extent of the callable capital if it runs into difficulty. Like any such arrangement, the call is expected never to have to be made; and if it is made, it is the end of the organisation. The callable capital is nevertheless valuable as it enables Efic to borrow

greater amounts at lower interest rates – since its creditors know that the government is standing behind it.

Efic manages risk by requiring adherence to prudent capital adequacy ratios. As per its latest annual report, Efic requires a ratio of cash capital (that is, excluding callable capita) to risk weighted assets of at least 8%, and a ratio of capital (including callable capital) to risk weighted assets of at least 16%. (p. 53). Actual ratios in 2017 were 17.6% on a cash capital basis and 25.2% if callable capital is included, that is, way above what Efic itself judges to be adequate. In other words, Efic already has too much capital. If there was no change to its risk weighted assets ($2.7 billion in 2017-18), then, upon the implementation of the announced callable capital increase, its capital adequacy ratio would increase to 62% (2.7/1.674). Let's say Efic wants to keep its capital adequacy ratio at 25%. Then its risk weighted assets would have to increase from $2.7 billion to $6.7 billion.

Where will Efic find an additional $4 billion of financing opportunities? There are a number of restrictions on Efic lending. They are not allowed to lend if private sector financing is available, and they are meant to focus on small and medium enterprise lending. As recently as 2013, Labor withdrew $200 million in capital from Efic. While this was subsequently reversed by the Coalition (in 2014), it nevertheless is hardly the context in which one would expect such a large increase.

An explanation is given by the Prime Minister's undertaking that Efic will be given a "new more flexible infrastructure financing power to support investments in the region which have broad national benefit for Australia." This has now been fleshed out through legislation put forward to the Australian parliament in February 2019, specifically the Export Finance and Insurance Corporation Amendment (Support for Infrastructure Financing) Bill 2019. Under this Bill, Efic's mandate is to be expanded to cover overseas infrastructure projects. Any overseas infrastructure project that can be shown to be of direct or indirect benefit to Australia will be eligible for funding. Benefits to Australia are defined extremely broadly. According to the Bill's explanatory memorandum, they include: "the involvement of Australian companies in infrastructure projects, as well as future and indirect benefits for Australia or Australians, such as greater Australian participation in supply chains, access to new markets for Australian businesses, more Australian jobs, payments, dividends or other financial proceeds from overseas to Australia, or stronger relationships with our regional partners, especially in the Pacific." Efic will effectively be allowed to fund *any* overseas infrastructure project.

It is worth clarifying that the requirement that Efic only has to show that the project benefits Australia rather than increases exports is the real reason why legislation is required. Efic can be given mandates by the Minister under existing legislation. For example, it has an existing Ministerial mandate to support "domestic or overseas resource projects including related infrastructure".[2] However, such a mandate has to be exercised in a way that increases Australia's exports, by being a project with "significant Australian content".[3]

While this is a welcome relaxation, for any infrastructure project that it does fund, Efic still has to act in such a way as is "likely to result in the maximum Australian benefits" (Section 5 of the 2019 Bill). As the Minister's second reading speech clarified, Efic "will be required to maximise Australian participation in overseas infrastructure projects."

Efic has a limit on its capital exposure of 25% per counterparty. Given that its capital, with the increase, will be $1.67 billion that would provide a maximum of lending to any one country or

[2] See the Efic Corporate Plan 2018-19, Appendix B.

[3] The assumption for domestic resource projects is presumably that the output will be exported. For overseas projects, the exports come through construction.

project of $400 million. Given that the PNG LNG project was US$350 million, this seems like a reasonable limit.[4] More lending to large projects, whether to support infrastructure and perhaps to support major resource projects, may require an increase in callable capital to avoid hitting individual country or project exposure limits.

There are no ODA implications of the Efic reforms. Up until 1996, Efic was used to manage the Development Import Finance Facility (DIFF), an aid-supported so-called "mixed credit" program. Under DIFF, companies were given a mix of export credit and aid funding to implement projects approved by both developing country governments and AusAID. Clearly, DIFF had ODA implications. But these announcements purely relate to export credit; there is no ODA component.

Issues with the Efic reforms and legislation

The main defence of the Efic legislation is that most countries have ECAs and most ECAs lend for infrastructure projects. What then is the big deal?

It is indeed the case that export credits dwarf concessional loans and DFI transactions. One estimate of just nine ECAs is that they provided $488 billion in export financing support in 2013. The primary job of any export credit agency is to promote its country's exports. If a country produces equipment used in infrastructure (e.g. power turbines, trains), then naturally an ECA starts supporting infrastructure. As this note explains, ECAs may provide financing either for the manufacturer of the equipment or, in the case of project financing, for the purchaser. When the financing is for the purchaser, it is on the basis of an understanding that there will be benefits for the home country in terms of supply decisions.

Infrastructure clearly is a priority for other ECAs. For example, UK Export Finance notes in its 2017-18 Annual Report that it made its "largest ever direct loan to an African government supporting the construction of Kabaale Airport in Uganda." (p.15)

That said, I am not aware of other OCED countries adopting legislation such as that proposed for Efic, and of making export credit a major plank of their developmental support. The legislation is a risky proposition especially in the context of the Pacific for the six reasons that follows.

Limited applicability to the Pacific. Efic is minimally involved in the Pacific. According to the 2017-18 annual report, Efic exposure is $2.6 billion. Of this, $387 million is to the Pacific, about 15%. $273 million of this, or over 70%, is to one project, the PNG LNG project discussed earlier. In the Pacific, only Fiji and PNG are able to borrow on commercial terms. Efic will find many more infrastructure projects outside the Pacific. There is nothing wrong with this, except that the reforms were announced in the context of a step-up in the Pacific. There is a risk that, in a couple of years' time, giving this framing, the initiative will be seen to have failed.

Undermining good governance. There is a risk that the Efic reforms will give a green light to Australian businesses to push projects in neighbouring countries, including by recruiting local political champions to their cause. The risks are obvious. They are that the better connected rather

[4] Note that US$250 million of the LNG project was on the "National Interest Account". These are projects that the Efic is directed to engage in by the Minister, and which are guaranteed separately by government. Presumably one reason for putting the project on the national interest account was the individual counterparty exposure limits then in existence.

than the better infrastructure projects will be approved, that good governance will be undermined, and competitive tendering sidelined.

This is not just a theoretical concern. This is exactly how much of China's development financing works (as documented here). As PNG's Deputy Prime Minster Charles Abel has gone on record saying, China's finance is welcome, but the country's way of doing business (that is, as described above) is weakening institutions. We should not be imitating China and further undermining governance in the Pacific by encouraging a supply-side, project-proponent-led, non-competitive approach to infrastructure.

Ignoring policy reform. Another problem with Efic being responsible for overseas infrastructure financing decisions is that what really matters for infrastructure success is not financing availability but the domestic policy framework. If that policy framework is sound, financing will follow. If it's not, no amount of official financing will lead to sustained development.

There are several factors that should make one wary of the risk that insufficient attention will be paid by both Efic and AIFFP to the critical issue of infrastructure policy. One will be the pressure to disburse. Another is the evident desire to compete with China. China avoids asking for policy reforms. It just funds.

The third and most worrying source of concern are the precedents set so far. The two big Pacific infrastructure projects announced by Australia in 2018 are the PNG-Solomon Islands cable and the PNG energy access project. Both have been characterized by early announcements, and a complete lack of any policy agreements. As far as I am aware, Australia has no agreement with either PNG or Solomon Islands as to how the cable from Sydney will be used once it comes on-shore, and whether arrangements governing its use will be monopolistic or competitive. There are certainly serious concerns in PNG that the cable will not be available to all internet service providers on an equal basis. These concerns are heightened by (a) the lack of any announced agreement on this issue; and (b) the fact that the cable owner, Dataco, is being merged with the state-owned utilities, PNG Telkom and Bmobile/Vodafone. Likewise, the key issue with the PNG energy access announcement (made late last year at APEC) is whether access will be extended through the grid or off grid. Extension through the grid will require Australia to work with the inefficient and financially weak PNG Power. Off-grid and mini-grid extensions open up private sector options. There is no indication which options will be favoured, but the PNG government has indicated that the primary route will be the former.

There is another precedent that also gives cause for concern. As mentioned, Efic provided US$350 million in financing for the PNG LNG project. Under, the PNG Oil and Gas Act, the relevant Minister is responsible for determining which landowners will be the beneficiaries of a petroleum project (section 169). That determination is meant by law to happen before or during the Development Forum or Fora (section 169), a process of consultation which in turn is meant to precede construction. In the case of the PNG LNG project, none of the landowner determinations were completed prior to construction. Even today, almost five years after the commencement of production, the process is still incomplete. Such determinations as have been made have only been in recent years.[5] For example, in this press article, the Managing Director of the Resource

[5] While there is provision for determinations to be delayed if there was a dispute, it is clear that in many areas there was no dispute, and in other areas disputes could have been resolved much more quickly.

Development Company says that in 2018, a determination was been made for landowners along the pipeline but not for "upstream landowners", that is, those who have land where the gas is, which are the majority. This 2018 article shows the Minister for Petroleum and Energy signing a number of determinations. This 2018 statement by the same Minister conveys clearly that the ministerial determination process is still seriously incomplete. This March 4 2019 statement by the same minister indicates that he "will soon sign the ministerial determination" for certain upstream landowner areas. To be clear, this PNG LNG landowner issue is not one relating to policy reform, but it has been a very serious issue for the project, and the long delays have definitely undermined the project's positive impact. Clearly Efic should have insisted that, as per the legislation, landowner determinations be completed as a condition for the release of its funds. That it did not calls into serious question Efic's ability to ensure that projects are legally compliant. If it cannot do this, how can it undertake the more serious task of ensuring not only what the laws or policies are but whether they need to be changed.

The multilaterals to their credit have a practice of only announcing loan packages once they have an agreement in place with the recipient government, an agreement covering policy as well as project issues. Even with this, the Banks struggle to get required policies in place. The tendency of Australia to announce and fund projects first and worry about policy later is likely to make it even less likely that a conducive policy environment will be created. There is a real risk that the Efic and AIFFP legacy will be one of more debt combined with poor policy leading to poor outcomes.

Putting Australia's interests first. The Efic legislation does not mandate tying to Australian producers, but it does require that benefits to Australia be maximised. There is no requirement that competitive tendering be used. This is bad for the Pacific, and bad for Australia's reputation. At fora such as G20 and APEC, we will continue to promote the virtues of open markets and competition. But in practice, we will be putting pressure on potential recipients to maximise Australian content in return for Australian financing.

More broadly, and still more worryingly, we could end up under the Efic legislation supporting projects that are not in the interest of the recipient country. Under the proposed legislation, Efic will be required to show that the infrastructure it planned to support was of benefit to Australia but would not be required to show that it was of benefit to the recipient country. Efic would need to show that the project is commercially viable, but it is all too easy for an infrastructure project, backed by government guarantees or loans or monopolies, to be commercially viable but bad for the country concerned.

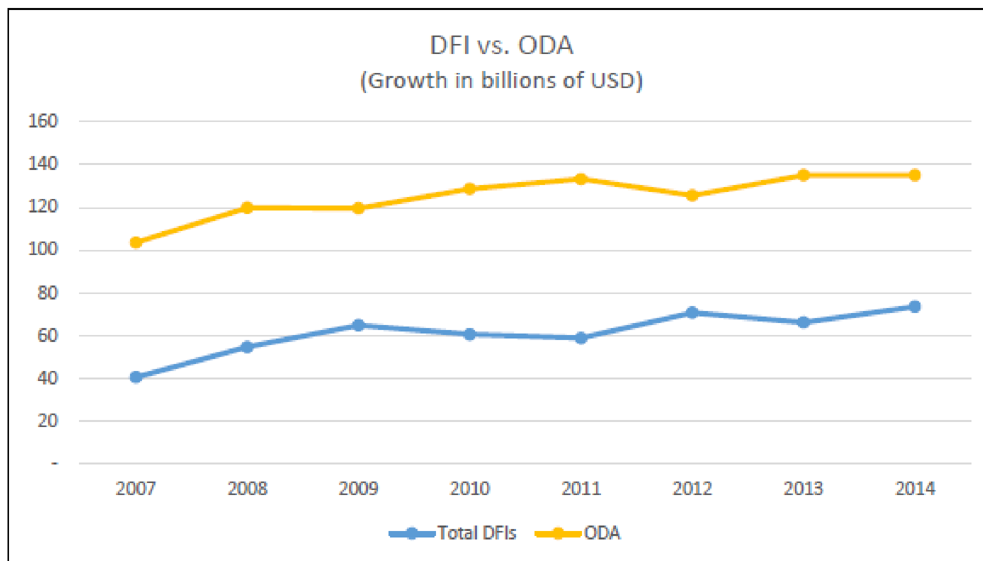
It is true that Efic needs to follow the OECD export credit "arrangement" or agreement to which Australia is a signatory. The arrangement prevent export credit agencies undercutting each other. Australia is also bound by agreed environmental and social guidelines. This is all good, but does not change the basic situation that Efic will be obliged to finance an infrastructure project if it is in Australia's interests, but has to make no assessment as to whether the project is in the interests of the recipient country.

Overly complex architecture. How will Efic relate to the government's other Pacific infrastructure initiative, the AIFFP? The minister's speech says that Efic will take the lead "where there are stronger commercial prospects", but the explanatory memorandum refers to sovereign borrowers, implying that Efic, like AIFFP, will be lending to governments. The minister's speech also talks about Efic

"administering" AIFFP loans, but not, presumably, its grants. We run the risk of moving from too little support for Pacific infrastructure to an overly complex architecture.

Efic reform may be a substitute for other more desirable initiatives to promote Pacific development. Financial support for the private sector of developing countries by OECD nations is typically provided through a dedicated agency, known as a Development Finance Institution (DFI). Every major European donor has a DFI. In addition, the US has OPIC (now being reformed), and Japan JBIC, both of which have DFI functions. Most recently Canada created a DFI, DevNet. DFIs typically benefit from government capital, but operate in a non-concessional manner. DFI operations are on the rise, both in absolute terms, and relative to ODA. The figure below illustrates.

DFI transactions and ODA flows



Source: Savoy, Carter and Lemma (2016).

DFIs not only provide loans, indeed lending in some cases is not their primary modality. In the UK 78% of CDC financing is via equity. About half of the commitments made by European DFIs are either equity or quasi-equity (Savoy, Carter and Lemma, 2016, p.18). The inability to invest in equity was one driver for the recent reforms of OPIC in the US.

If Australia wants to support commercial projects in the Pacific, its first priority should be to establish a DFI, as several experts have recommended (Jim Adams, former Vice President of the World Bank; Bob McMullan former Parliamentary Secretary for International Development; and Clay O'Brien, a financial sector specialist). There is no reason Australia can't proceed with these reforms of Efic and establish a DFI, but, given that there has been no mention of a DFI so far, there is a risk that the focus on one will crowd out action on the other.

Recommendations

While Efic should not be barred from supporting Australian exporters engaged in infrastructure, such support should not be a major plank of Australian support for the Pacific. The problems identified in the previous section regarding the risks of undermining governance, Efic's inability to promote policy reform, and Efic's mandate to put Australian interests first are too serious to ignore. There are also the issues raised around management and coordination. It is unclear how Efic and AIFFP will

differentiate their roles, and a risk that they will overlap. Finally, there is a real risk that action on Efic will become an excuse for inaction in other, more important reform areas.

A higher priority than reforming Efic in the way envisaged would be to establish an Australian Development Finance Institution (DFI). This would make for a much clearer division of labour, with the DFI supporting the private sector, in infrastructure and other sectors, and AIFFP lending to government for infrastructure, at a concessional rate. Canada provides an interesting example. Canada recenlty asked its ECA to establish a DFI, FinDev Canada, which focuses on green growth, agribusiness, and the financial sector under a general mandate to “support the growth and sustainability of businesses in developing markets.”

If, however, the government decides to continue going down the track of Efic reforms, then the Committee should recommend the parallel establishment of a DFI or at least further study of the issue. Further, two amendments to the proposed legislation are needed to address the various issues and risks raised above.

First, Efic should be required to certify that the policy framework for any infrastructure project it supports is satisfactory. If it is able to do this, and if the project is commercially viable, then we know that the project must be in the interests of the recipient. Absent a satisfactory policy framework, even commercially viable projects may not be in the interests of the recipient. Possibly, Efic could be allowed to certify that the policy framework would be satisfactory if a number of agreed policy reforms are made. Such an approach adds the risk that the policy reforms won’t actually be made, but is consistent with the practices of the multilateral banks.

Second, the requirement that Efic maximise Australian participation should be dropped. This initiative is meant to be about helping the Pacific. To benefit the Pacific, to be consistent with our stand in multilateral fora in favour of free trade and open competition, to avoid having to bargain with governments to increase Australian constant, and to distinguish ourselves from Chinese export credit (which maximises Chinese participation), the requirement of maximising Australian participation should be waived. Such an approach would be consistent with recognising that this infrastructure initiative would be different from Efic’s other work. The message would be that the rest of Efic’s work is for Australian business, but this initiative is for the Pacific.