

## ***BIAC Discussion Paper***

# **Good Governance for Investment in the Energy Sector: Cleaner Development and Access to Energy**

### **Introduction: Energy, Development and the Private Sector**

Dependable access to affordable energy is a prerequisite for continued economic growth as well as sustainable social and economic development and environmental protection. For developing countries in particular, energy is an indispensable enabling condition for achieving the Millennium Development Goals (MDGs). The importance of energy in economic growth is illustrated by the experience of Asia and other rapidly industrializing regions, where dynamic economic growth has recently led to a sharp rise in demand for, and in some cases a shortage of, energy. At the same time, many citizens of least developed countries, particularly in rural areas, lack access to the most basic energy services.

Investment to improve the supply of and access to energy, particularly cleaner energy, is needed throughout industrializing and rural areas in the developing world. However, the experience of business suggests that disincentives and barriers to investment, be they in the form of sub-optimal regulatory frameworks or inhibiting business conditions, hinder or discourage private foreign investment. BIAC believes improvement in public governance would play an influential role in lifting those barriers and increasing investment in the energy sector, ultimately contributing to much needed development in poorer countries. This paper focuses primarily on governance and energy investments in developing countries.

### **Investment Challenges in the Energy Sector**

In its 2003 World Energy Investment Outlook (WEIO), the International Energy Agency (IEA) calculates that the total worldwide investment required for energy-supply infrastructure over the period 2001-2030 is US\$16 trillion. Although it may seem modest at about 1% of global GDP, it poses a serious challenge to developing countries. And even with the investments envisioned by the WEIO, 1.4 billion people will still lack access to electricity in 2030.

Developing countries, where production and demand are expected to increase most rapidly, will require almost half of global investment in the energy sector as a whole. This will require considerable investments in the production and distribution of energy. Unless this demand can be met reliably and affordably, the prospects for development in the poorer regions of the world will face a significant setback.

From a business perspective, access to secure and affordable energy has to be considered as involving a range of business sectors in addition to the traditional sectors of power generation, utilities and natural resource extraction. Transport, grid maintainers, automotive and energy intensive sectors are also essential parts of the energy supply and use chain. Their needs and operating realities have to be taken into account as decision-makers consider how to attract and retain the investment that will be necessary to meet the challenges of the WEIO's forecasted needs in developing countries.

## Key Issues in Energy Governance and for Energy Investments

In particular, we would like to underline the following issues with regard to energy governance and encouraging energy investment:

- **A business-friendly environment:** A sound institutional setting is critical to attract and leverage necessary capital. Governments should promote long-term political stability as well as sound legal and regulatory regimes thereby contributing to an atmosphere of trust, transparency, accountability and predictability. Market conditions supporting business activities should be established.
- **A competitive, free and open market:** Operating within a clear, transparent, stable and well-designed legal, fiscal and regulatory framework will best serve the interests of economic prosperity, consumers, suppliers, investors, local communities and the environment.
- **Local entrepreneurship:** The business sector in developing countries often faces difficulties from the lack of the right market conditions such as sufficiently developed local markets or financial systems. Lack of transparency and predictability impedes inward capital flows.
- **Mitigate risk for investors:** The risks inherent in the energy sector in some developing countries – of technical, geopolitical, macroeconomic and regulatory nature – persist and put a further damper on attracting outside investment. Governments should bear in mind the need to mitigate risk for investors in investment and commercial activities in the energy sector.
- **Infrastructure requirements:** In many instances, energy companies require infrastructure that developing countries lack. In numerous instances, energy companies are expected or obliged to actually provide the lacking infrastructure (building roads, providing health care, etc.). In areas where there is a lucrative source of energy to be extracted, this is part of the business equation. In other areas where the challenge is providing energy to far flung rural communities, the dynamic will be very different.
- **Corporate and government responsibilities:** It is important to define corporate and government responsibilities. On the one hand, energy industries have a crucial role in local and global economies. On the other, governments should have the institutional capacity to secure adequate supply of energy while responsibly managing revenues in the face of fluctuating prices. They should also provide the institutional and legal framework in which investors should be transparent in their commercial activities.
- **Environmental protection:** There are major opportunities to make environmental progress with more environmental friendly investments in all areas of the energy sector. There is no “trade-off” between environmental and development priorities. All energy sources should be kept open, and no conditionalities or other obstacles should be imposed in lending or ODA contexts. Science- and risk-based environmental rules are crucial to underpin investment that is environmentally sound.
- **Revival of “dead” capital:** In some regions, financial resources, such as domestic private savings, that could constitute an important part of the needed collateral to leverage credit or the actual capital for investment in energy are not sufficient or legally recognized. In many developing countries, lack of title to land has meant that small business owners and rural landowners – who often use their residence as a place of business – cannot use it as collateral to secure their credit or guarantee payment of utility charges. This is dead capital.

BIAC would like to underline the following facets of good governance with particular relevance to attracting and supporting energy investments:

**1. Political and legal stability and strong institutions are in tune with the long-term investment horizon of the energy sector**

Political stability promotes consistent policy frameworks to improve public governance, which in turn profoundly affects the planning basis for business development, investment decisions, and cost-recovery in the longer term. Thus, political stability emerges as a crucial issue regarding international investments for energy production and distribution projects to develop long-lived infrastructure.

Legal stability stems from a sound and consistent legal and regulatory regime. It enhances the quality of the business and investment environment and gives confidence to investment decision-makers. A reliable regulatory and legal redress process is a key to reducing 'regulatory risks' which tend to be prevalent in developing countries. Business understands that full regulatory certainty can never be guaranteed, nor is it always desirable. In fact, new information may require new approaches; for example, environmental or safety risks or unforeseen consequences of regulations may emerge.

**2. Improving public governance and practices through regulatory reform and alternatives to onerous command and control approaches**

Regulatory reform can be a daunting process, and there are relatively few incentives for government officials to be innovative in regulatory approaches. Outdated regulations tend to contribute to a bureaucratic, less efficient and less user-friendly environment, often inhibiting the potential of private sector or foreign direct investment. Giving attention to the following concepts can facilitate promotion of a free open market

- **Free market** - An economic system promoting individual business/property rights and freedom of entry, with market prices and profit-and-loss incentives used to allocate scarce resources to competing uses.
- **Open market** - Markets where barriers to entry are few and primarily defined by an enterprise's competitive/financial capabilities and its profit-and-loss incentives. In this regard, other potential barriers as might be established by government policy should be minimal. Relates to practices that enable and ensure an impartial, non-discriminatory environment for competing alternatives.
- **Market solutions** - A free market approach to determine solutions and prices to consumer, supplier, investor or government objectives. This contrasts with a government "command and control" policy or regulatory approach that sets mandates and restricts potential options for affected parties.
- **Cost/benefit analyses** – A quantifiable approach to account for and determine how the expected tangible costs (including foregone opportunities) of a policy, project or action compare with the expected tangible benefits. Regulatory Impact Analysis (RIA) is another useful tool to assess and seek areas in which to improve rule making.
- **Rule of law** - A system of government whereby a reliable and transparent framework of laws provides a common and stable foundation to promote law and order, standards for personal and business conduct, and justice via due process.

It is important that policy options are transparent and can be discussed publicly involving independent business organisations as major stakeholders.

### ***3. Transparency and partnerships can increase buy-in and efficiency***

Business needs transparency of regulation and policy instruments. Deliberately non-transparent regulatory systems serve as a significant barrier to private investment. Transparency has numerous benefits on investment environment: It reduces risks and uncertainty while promoting consistency and predictability; it reduces opportunities for corruption and discrimination; it promotes competition; and it strengthens responsibility of governments.

The unique characteristics of the energy industry in terms of its very long term and capital intensive nature of its investment and commercial activities, its price and revenue flows fluctuations, and its economic significance and impacts in the producer countries and world markets emphasise the importance of transparency. Since energy sector investors in a number of developing countries face a high risk of policy reversals and policy uncertainties, there is a strong argument to establish transparency, not only through national laws and regulations but also through international cooperation. This enhances international investors' perception that the regulatory structure of an investment regime is stable and predictable. Specific initiatives, such as the Extractive Industries Transparency Initiative (EITI) which was launched at the World Summit on Sustainable Development, aim at improving transparency in the energy sector.

The World Summit on Sustainable Development (WSSD) recognized partnerships as an important means to implement real solutions to the challenges of sustainable development that complement regulatory approaches. Public-private sector partnerships have the potential to promote greater access to more environmentally friendly energy, build capacity of policymakers to strengthen governance, and streamline legal procedures.

### ***4. Eliminating bribery and corruption will help ensure trust, accountability and better deployment of limited financial resources***

Due to its unique relationships with governments, anti-corruption and bribery efforts in the energy industry are a particular priority. Bribery is often referred to as a significant inhibiting barrier of business activities. To promote investment in the energy sector, the business community sees a strong need to reduce or eliminate acts of bribery and corruption. It is a shared responsibility. BIAC believes that governments also have an important role to play in assisting companies in the prevention of bribe solicitation as well as prosecution. In addition, inter-governmental actions against bribery and corruption can play an important role.

The OECD represents the majority of world investment activities and as such is well suited to assist governments in reducing bribery solicitation, based on experience and oversight of the OECD Anti-Bribery Convention. Convention-related outreach activities with non-member countries and initiatives on better governance and regulatory reform are very useful. In addition, the OECD Multinational Enterprises (MNE) Guidelines have a role to play to discourage and address bribe solicitation. The fight against bribe solicitation must be an integral part of the OECD's anti-corruption and regulatory reform activities with non-member countries.

## **Conclusions**

Energy investments consist of long-term projects that are based on returns over decades. In developing countries, they lay the groundwork for improved quality of life, and are the stepping stone to broader commercial activity. As such, they should be seen as involving a range of sectors that are part of the supply, transport and use chain. Special attention should be given to instances where governments are not able to establish a consistent policy framework because of the difficulty to make credible long-term commitments, e.g. to tolerate volatile power prices, or a sudden shift in

politics. International cooperation to encourage consistent political strategies to reform and strengthen public governance is thus crucial.

To strengthen investment conditions, business encourages governments to:

- Take a long-term view, and maintain their policy focus on market reforms to foster greater inward investment in the energy sector;
- Encourage a consistent regulatory and governance framework over the period of investments, which in the energy sector generally amounts to decades;
- Promote free open market to leverage competition and supply demand fluidity;
- Refrain from market interventions and implement rules that do not hamper investment while realising a secure, efficient and environmentally sound energy system.

BIAC believes that IEA and OECD initiatives to improve public governance can make a major contribution to further facilitation of investment in non-member economies, particularly through partnerships and capacity-building for the public sector. Regulatory reform that encourages open markets and competition will have to overcome entrenched interests and this will require international dialogue, incentives and cooperation. Sound data and analysis are indispensable to this effort, particularly to identify patterns of regulatory reform that have been successful and sustainable in one or more member countries. A main focus should be on promoting the adoption of these approaches and finding ways to bring these messages to the attention of relevant non-member countries.