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Sustainable infrastructure for shared prosperity and poverty reduction: A policy framework

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Summary

This Policy Framework identifies priority actions to enhance the strategic focus and impact of DFID's work on infrastructure development. The Framework encompasses DFID's work on energy, transport, water and sanitation, information and communications technology (ICT), housing and public buildings. It focuses on issues of relevance across infrastructure sectors.

Rationale for DFID engagement

Improved and expanded delivery of infrastructure services is central to the delivery of the UK's international development objectives. Reliable, accessible transport, energy and ICT services support increased productivity, facilitate trade and create an environment in which business can flourish. Access to infrastructure enables people to take advantage of economic opportunities and access markets, jobs, information and training. Clean water, sanitation, rural roads and modern sources of energy play a crucial role in improving health and education outcomes for poor women and men.

The DFID focus regions of sub-Saharan Africa and South Asia have the largest infrastructure gap globally in relative terms. Many hundreds of millions of people lack access to electricity, transport and water and sanitation. Inadequate infrastructure is consistently identified as a major constraint to doing business in these two regions.

The causes of inadequate service provision are complex. Inadequate finance is often identified as the proximate cause, but underlying this are fundamental challenges related to the capacity and accountability of state institutions responsible for infrastructure delivery.

DFID's current portfolio and areas of comparative advantage

DFID currently allocates around £1.1 billion per year to infrastructure, split approximately evenly between bilateral spend and imputed spend through core funding to multilateral organisations. In addition, the UK's Development Finance Institution, CDC, has an infrastructure portfolio amounting to £690 million. The majority of DFID bilateral spend on infrastructure does not finance the full capital costs of infrastructure construction, but is used catalytically to improve the way infrastructure investment is undertaken through technical or policy reform or to buy down the risk of infrastructure projects in order to attract private finance.

Six areas of DFID comparative advantage have been identified as follows, defined as where our business model, expertise and experience enable us to add significant value:

- 1) The provision of flexible, politically astute, **technical assistance** that can make projects happen and influence large-scale funding from others.
- 2) **Mobilising private finance** with a strong focus on the poorest countries.
- 3) **Community-focused** infrastructure service delivery that supports human development objectives and creates access to economic opportunity for the poorest, including in conflict-affected states.
- 4) Regional public goods and infrastructure associated with **trade**.
- 5) **Influencing key international actors** through our positions on the G7, the G20 and engagement with emerging powers and the private sector.
- 6) **Building the evidence base** through high quality research.

Many of these areas of comparative advantage are not unique to DFID, but the scale of the infrastructure challenge combined with strong demand for the types of support we can offer creates a powerful case for engagement.

Conversely, there are areas in which DFID does not have a comparative advantage. Regional and Multilateral Development Banks (MDBs) are able to provide large-scale loans and other non-grant financial instruments to governments and the private sector for capital-intensive infrastructure projects. Under DFID's current business model, we do not engage in these activities.

The nature of DFID's offer in the infrastructure sector needs to respond to changes in global systems and the aid sector.

The role of ODA is changing as other forms of capital and funding become more available. To be effective in this new context, ODA funds need to be more focussed, more nimble and catalytic, helping to unleash national and regional drivers for development. This means using more of our aid to overcome fundamental barriers in the enabling environment and to unlock other sources of funding.

Many DFID focus countries are experiencing rapid rates of urbanisation, associated with potential growth and job creation but also significant risks. DFID is developing a more coherent and strategic offer on urbanisation.

New international infrastructure project development and financing facilities are being established by MDBs and emerging economies, representing a significant shift in public agencies' approach to mobilising private finance for infrastructure. We will develop a strategic approach to influencing the development of new Facilities where we can add value, and will assess how they affect DFID's role in infrastructure.

The UK's aid programme is increasing its focus on economic development and our allocation of Development Capital Investment (DevCap) is increasing. We will scale up our activities in sectors that support economic development using DevCap where this supports our strategic objectives, particularly working with the private sector.

Four Priority Actions to Enhance Impact

1. Further enhance the effectiveness of existing tools and peer review to ensure that we consistently select interventions that have the greatest returns to growth and poverty reduction, and that capitalise on DFID's comparative advantage. This Framework sets out diagnostic tools to support this aim as well as a new high-level peer review process for large and strategic projects. This will be complimented by a 'light touch' diagnostic to be carried out by Country Offices in 2015 which will identify priority areas for intervention to support economic transformation.

2. Drive effective influencing of key multilateral partners and in international fora. The scale of UK funding to the major multilaterals puts us in a good position to shape their policy and programme priorities. Emerging priorities include influencing MOs to use their funds catalytically to mobilise other sources of finance, including through new Facilities and funding modalities, and engaging with MOs as they consider their approach on key sectors, including energy and urbanisation. We will also look beyond the traditional boundaries of the aid agenda to engage in 'international actions' that influence global financial, economic and environmental systems. We are in a position to scale up our engagement, including through the G20.

3. Scaling up activities in sectors and modalities that support economic development and where we have – or can quickly develop – a comparative advantage. Two areas have been identified where we have an existing comparative advantage: **transforming the enabling environment and mobilising private sector finance.** Evidence suggests that transformative change in the infrastructure sector is achieved only where significant changes occur in the national policy, legal and regulatory environment.

DFID is well placed to engage in this space due to our access to strong technical knowhow, political economy awareness and capacity to be nimble. We will scale-up engagement principally through bilateral channels. DFID funds can be used to buy down the risks of specific infrastructure projects that have high developmental returns. Using donor funding in this way can mobilise significant flows of private sector finance, far in excess of the original ODA contribution. We will scale up bilaterally by continuing to build on existing successful instruments such as the PIDG and by working with CDC to capitalise on its transformative potential.

We have identified two areas where we will work to develop a comparative advantage: **urbanisation and regional infrastructure.** Rapid urbanisation in DFID focal countries creates a time-bound opportunity to support countries in capturing the growth potential of cities. DFID's current urban development portfolio is small but we have the foundations on which to build a comparative advantage in this field. We are developing new programming in this area and will develop a concept paper on DFID's role in supporting urbanisation for jobs and growth during 2015.

Inadequate regional infrastructure in Sub Saharan Africa and South Asia is a major barrier to economic development and greater regional economic integration also has the potential to support peace and stability. DFID is developing new economic corridor programming in Asia and Africa, learning lessons from existing programmes.

Energy has been identified as a priority sector for increased activity. We are developing policy guidance to inform our approach.

4. Systematically integrate key cross-cutting priorities, particularly on climate and environment, poverty and girls and women, across all elements of our refreshed approach. DFID will support countries in making the best choices to support sustainable and climate resilient, long-term, inclusive growth, making efficient and effective use of the £3.7 billion International Climate Fund, including in our energy work. This Framework sets out strategic principles that define how our infrastructure investments will benefit the poor and girls and women. We will continue to have a strong focus across our portfolio on results, fighting corruption and increasing transparency.

1. Introduction

The aim of this policy framework is to guide future DFID engagement in infrastructure sectors to enhance coherence and strategic focus across our portfolio. In turn this will enable DFID to maximise the impact of our infrastructure investment on growth and poverty reduction in our focus countries and regions.

The Framework sets out priority actions to increase our impact and scale up our focus on economic development based on an analysis of the nature of the infrastructure challenge in DFID focus regions, the areas in which we can add most value, and the ways in which the changing international landscape affects our offer on infrastructure.

The framework covers all the infrastructure sectors DFID is engaged in, these being energy, transport, water and sanitation, information and communications technology (ICT), water management, housing and public buildings. The energy sector has been identified as a priority area to develop further policy analysis. This work will start in the latter part of 2014. Further information on the DFID focus sectors of energy, transport and water is provided in Annex B and a discussion of how DFID objectives and engagement modalities vary by sector can be found in Section 2.

2. Rationale: The role of infrastructure services in driving shared prosperity and poverty reduction

In 2014, DFID published its economic development strategic framework. The framework sets out the UK government's vision to eradicate poverty and transform economies through supporting countries to achieve long term, high rates of economic growth accompanied by a wider economic transformation that benefits the poor and shares prosperity broadly. While increasing its focus on economic development, the UK will continue to set a high priority on human development and to deliver results on health, education and water and sanitation. **Improved and expanded delivery of energy, transport and water services and urban housing is a key element of the UK's vision for economic development and human development.**

There is a very significant infrastructure gap in DFID focus countries

The DFID focus regions of sub-Saharan Africa and South Asia have the largest infrastructure gap globally in relative terms. Across the two regions, 1.32 billion people lack access to an all-weather road (630 million Africa, 690 million in South Asia), 1 billion people lack access to electricity, 1.63 billion people lack improved sanitation (640 million in Africa, 990 million in South Asia) and 470 million people lack access to improved water sources. Access rates are far lower for the poorer segments of society¹.

Inadequate infrastructure is a major constraint to doing business. Inadequate infrastructure is estimated to depress firm productivity in Africa by around 40 percent² and according to businesses in South Asia, infrastructure is a major or severe

¹ Estache, A. (2006) Infrastructure: A Survey of Recent and Upcoming Issues. World Bank

² Foster, V. and Briceño-García, C. (Eds.) (2010) Africa's Infrastructure: A Time for Transformation, Washington D.C.: World Bank

hindrance to their growth³. Energy is the greatest constraint in low-income countries, being cited by more than half of firms in more than half of African countries as a major business obstacle⁴ and identified also as the most significant obstacle in South Asia⁵. Given the private sector's central role in creating jobs and productive growth, improved infrastructure for business is central to DFID's objectives.

The demand for infrastructure investment is rising. The increasing role of global value chains in trade, rapid urbanisation, and the challenge of climate change are all adding to the need for increased investment in infrastructure capacity, modernisation, and adaptation⁶.

Affordable, sustainable infrastructure services are a cornerstone of economic development

Well-planned and managed infrastructure is a key element of the foundation for economic transformation that converts growth into economic opportunity for the poor as set out in the Theory of Change in figure 1. There is good evidence that infrastructure services are key enablers for economic growth⁷. For example, the World Bank's recent Africa Infrastructure Country Diagnostic estimates that Infrastructure has been responsible for more than half of Africa's recent improved growth performance⁸. Improved economic infrastructure is often identified as a priority by DFID partner country governments⁹.

Improved infrastructure supports increased productivity, facilitates trade and creates an environment in which business can flourish. Businesses need reliable and affordable energy, ICT and transport services to scale up their activities and to trade within their region and internationally. Good infrastructure creates incentives for businesses to invest and grow, which in turn helps to create new jobs. Access to transport, energy and ICTs enables people to travel to where new jobs are being created, helps people to access information about new job opportunities and provides new ways for people to connect to training opportunities. Well planned transport, energy, ICTs, water and housing are particularly crucial for rapidly growing cities in developing regions. These services are also important to enable poor people to set up and run their own businesses more efficiently¹⁰.

³ Andrés, L., Biller, D. & Herrera Dappe, M. (2013) Reducing Poverty by Closing South Asia's Infrastructure Gap. World Bank & Australian Aid

⁴ Foster, V. and Briceño-García, C. (Eds.) (2010) Africa's Infrastructure: A Time for Transformation, Washington D.C.: World Bank

⁵ Andrés, L., Biller, D. & Herrera Dappe, M. (2013) Reducing Poverty by Closing South Asia's Infrastructure Gap. World Bank & Australian Aid

⁶ World Bank Group (2014) Strong, Sustainable and Balanced Growth: Enhancing the Impact of Infrastructure Investment on Growth and Employment: Background note for the G20 prepared by Staff of the World Bank Group

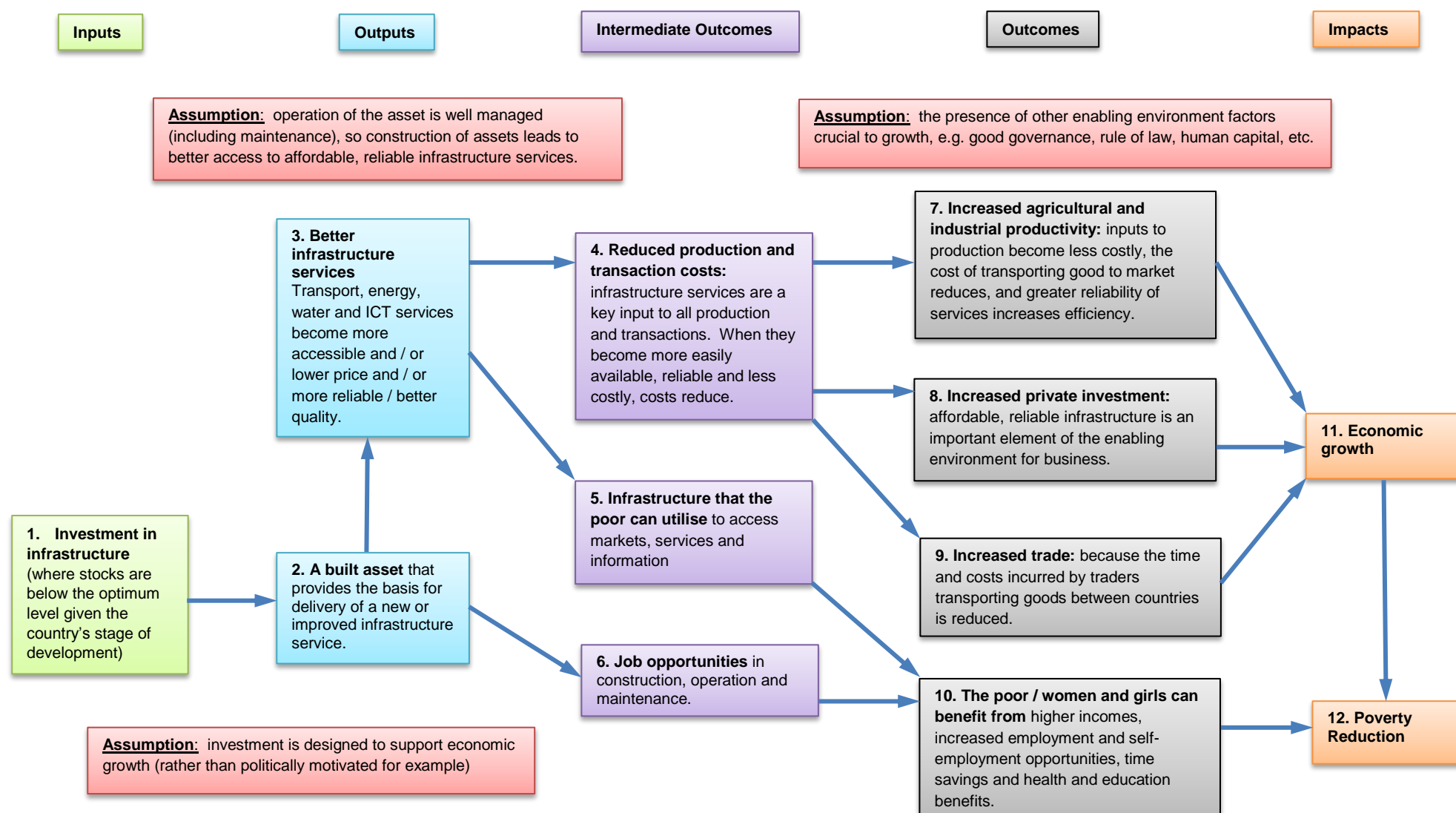
⁷ Commission on Growth and Development (2008) The Growth Report. Washington D.C

⁸ Foster, V. and Briceño-García, C. (Eds.) (2010) Africa's Infrastructure: A Time for Transformation, Washington D.C.: World Bank

⁹ This is evidenced, for example, by African governments' enthusiastic engagement with the support China is offering in this area.

¹⁰ Turok, I. & McGranahan, G. (2012) Urbanisation and Economic Growth: The Evidence for Africa and Asia: Report prepared for DFID

Figure 1: Theory of change for investment in economic infrastructure¹¹



¹¹Adapted from: OECD (2006) Promoting Pro-Poor Growth: Infrastructure. Paris: OECD, with inputs from Engineers Against Poverty

Improved infrastructure supports DFID objectives on human development, stabilisation, empowering girls and women and climate and environment

Access to infrastructure also enables people to lead more productive, healthy lives.

Access to clean water, adequate sanitation and modern forms of energy could save several million lives every year by preventing illness associated with drinking unsafe water and inhaling smoke from cooking on an open fire¹². The benefits often accrue disproportionately to women and children.

DFID's work in the infrastructure sector is central to our efforts to support countries in developing sustainable growth paths and in adapting to climate change. Many DFID focus countries face increasing risks due to climate change impacts. Poorer countries are often unable to finance the high up-front costs of sustainable energy technologies, including renewables, even where these are cost competitive over more polluting sources over the generator lifetime. Development assistance can play a key role by helping a partner government to meet upfront costs and reap longer term rewards.

Rebuilding infrastructure and reinstating basic service provision can make an important contribution to the regeneration of societies and economies affected by conflict¹³. Reconstruction of infrastructure can allow security forces to access isolated areas, re-establish communication, help to build confidence in the state and create jobs¹⁴.

Infrastructure access empowers girls and women. Access to water and modern forms of energy close to, or in, the home frees up time for girls and women, enabling girls to attend school and women to engage in productive activities including paid employment¹⁵. Where there is access to safe transportation, girls are more likely to attend school and childbirth is more likely to take place in the presence of a health professional or in a hospital, decreasing associated risks¹⁶.

DFID's work in infrastructure sectors is designed to achieve a range of objectives that vary by sector, and which require a range of different delivery modalities.

DFID engages on a range of infrastructure sectors which have varying characteristic and objectives. They can be categorised under three broad categories:

- (1) Programmes that meet **human development objectives** for the poorest, for example providing clean drinking water and adequate sanitation in rural areas with the principal aim of improved health;
- (2) Programmes directly targeted at the poorest with the dual objectives of providing them with **access to economic opportunity** and improving human development outcomes.

¹² Prüss-Üstün A, Bos R, Gore F, Bartram J. (2008) Safer water, better health: costs, benefits and sustainability of interventions to protect and promote health. World Health Organization, Geneva : World Health Organisation (2011) Indoor Air Pollution and Health, Media Fact Sheet.

¹³ World Bank (2011) World Development Report : Conflict, Security and Development. Washington D.C.: World Bank

¹⁴ United Nations (2009) United Nations Policy for Post-Conflict Employment Creation, Income Generation and Reintegration. Geneva: United Nations

¹⁵ Blackden, C. M. & Wodon, Q. (Eds) (2006) Gender, Time Use, and Poverty in Sub-Saharan Africa: World Bank Working Paper No. 73. Washington D.C.: World Bank: Dinkleman, T. (2011) "The Effects of Rural Electrification on Employment: New Evidence from South Africa." American Economic Review, 101(7): 3078-3108

¹⁶ Willoughby, C (2004) Infrastructure and the Millennium Development Goals. Session on Complementarity of Infrastructure for Achieving the MDGs. Berlin 27 Oct 2004

Examples include rural roads and rural energy supply which help poor people access markets, job opportunities and information flows, as well as education and health services; (3) Programmes designed to **release binding constraints to growth** in the country or region but that do not directly target the poorest, for example large-scale energy generation and transport and economic corridors.

Taken together, these different programming types enable us to achieve our Economic and Human Development objectives.

Programmes under objective (1) enable us to support partner countries in the vital human development priorities set out in the MDGs and in ‘finishing the job’ for those targets that will be carried forward to the Post-2015 Framework.

Programmes under objective (3) are designed to release countries’ growth potential, enabling them to industrialise and engage in international and regional trade, and so create the jobs of the future for those currently trapped in poverty and their children.

Programmes under objective (2) contribute to both objective (1) and (3) (e.g. improved rural transport supports greater value-added in agriculture and enables people to access schools) but also creates a link between objectives (1) and (3) by connecting poor people to the economic opportunities created by growth. These programmes therefore support the UK’s objective under its Economic Development Strategic Framework, of supporting not just growth, but economic transformation that benefits the poor and shares prosperity broadly.

3. What are the key barriers to scaled-up infrastructure service provision in DFID focus regions?

The causes of inadequate service provision are complex. Inadequate finance is often identified as the proximate cause, but underlying this are fundamental challenges related to the capacity and accountability of state institutions responsible for infrastructure delivery. These two themes are treated in turn below.

Inadequate Finance

Available finance is inadequate to meet infrastructure needs. In Africa, financial resources available for infrastructure are estimated to fall short of the level required to meet developmental goals by \$48 billion per year out of a total requirement of \$93 billion per year¹⁷, although it is estimated that efficiency gains could save \$17 billion per year¹⁸. For South Asia, estimates of the finance currently being supplied are not available, but estimates of total capital expenditure needs to meet developmental goals are estimated at between \$152 billion and \$237 billion per year through to 2020¹⁹. The infrastructure gap suggests that supply is considerably lower than demand.

¹⁷ Foster, V. and Briceño-García, C. (Eds.) (2010) *Africa’s Infrastructure: A Time for Transformation*, Washington D.C.: World Bank

¹⁸ *Ibid.* Principal areas for efficiency gains are: better allocation of resources; improved budget execution (African countries are typically executing only about two-thirds of the budget allocated to public investment in infrastructure); improved maintenance of existing assets; and, improved efficiency in water and electricity utilities.

¹⁹ Bhattacharyay, B. N., 2010. *Estimating Demand for Infrastructure in Energy, Transport, Telecommunications, Water and Sanitation in Asia and the Pacific: 2010-2020*. Tokyo, Japan: Asian Development Bank Institute; Andrés, L., Biller, D. & Herrera Dappe, M., 2013. *Reducing Poverty by Closing South Asia’s Infrastructure Gap*, Washington, DC: World Bank

A large proportion of infrastructure service delivery is, in theory, commercially viable and so could be financed and delivered by the private sector. But, at present, the majority of financing for infrastructure in developing countries is sourced from domestic governments. Approximately two thirds of infrastructure investment across emerging markets and low-income countries is financed by domestic government budgets, 20 – 30% by the private sector and the remaining 8 – 12% by ODA, mainly from MOs²⁰. Scaling up private investment is a priority as, in contrast to public sources, there is theoretically potential for a very significant increase in private finance for commercially viable infrastructure projects²¹. There is limited scope for a major scale-up in domestic public finance at present due to debt sustainability ceilings and limits to the potential funds available from increasing the tax base. ODA is likely to remain a small proportion of overall spend and will need to leverage other resources to maximise impact. Investment in infrastructure in Low-Income Countries (LICs) from Emerging Economies is a growing and important source of finance, but is not increasing at rates that will close the gap.

Private investors are deterred by significant risks in DFID focus countries and regions. Flows of private finance have increased significantly since the 1990s, but have fallen far short of the levels anticipated. The principal risks deterring private investment are political risk (e.g. post-investment expropriation of assets), macroeconomic risk (including exchange rate risk) and regulatory risk (the risk that ex-post regulatory changes make the asset commercially unviable)²². The investment appetites of private financiers are also vulnerable to financial shocks. The 2008 financial crisis saw a significant drop in private financing and the Basel III regulations introduced to promote greater stability in the banking sector will make long-term lending for infrastructure increasingly challenging for commercial banks. This makes exploring other sources of long-term private finance important, for example institutional investors such as pension funds and life insurance companies.

Public finance will continue to have a crucial role in infrastructure sectors. Key market failures in infrastructure sectors, combined with equity concerns, create a requirement for state engagement in both financing and in creating an enabling environment for financing and service delivery by the private sector (see Annex A for a discussion of market failures). In sectors with significant positive externalities there is a stronger case for public contributions to infrastructure in the public interest. For example, private firms cannot capture the health benefits of clean water or the economic and social benefits of better school infrastructure, creating a case for public investment. Even for sectors with clear potential to be commercially viable, the persistence of high levels of risk in DFID focus countries implies that there will continue to be a role for the public sector in buying-down risks to mobilise private sector investment. In this case, it is critical to ensure that scarce public and ODA resources are properly targeted and do not simply displace private investment.

²⁰ Bhattacharya, A., Romani, M. and Stern, N. (2012) Infrastructure for Development: Meeting the Challenge, London School of Economic and Political Science and Intergovernmental Group of 24 (G24)

²¹ Efforts to increase private lending must be carried out with an awareness of the risk of contributing to unsustainable levels of government debt, as discussed in Section 5.1.

²² Estache, A. & Fay, M. (2007) Current Debates on Infrastructure Policy. Washington D.C.: World Bank

Developing Capable, Accountable State Institutions

Many would argue that the underlying cause of inadequate infrastructure service delivery is the absence of capable, accountable state institutions. In many LICs and Fragile and Conflict-Affected States (FCAS), the state institutions responsible for infrastructure have limited capacity to plan, procure and finance sustainable infrastructure services²³. Governments often do not plan their investment for the medium or long-term, or do not prioritise on the basis of economic returns, reducing potential overall returns and leaving space for politically-driven ‘white elephant’ projects. Inadequate procurement practices in many countries increase capital costs. Construction is often poorly managed and inadequate maintenance regimes result in high costs for rehabilitation, reducing overall economic returns²⁴.

Vested interests and poor accountability mechanisms create incentive structures that are not aligned with the public good. For example, in many countries political economy incentives run against increasing tariff levels to cost recovery rates, but subsidies often benefit the better off, whilst starving state entities of the funds they need to maintain services and expand them to poorer segments of society. The construction of infrastructure provides substantial opportunities for corruption because contracts often are very large in value and there are many layers of transaction which increase the difficulty of achieving transparency and accountability²⁵. Some estimates put losses from corruption as high as \$2.5 trillion per year²⁶. Corruption is a significant disincentive for investment and can also result in sub-standard works.

Many would argue that, without addressing the underlying barriers, adequate finance will neither be sourced nor could be deployed. These barriers are represented in Figure 2.

Barriers blocking infrastructure service delivery vary significantly depending on the sector and context, as do the most appropriate intervention approaches. Engagement strategies need to be based on rigorous analysis of the specific context, including analysis of the political economy to understand what can be achieved and to identify entry points to leverage change.

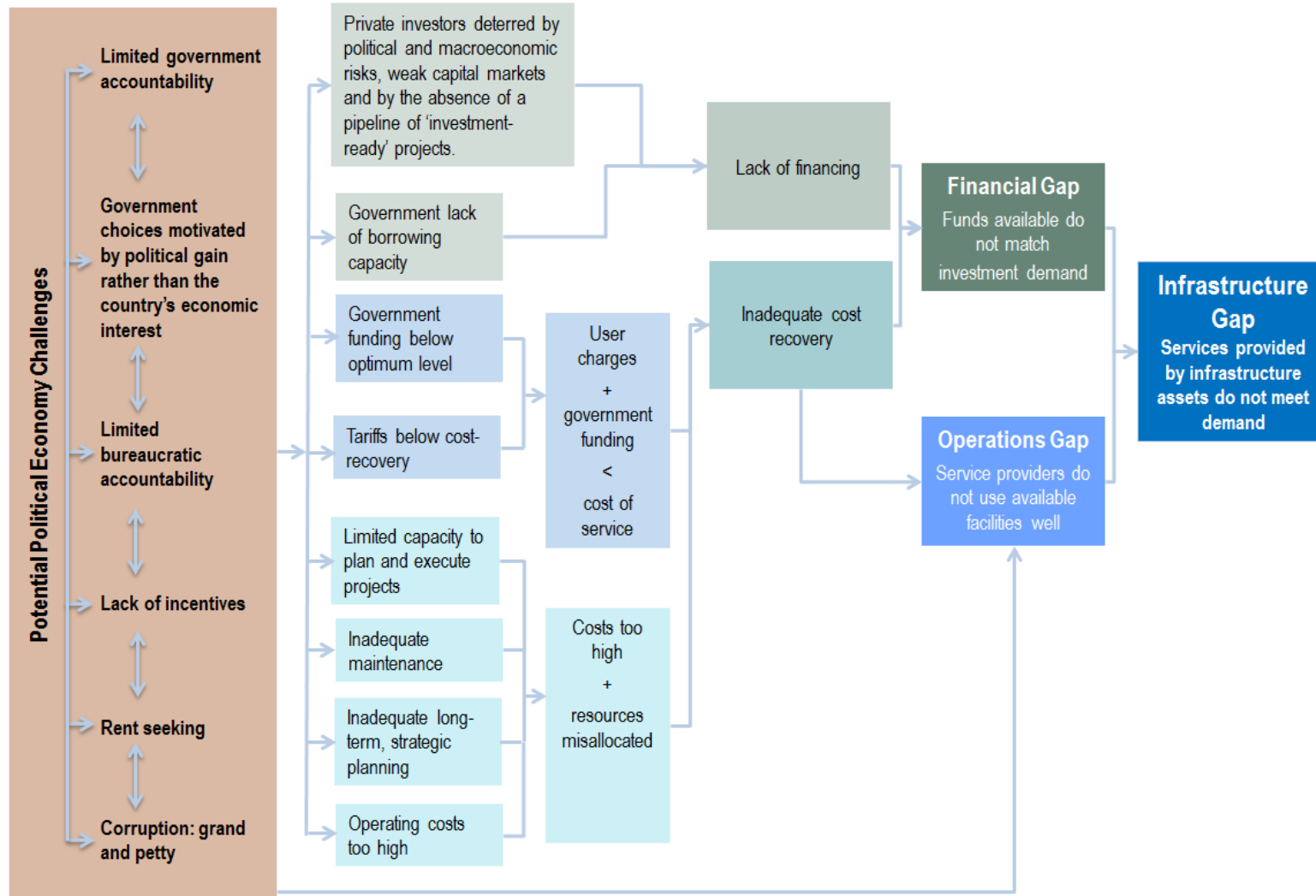
²³ Castalia (2014) Evidence Review on the Barriers to Scaling up Infrastructure Provision in Sub-Saharan Africa and South Asia: Report Commissioned by DFID. Available at Annex C

²⁴ The World Bank estimates that, in Africa, every \$1 spent on road maintenance saves \$4 on rehabilitation

²⁵ Construction Sector Transparency Initiative, 2014. *Construction Sector Transparency Initiative*. [Online] Available at: <http://www.constructiontransparency.org/home>

²⁶ CoST (2012), ‘Openness and accountability in public infrastructure could save US\$2.5 trillion by 2020’, October 2012

Figure 2: Barriers to scaled up infrastructure service delivery²⁷



²⁷ This figure has been adapted from "Castalia (2014) Evidence Review on the Barriers to Scaling up Infrastructure Provision in Sub-Saharan Africa and South Asia: Report Commissioned by DFID".

4. DFID's role in the infrastructure sector: current portfolio and analysis of comparative advantage

4.1 DFID's current portfolio

On latest estimates, DFID's annual infrastructure spend is around £1.1 billion, split approximately evenly between bilateral spend and imputed spend through core funding to multilateral organisations. The UK also has major infrastructure funding commitments through CDC, the UK's Development Finance Institution (DFI), currently estimated at £690 million. This section first considers our bilateral portfolio and goes on to discuss imputed spend through multilaterals. We classify our engagement with the Private Infrastructure Development Group (PIDG) as part of our bilateral portfolio in this section on the basis of DFID's role in establishing the PIDG and our continuing significant influence on its policy. The PIDG is internationally classified as a Multilateral Organisation.

Bilateral modalities

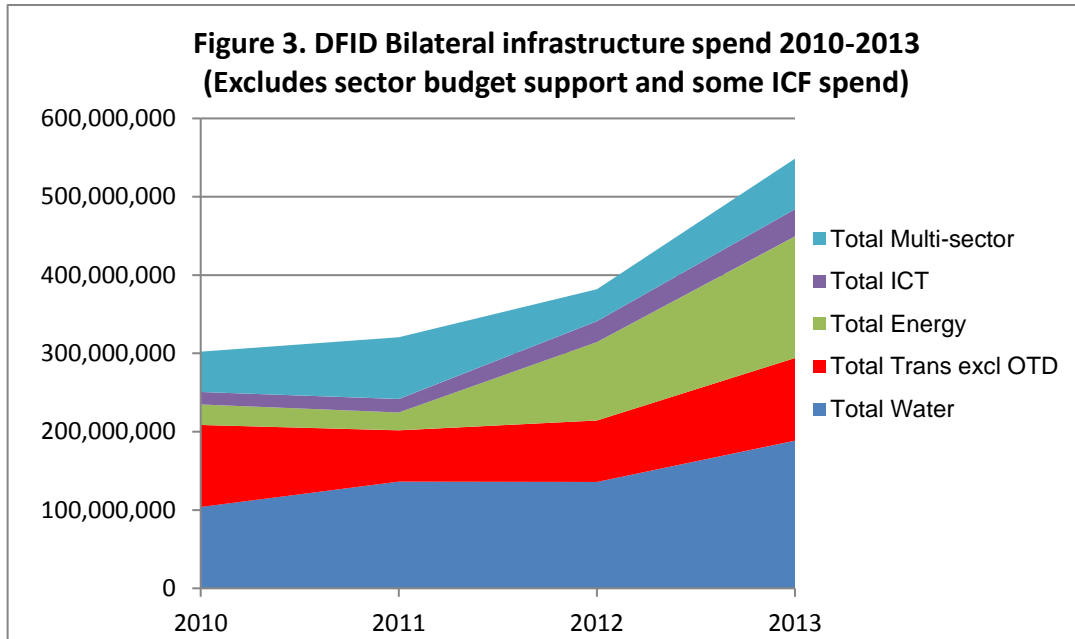
The majority of DFID bilateral spend on infrastructure is designed to improve the way infrastructure investment is carried out (policy / technical assistance) or to mobilise finance from other sources, particularly the private sector. For example, a recent analysis of DFID spend on infrastructure for economic growth (transport, energy and ICT) found that, between 2008-2012, 48% of spend was allocated to policy and technical assistance, 32% to mobilising private finance, 18% to grant funding of capital infrastructure, and 2% to research. This is largely as we would expect from an organisation that is principally a grant funder at present. DFID uses its scarce resources mainly to improve the enabling environment and mobilise and influence other sources of funding. Where we directly provide grant funds to fully cover the costs of infrastructure construction, it is generally to meet human development objectives in sectors in which market failures justify the use of public funds and / or in conflict-affected countries in which needs are urgent and high country risk makes other sources of finance difficult to access.

Bilateral sectors

DFID current bilateral spend is concentrated in water, energy and transport (see Figure 3)^{28,29}. Analysis shows that our bilateral programme is responding to the increased focus on economic development. Projected spend profiles indicate a significant increase in spending on energy and transport, while spend on water (which is less directly associated with economic development) is levelling off. Major new projects in the pipeline include economic corridors in South Asia, large energy projects in Nigeria and Tanzania and transport projects in Tanzania and Nepal.

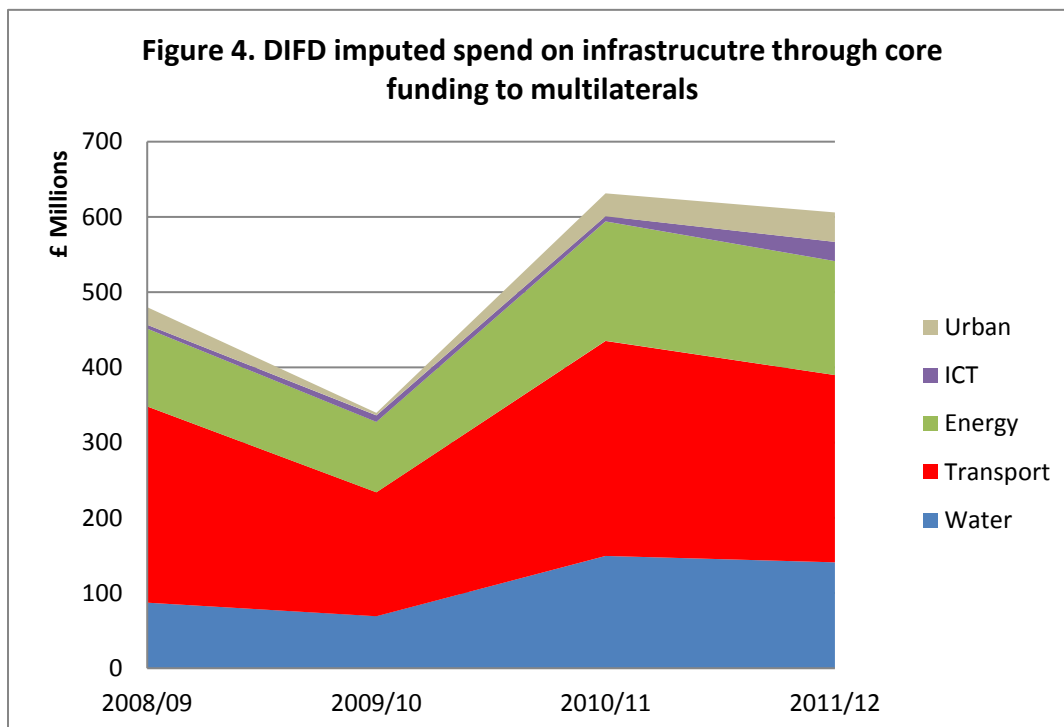
²⁸ The analysis here excludes infrastructure spend in UK Overseas Territories. This is because the UK's approach to working with the OTs differs in significant ways to our mainstream programming and so its inclusion would distort the analysis.

²⁹ Overall the figures here are likely to be a minor underestimate because: (1) they do not capture all spend on energy and low-carbon infrastructure under the International Climate Fund (ICF); (2) they do not capture all infrastructure spend through budget support.



Imputed spend through core funding to multilaterals

Imputed spend on infrastructure through multilaterals stood at over £600 million in FY 2011/12. DFID's principal multilateral partners in infrastructure for growth are the World Bank Group, the African and Asian Development Banks, the European Union and European Investment Bank. Transport is the largest sector for imputed spend by a significant margin, as illustrated by Figure 4.



4.2 DFID's Comparative Advantage in Infrastructure Sectors

Comparative advantage is defined here as areas where our business model, internal expertise and the broader UK expertise we can draw on enable us to add significant value. Poor countries can seek support from a large and growing number of providers of public concessional finance for infrastructure. This makes it important for development agencies to identify and focus on their niche, as well as opportunities for catalytic collaboration with others, in order to make best use of collective resources.

Many of the areas of comparative advantage identified are not unique to DFID.

However, strong demand for the types of support where DFID is able to add value combined with the scale and significance of the infrastructure challenge make a strong case for continued and scaled-up engagement.

UK expertise is an important element of our comparative advantage. The UK is a world leader in a number of areas of infrastructure policy and financing, with expertise in the private sector, government, academia and world class engineering institutions.

Context: How DFID's approach and scale of activities compares to others

DFID comparative advantage must be considered in the context of other actors' activities and strengths. Considering first the Multilateral Organisations, MOs allocate far larger quantities of funding to the infrastructure sector than DFID. For example, the World Bank Group allocated \$30 billion in fiscal year 2010 compared to DFID's approximate \$0.85 billion through our bilateral programming (plus approximately the same again through multilaterals). Beyond their scale, MOs have a number of important areas of comparative advantage. They are able to provide large-scale loans and other non-grant financial instruments to governments for capital-intensive infrastructure projects, whereas DFID at present does not. Unlike DFID, the Multilateral Development Banks (MDBs) are able to directly support private investment in infrastructure through private sector lending, investment and risk guarantees for investors. MOs also reach many countries in which DFID does not have a bilateral programme. In recognition of these areas of comparative advantage, around 50% of DFID infrastructure funding is channelled through core funding to multilaterals.

DFID is amongst the largest bilateral donors to infrastructure sectors, estimated as the sixth largest in 2012 after Japan, China, France, Germany and the USA. An analysis of DFID versus other bilateral donors suggests that DFID has characteristics which enable us to add significant value. These include: a strong focus on the countries with greatest need now and in the future; our relatively high risk appetite and capacity to deploy flexible technical assistance; and our staff's political awareness and multidisciplinary approach.

DFID Current Comparative Advantage

Six areas of DFID comparative advantage have been identified as set out below.

1. **Flexible technical assistance (TA) that can be used opportunistically to make projects happen and influence large-scale funding from others.**

DFID's close relationships with partner governments and ability to respond rapidly and flexibly to their needs, combined with a good understanding of political economy, enables us to support political opportunities for reform as they arise. For example, under the Nigeria Infrastructure Advisory Facility (NIAF), DFID support on power infrastructure was specifically requested from the President's Office. This led to substantial TA support including support to a large scale power sector privatisation which has generated around \$2.5 billion for the government and is forecast to generate around the same again for power sector investment.

Flexible TA that can be used in the early stages of project preparation is an area in which DFID is seen by many to have a comparative advantage over the multilaterals. Multilaterals have much to offer, but they are limited by resource constraints as well as the willingness and capacity of client countries to borrow for project preparation³⁰. For example, under the Mozambique Regional Gateway Programme, DFID carried out scoping, feasibility and design work on the rehabilitation of a 314 km stretch of railway which would enable Mozambique to capture wider economic benefits from mining investment. This work, costing approximately £800,000, was necessary to release £90 million in loans from the European Investment Bank (EIB) and Agence Francaise de Développement (AFD).

2. Mobilising private finance with a strong focus on the poorest countries.

DFID has been able to develop a comparative advantage in this area due to our ability to draw on domestic expertise, particularly in supporting private sector participation in infrastructure, a business model that encourages innovation and the Ministerial drive to work with the private sector. Our leadership in this area is demonstrated by the role we took in developing the Private Infrastructure Development Group (PIDG)³¹, a multilateral organisation with a portfolio of facilities that catalyse private investment by reducing risks for investors. Since it started operations in 2003, 46 PIDG supported projects have been completed and are now operational. These projects have mobilised \$11 billion in private sector investments and provided new or improved access to infrastructure to 113 million people. PIDG works in challenging environments: in 2013 alone, 71% of PIDG-supported projects were located in Least Developed and Low Income Countries and 57% were in fragile and conflict-affected states (FCAS)³².

CDC is one of UK aid programme's most powerful instruments for engaging with the private sector in infrastructure. CDC's strategy is set in conjunction with DFID. In recent years, CDC has scaled up its engagement in infrastructure in recognition of its role in economic development and job creation. Between 2011 and 2013 the proportion of CDC's investment portfolio invested in infrastructure (as defined by this Framework) had increased from 19% to 28%. This equates to an increase in investment of over £300 million, to reach a total of £670 million. Since 2012 CDC has been able to make direct debt and equity investments in businesses as well as indirect investments to fund managers. This enables CDC to add value in more ways, including through introducing improved management practices and structuring capital instruments creatively to meet specific needs. CDC provides forms of finance to the infrastructure sector which are in desperately short supply in Sub-

³⁰ G20 MDB Working Group on Infrastructure (2011) Supporting Infrastructure Development in Low Income Countries: Interim Report

³¹ The PIDG was set up by DFID and three partners in 2002

³² The PIDG base their definition of FCAS on the OECD-DAC International Network on Conflict and Fragility (INCAF) methodology.

Saharan Africa and South Asia: long-tenor ('patient') debt, equity and mezzanine finance. CDC is significantly scaling up its work in the energy sector in Africa as described in section 5.

DFID also supports innovative work on the enabling environment and on ensuring private investment benefits the poor. DFID was a founding member of Public-Private Infrastructure Advisory Facility (PPIAF) which provides technical assistance to governments to improve the enabling environment for private investment in infrastructure. One leading academic has said that "DFID's support to PPIAF... may be one of the most impressive success stories in the collective efforts of donors to support infrastructure"³³.

3. Community-focused infrastructure service delivery that supports human development objectives and create access to economic opportunity for the poorest, including in conflict-affected states

DFID's strengths in basic service delivery have their origins in our strong capacity in-country, our focus on reaching the poorest, on using the best evidence of what works, our strong focus on value for money, as well as consistent attention to ensuring the long-term sustainability of the services delivered. An example of a long-running, highly regarded programme is the Rural Access Programme (RAP) in Nepal. RAP will build or upgrade over 4,000km of road in some of the most deprived areas of Nepal between 2002-2015. The programme has created 13 million days of employment for about 24,000 poor and disadvantaged households. As identified in the MAR, MDBs may be less suited to develop projects with intensive community engagement due to their incentives to disburse large loans and lighter presence on the ground. The EC is currently a large provider of grant finance and this is one area for increased collaboration between DFID and the EC

DFID has also had some recent success in delivering infrastructure that supports stability and a return to economic activity in the challenging environment of conflict-affected states. Between 2008 and 2014 in Helmand province of Afghanistan, DFID worked with the Specialist Team Royal Engineers on small-scale infrastructure projects needed for security and stabilisation. The work later extended to development of a highway. This unique partnership would not have been possible through civilian consultants or contracted project managers. DFID has the potential to play a valuable role in these environments because our business model and strong capacity in-country enables us to respond rapidly and flexibly to evolving situations and to develop and implement programmes where conflict has left the government unable to act as a counterpart. A key strength is our ability to operate an integrated approach in conjunction with its UK Government diplomatic (Foreign and Commonwealth Office (FCO)) and defence (Ministry of Defence (MOD)) partners through the tri-ministry Conflict Pool (Conflict, Security and Stability Fund from 2015). Going forward, we will apply the lessons learnt in our Afghanistan programme to infrastructure development in other conflict-affected areas.

4. Regional public goods and infrastructure associated with trade is identified as an area with some established programmes and the potential for expansion.

³³ Prof. Antonio Estache, Universite Libre de Bruxelles (formerly World Bank): Written evidence for the 2011 IDC enquiry on DFID's Role in Building Infrastructure in Developing Countries

DFID flexible TA can be used to unlock funding and to support negotiations that enable regional infrastructure projects. The benefits of greater regional cooperation and connectivity are widely recognised: facilitating the movement of goods, power and people, and stimulating shared responsibility for economic growth, long-term regional stability and prosperity^{34,35}. But the higher costs, greater uncertainty and long preparation time of regional projects creates disincentives that deter many development agencies. The DFID-established TradeMark East Africa (TMEA) is a multi-donor initiative which provides technical assistance grants to regional institutions and governments to help countries attract investment resources from development agencies and the private sector. By 2016, TMEA aims to achieve a 10 % increase in the total value of exports from the East African Community (EAC) region and a 25 % increase in intra-regional trade exports. Lessons from DFID's regional work in Africa are being incorporated in the recently initiated South Asia Regional Trade and Integration Programme (SARTIP). DFID will continue developing our approach in this complex area, including learning lessons from existing programmes. We will also explore how we can work most effectively with MOs and private investors that have access to the large scale finance needed for regional projects.

5. Influencing key international actors through our positions on the G7, the G20 and engagement with emerging powers and the private sector

DFID, with its access to expert advice and its presence at key international fora, has a significant role to play in building consensus and mobilising political will for international action to address the infrastructure deficit in developing countries. In the current G20 negotiations, DFID is working closely with Her Majesty's Treasury (HMT) to push for scaled-up efforts to mobilise international private finance. DFID's close working relationship with HMT and the UK's strong government support for development allows us to push effectively for development concerns across the wider G20 global economic framework. The UK Government's strong partnership with the private sector also puts in a position to act as a well-informed interlocutor between public and private interests in international fora. In addition, there are potentially opportunities to engage with China on their infrastructure portfolio in Africa. For example, DFID recently signed a Memorandum of Understanding (MoU) with the China Development Bank (CDB) on cooperation in Africa where infrastructure is expected to be a focus area.

6. Building the evidence base through high quality research.

By developing high quality evidence through research and rigorous project evaluations, DFID has the potential to improve the impact of UK programmes and those of others. Infrastructure spending is vast, absorbing between 2- 6% of GDP in most developing countries³⁶, yet large infrastructure spending decisions are often made with an inadequate base of evidence. This almost certainly leads to poor or inefficient decisions.

³⁴ World Bank World Development Report 2011: Conflict, Security and Development, Washington D.C.: World Bank

³⁵ Recent estimates find that Africa accounts for just 3% of global trade and African countries trade just 10% of their goods with each other, compared to 65% between European countries (UN Economic Commission for Africa (UNECA) and OECD (2011) The Mutual Review of Development Effectiveness in Africa: 2011 Interim Report)

³⁶ ECG (Evaluation Cooperation Group) (2007) The Nexus Between Infrastructure and Environment: From the Independent Evaluation Offices of the International Financial Institutions. Washington D.C.: ECG

DFID's capacity to carry out high-quality infrastructure research relevant to the poor is based on DFID and broader UK technical expertise and will remain an area of comparative advantage in the coming decades. DFID has a number of important infrastructure research programmes which support key development aims in LICs and yield significant return on investment. For example, through the DFID established Africa Community Access Programme (AFCAP), applied rural roads research will contribute to the improved provision and maintenance of over 130,000 km of rural roads by 2020. The application of AFCAP research to date is estimated to have saved around £59 million of public funds.

The changing landscape and DFID's evolving comparative advantage

Changes in global systems and in the aid sector, as well as in DFID's business model, will impact on DFID's comparative advantage and areas of focus.

External changes

The role of ODA is changing as other forms of capital and funding become more available. Private investment in developing countries and remittance flows are now approximately six and three times greater than ODA flows respectively³⁷. Concessional transfers from emerging economies are also increasing rapidly³⁸. Growth rates in most developing countries have accelerated and their growth is the main driver of development. To be effective in this new context, aid needs to be more nimble and catalytic, helping to unleash national and regional drivers for development. For DFID this means using more of our aid to overcome fundamental barriers in the enabling environment, influence or mobilise other sources of funding, and produce technical global public goods relevant to the poor. It also means influencing the multilaterals through which we channel funding to increase their catalytic impact.

Many DFID focus countries are experiencing rapid rates of urbanisation, associated with potential growth and job creation but also significant risks. Well-planned and managed urban infrastructure plays a vital role in enabling cities to fulfil their potential. Our evolving approach is discussed in section 5.3.

Infrastructure has a high profile in international fora at present, including in the G20. With a clear set of objectives in mind, DFID will need to ensure we use our influencing position to maximum effect while this opportunity remains.

New international infrastructure project development and financing facilities are being established by MDBs and emerging economies. These Facilities are designed to fill the gaps in the current system for mobilising finance for infrastructure services that can create commercial or close-to-commercial returns. Their development represents a significant shift in public agencies' approach to mobilising private finance for infrastructure. Significant examples under development include: the World Bank's Global Infrastructure Facility (GIF); the African Development Bank's Africa50; China's Asian Infrastructure Investment Bank

³⁷ Data from a recent DFID Horizon Scan shows that ODA remains a significant proportion of GDP in low-income countries with low growth rates, a category which applies to many DFID focus countries. Grant aid remains important to support basic state functions in many countries in this category.

³⁸ China is now the largest external provider of concessional financing for infrastructure in Africa. In 2006/07, China was estimated by the World Bank to have infrastructure financing commitments of \$6 billion per year in Africa. This figure is likely to have increased significantly.

(AIIB); and the BRICS countries' New Development Bank (NDB). The existing EU-Africa Infrastructure Trust Fund (EU ITF), to which DFID has given more than £60 million, is also changing, with a substantial increase in resources.

DFID will respond to the development of new facilities in our bilateral portfolio and through our engagement with MOs. DFID support to CDC and the PIDG has similar objectives to these new Facilities, although they each have unique objectives and business models. In our future engagement with CDC and PIDG we will consider whether their business models require adjustments in order to add maximum value in this changed environment. We will also develop a strategic approach to influencing the development and operation of the new Facilities where we identify opportunities to add value based on DFID and broader UK expertise. In the case of the GIF and Africa50 we have a clear influencing channel as contributors and shareholders to their parent organisation. In the case of Facilities sponsored by emerging economies we will consider providing technical advice if invited to do so and where we believe we can add value. We may consider contributing to a Facility or Facilities where objectives are closely aligned with ours. This will depend on the outcomes of a broader dialogue around the right balance between bilateral activities and support through MOs.

Focusing on the aid sector, the Post-2015 Framework will almost certainly have a stronger focus on water, energy and cities than the current set of MDGs. DFID will need to reconsider its approach in the light of the Framework.

Internal Changes

The UK's aid programme is increasing its focus on economic development as described in section 2. In response, DFID is scaling up our activities in sectors that support economic development using modalities in which we are able to add value, and developing our offer in areas where we have identified potential to add value, as described in section 5. The UK's increased allocation of Development Capital Investment (DevCap) creates a new set of opportunities to support economic development as DevCap is often a more appropriate instrument for working with the private sector and can deliver better value for money by leveraging private sector capital and realising financial returns to enable funds to be recycled.

Conclusion

In conclusion, while others (particularly MOs) provide larger volumes of finance, DFID's business model, approach and expertise enable us to add significant value in the sector. Identifying our comparative advantage and how it will evolve with the changing landscape, and matching our strengths with high need areas will enable us to deploy our resources with greater impact.

5. Priority actions to enhance impact

The first part of this framework sets out the scale and urgency of the infrastructure challenge in DFID focus regions, identifies a number of sectors and modalities in which DFID currently adds value and presents a number of significant changes in the international landscape that impact on the way we work. On the basis of this analysis, this section concludes by setting out how we will refresh our approach to increase our impact and scale up our focus on economic development.

5.1 A rigorous approach to selecting and designing programmes

DFID will further enhance the effectiveness of existing tools and peer review to ensure that we consistently select interventions that have the greatest returns to growth and poverty reduction, as well as utilising DFID's comparative advantage. This approach will be based on the Decision Tree tool set out in Figure 5, supported by a 'light touch' Inclusive Growth Diagnostic to be carried out by Country Offices from January 2015 and an 'Early Stage Strategic Review' process for major and strategic programmes, set out in Annex C. The Inclusive Growth Diagnostic will complement the existing Country Poverty Reduction Diagnostics and support the 2016/17- 18/19 Comprehensive Spending Review process. It will identify priority areas for intervention to support economic transformation in the light of the political economy context and will go through a robust peer-review mechanism to ensure consistency and coherence. DFID's quality assurance procedure will continue to ensure that value-for-money assessment follows existing rigorous guidance. We are also developing guidance to support improved rigour in our economic appraisal of infrastructure programmes. Working and cooperating with the Department for Transport (DfT) and HMT we are developing an approach to presenting ex-ante economic appraisal in a clearer and more consistent way.

The majority of DFID's bilateral infrastructure spend is catalytic and this is a pattern that should be maintained and reinforced. Grant funding of capital infrastructure (and budget support used by governments for this purpose) is not catalytic in the way described in section 4.1, but there are potentially important justifications for using this instrument. New programmes using this instrument should set out how they comply with the criteria in box 2.

Box 2: Criteria for the use of capital financing of infrastructure using grant funding

There are two possible sets of criteria:

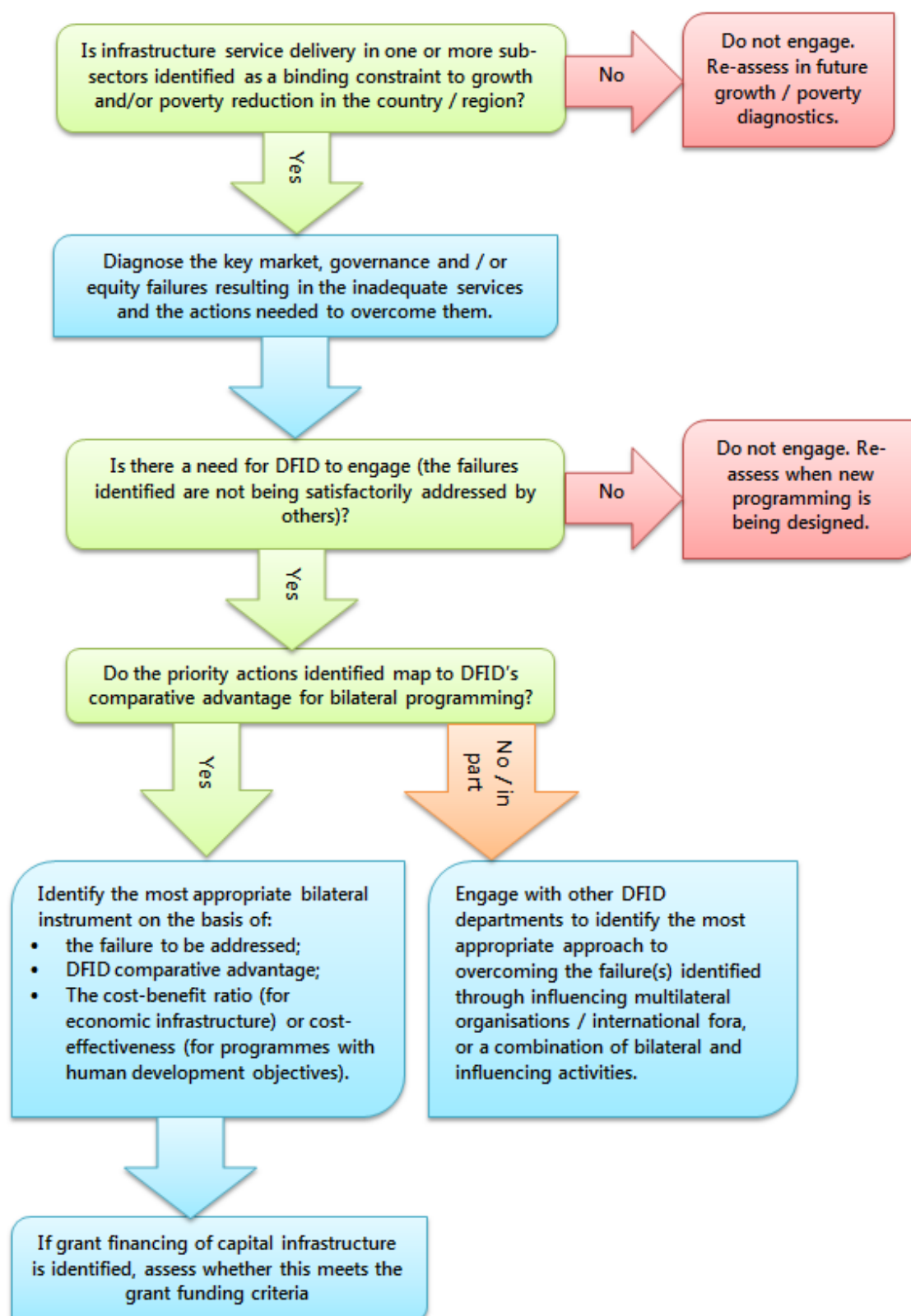
1. Market failures, equity considerations and / or low potential for private sector participation justify public funding **and** public funding is not available from other sources in time to meet key developmental goals (particularly the MDGs or future SDGs). In addition, programme design demonstrates concerted efforts to mobilise match-funding from the government, particularly in middle income countries.
2. The country / region is conflict-affected and infrastructure construction has been identified as likely to make a significant contribution to stabilisation and / or economic recovery³⁹, **and** neither private financing nor MO financing can be accessed to meet needs on a timeline consistent with stabilisation goals.

A further criterion is ensuring that DFID-supported programmes do not contribute to unsustainable debt levels in our partner countries. Where DFID Business Units are considering a programme which is likely to result in government borrowing for infrastructure there should be an early stage check of the country's status in the IMF/World Bank Debt Sustainability Analysis. Analysis of the risk of the programme contributing to unsustainable

³⁹ There is evidence that economic returns to well-managed infrastructure investment in post-conflict environments can be very high. For example, in the first phase of recovery the government of Uganda placed a high priority on rural roads. Subsequent evaluation by the World Bank estimated that the rate of return on this investment was an astonishing 40%. Collier, P., (2007), *Post-Conflict Recovery: How Should Policies be Distinctive?*, Centre for the Study of African Economies, University of Oxford, May

debt should be included in the Business Case and, where relevant, monitored in the Annual Reviews. This also applies to programmes supporting PPPs which would result in contingent liabilities on governments' budgets.

Figure 5. Infrastructure programming decision tree



5.2 Scale up strategic influencing activities with multilateral partners and in international fora

5.2.1 Engage strategically with multilateral partners to support improved effectiveness, appropriate division of labour and harnessing synergies with DFID's work

Around half of DFID spend on infrastructure is channelled through MOs, and our MO partners allocate half or more of their funding to infrastructure sectors. The scale of UK funding to the major multilaterals puts us in a good position to influence. We will be the largest contributor in terms of grant element to the replenishments of the International Development Association (IDA) and the African Development Foundation (ADF) this year, and one of the largest to the European Development Fund (EDF). Over a third of our bilateral programme is delivered through non-core funding to multilaterals, creating further opportunities for influence. Early thinking has identified the following provisional priorities for influencing:

- 1. Encouraging MOs to fulfil their potential to use their funds catalytically, including through new Facilities and funding modalities.** Our main MO partners are acting to scale up their catalytic impact: the WBG through the Global Infrastructure Facility (GIF) and other approaches to leveraging their balance sheet, the African Development Bank (AfDB) through Africa50 and the EU through increased use of 'blending' to mobilise other sources of finance. The UK's strong influencing position and expertise in private sector participation in infrastructure puts us in a position to add value as these potentially transformative facilities develop. We will develop our engagement strategy on these facilities and will consider whether we should encourage MO partners to scale up use of other instruments with catalytic potential, for example expanding use of guarantees including political risk insurance.
- 2. Working towards a better division of labour.** In order for relatively small quantities of aid to make a significant difference, each agency will need to work to its comparative advantage and agencies will need to collaborate in many instances to combine comparative advantages. As our infrastructure portfolio develops, we need to be clear where we draw the line between providing additional catalytic funding and proactive engagement with MOs where we believe there are areas where their business models should be adjusted to release core funds. There are a number of immediate opportunities for influence including: the WBG's upcoming review of safeguards and procurement; the EU's current strategy development under its new Commissioner; and, the development of the GIF and Africa50.
- 3. Encouraging MOs to base strategies on rigorous diagnostics and supporting enhanced impact of MOs through our position on the G20.** These two influencing priorities are relevant across all sectors but have strong relevance for infrastructure. Basing interventions on rigorous diagnostics that identify binding constraints to growth and poverty reduction can contribute to maximising the impact of MOs' scarce resources. The WBG is acting on this. We will consider whether we should be engaging with other MO partners to encourage greater use of diagnostics. We will support the G20 Infrastructure Investment Working Group as they seek to improve the impact of the MDBs and infrastructure investment facilities through: closer cooperation and coordination; the development of shared diagnostic tools; and increased harmonization of procedures and policies. Through the Development Working Group we will also work to enhance the enabling role of the MDBs, particularly in LICs.

5.2.2 Scale up our influencing activities in international fora

A key part of the UK's development effort is engaging in 'international actions' that influence global financial, economic and environmental systems in ways that benefit DFID focus countries. International actions have potentially very large payoffs for relatively small resource inputs, and utilise key areas of UK comparative advantage: our political influence and technical capacity. DFID has a modest portfolio in this area, including through the G20 and our nascent engagement with China as described in Section 4.2. Our work across government plays an important role in the 'beyond aid' agenda. An example is the UKTI/FCO/DFID strategy under development for joint working in frontier markets in Africa which will draw on British expertise and package it to optimise impact across Government.

We will work with like-minded partners to support an ambitious agenda on infrastructure in the G20. We will focus in particular on international actions to unlock private finance for infrastructure including: improve project preparation; risk management and mitigation; and will support the development of domestic capital markets. We will continue to scope opportunities for engagement with China where this has the potential to create benefits for our focus countries, particularly in sub-Saharan Africa.

5.3 Scale up activities in sectors and modalities that support economic development and where we have – or could develop – a comparative advantage

5.3.1 Areas where we have an existing comparative advantage: transforming the enabling environment and mobilising private finance

Work in partnership to improve the infrastructure enabling environment in DFID focus countries

Rationale

Evidence suggests that transformative change in the infrastructure sector is achieved only where the national enabling environment significantly improves. Changes such as improved regulation in sectors with natural monopolies, the introduction of sound public-private partnership (PPP) laws supported by expert staff in government, improved public procurement processes and medium-term strategic planning of infrastructure investment can transform moribund sectors to become the very elements of the economy that attract and generate investment that drives economic development. At the same time this is often the most challenging area in which to make progress and demonstrate results. Existing institutions and regulations are often propped up by powerful vested interests and change is inhibited by institutional inertia.

Catalysing change in the enabling environment requires strong political economy awareness, the capacity to be nimble and react to changing political priorities, strong relationships with partner governments, and an appetite for risk as programmes will not always achieve their objectives. Our analysis suggests that DFID is in a unique position to engage in this space. Where we are able to do so successfully, we catalyse positive outcomes far beyond individual programmes, including increased public and private

investment, better value for money, and ultimately better service delivery and economic development.

Approaches and instruments

We will scale-up DFID's engagement in this area, principally through bilateral channels. At country level, we can learn from existing successful programmes such as Nigeria Infrastructure Advisory facility (NIAF). Country-level programmes can be complemented by central support to successful global facilities providing enabling environment technical assistance, such as the Public-Private Infrastructure Advisory Facility (PPIAF).

Decisions on areas of focus will be based on combined diagnosis of the changes that would have the greatest impact as well as where the political economy environment creates room for change. The most successful programmes will always be demand-led and we should engage only where we have identified potential levers for change. Key areas for reform are likely to include improved regulation, PPP laws and other changes to enable private sector participation, the development of medium-term strategic plans for infrastructure investment based on an analysis of economic returns⁴⁰ and working with governments to develop improved maintenance regimes, particularly in the roads sector⁴¹.

Leverage private sector participation in infrastructure in frontier sectors and countries in ways that lead to shared prosperity and poverty reduction

Rationale

Development agency funds can be used as a catalyst to buy down risks and mobilise private sector finance that amounts to far more than the original ODA contribution. This approach can also create other advantages associated with private sector participation in infrastructure service delivery. Private sector investment is needed to fill the infrastructure financing gap and, while performance varies, evidence suggests that private sector participation can create additional benefits including lower prices and improved productivity, efficiency and asset maintenance⁴². There is a strong focus on mobilising private finance for infrastructure in the international community as well as amongst potential private investors. This is therefore a strategic moment for DFID to scale up activities with key partners. DFID's increased allocation of Development Capital Investment opens up opportunities to engage with the private sector in new ways.

Approaches and instruments

Bilaterally, DFID will continue to build on existing successful instruments, in particular the PIDG and CDC, as our offer on private sector participation evolves.

⁴⁰ This can channel public funding more effectively, create a platform for greater government accountability and create greater certainty for potential private investors. "countries and development institutions allocate \$3.3 billion in infrastructure spending to areas that appear surplus to the basic infrastructure requirements...which suggests that public and aid flows can be redirected toward areas of greater impact on development." Foster, V. and Briceño-García, C. (Eds.) (2010) *Africa's Infrastructure: A Time for Transformation*, Washington D.C.: World Bank pg. 65

⁴¹ Maintaining rural road networks is a daunting challenge for many countries. In Madagascar, Malawi, Mozambique, and Niger, the value of the road network exceeds 30% of gross domestic product (GDP). The World Bank estimates that, in Africa, \$1 spent on road maintenance saves \$4 on rehabilitation.

⁴² Harris, C. (2003) *Private Participation in Infrastructure in Developing Countries: Trends, Impacts, and Policy Lessons*. World Bank: Washington D.C.

DFID is considering a wide range of options for future support of the PIDG depending on developments in strengthening governance and the needs of the market. This may include some form of Development Capital Investment. We are in early stages of exploring what more CDC can do in the future to support our economic development strategy, this includes looking at the future role of CDC in the sub commercial space, defining the boundary between CDC and DFID in the use of Development Capital Investment and reviewing CDC's business model. CDC is scaling up its work in the energy sector in Africa by creating a new regional platform to catalyse project development and mobilise finance.

Given the importance of the institutional investor agenda, we will seek to engage through other channels in addition to the G20. We will consider how we can support this through the development of the next phase of support to the PIDG and a new capital markets programme being developed. We will also consider engagement at country office level to support increased financing from national institutional investors, for example support for appropriate national regulatory reform⁴³.

Recent research has demonstrated that the lack of a pipeline of bankable projects and weak domestic capital markets are major barriers to mobilising increased private finance in DFID focus regions⁴⁴. DFID will consider potential avenues for enhancing our impact on project preparation, based on our comparative advantage and the instruments at our disposal. DFID's work in supporting the development of capital markets is scaling up. In the future, we will seek opportunities to join up work on capital markets and mobilising private finance. One potential avenue is through working to mobilise capital from national institutional investors in our focus countries.

5.3.2 Areas where we have the potential to develop a comparative advantage: urbanisation and regional infrastructure

Urbanisation

Cities already create 70% of GDP and have the potential to play a central role in supporting an economic transformation that would enable countries to graduate from aid dependence. Cities create 'agglomeration economies' which enable businesses to share fixed costs, efficiently match supply and demand of specialised goods, services and workers, and spread and use knowledge. Under the right conditions, cities can generate large-scale, productive employment, which can be a national driver for growth and development⁴⁵. But this process is not automatic. Poor planning, inadequate governance and environmental damage can lock cities into dysfunctional forms which set development back decades.

Most DFID focus countries – especially in Africa – are urbanising very rapidly. There is a limited window of opportunity to intervene to enable countries to capture the growth opportunity. There is broad consensus that support from the development

⁴³ This is being considered by DFID-India.

⁴⁴ See, for example, Nathan Associates Inc (2014) Study to Examine the Use of Grant Funding by Bilateral Donors for Infrastructure Financing

⁴⁵ Miller, H. (2014) What are the features of urbanisation and cities that promote productivity, employment and salaries? Evidence review commissioned by DFID under the Professional Evidence and Applied Knowledge Services (PEAKS) Framework

community for well-planned and managed urbanisation is currently inadequate. DFID's current urban portfolio is small but we believe we have the potential to develop a comparative advantage in urbanisation due to our capacity for nimble, politically aware technical assistance, mobilising private finance and multi-disciplinary working.

We are developing new programming in this area which will help us to identify entry points matched with our comparative advantage and will develop a concept paper on DFID's role in supporting urbanisation for jobs and growth during 2015. The paper will propose a holistic approach that goes beyond infrastructure.

Rural infrastructure will continue to be a focus, as will infrastructure linking rural and urban areas. Despite rapid rates of urbanisation, the majority of poor people will continue to live in rural areas for some time to come. Enhanced productivity and value-added in agriculture is important to reduce rural poverty while countries build up their manufacturing and services base. Integration of rural and urban markets enables cities to access the food and raw materials they require to support economic development and helps share the economic benefits of urbanisation to rural areas. DFID will continue to support rural infrastructure as we develop our strategy on urbanisation.

Regional public goods and trade related infrastructure

Inadequate regional infrastructure in sub Saharan Africa and South Asia is a major barrier to economic development and greater regional integration has the potential to support peace and stability⁴⁶. Creating the right conditions for regional infrastructure projects to go ahead requires a complex mix of political, technical and financial inputs. DFID's track record of politically aware technical assistance and engaging in political and technical process to lay the groundwork for developmental change puts us in a good position to scale up our current regional portfolio.

DFID is developing a number of channels for a bilateral scale-up, in addition to our existing TMEA and SARTIP programmes. New options under development include proposals to support Economic Corridors in South Asia and Pakistan through technical assistance and strategic use of capital. A further option is replicating TMEA in other parts of Africa.

Encouraging more work on regional infrastructure will form part of DFID's influencing strategy with the MOs.

5.4 Across all elements of our refreshed approach, systematically integrate key cross-cutting priorities, including on climate and environment, poverty and girls and women

Climate and environment

Enhancing the resilience of the built environment is an important step in reducing the vulnerability of those affected by extreme weather events and climate change

⁴⁶ World Bank World Development Report 2011: Conflict, Security and Development, Washington D.C.: World Bank

impacts. Over 60% of greenhouse gas emissions originate from energy use in transport, buildings and industry⁴⁷. There are often higher initial capital costs associated with sustainable, resilient infrastructure options which will have the highest whole-life economic returns. Without data and analysis and in situations with constrained budgets, initially cheaper but less appropriate options are often chosen. Development assistance can play a key role in these situations by helping partner governments meet upfront costs and reap longer term rewards.

DFID will support countries in making the best choices to support resilient, long-term, inclusive growth, making efficient and effective use of the £3.7 billion International Climate Fund (ICF). Key approaches include exploiting domestic renewable energy resources, addressing market failures to enable investment and building analytical capacity and knowledge systems to understand energy, resource and other trade-offs and technical and policy options. ICF resources will continue to be used to support programmes with specific climate and environment objectives, but will also increasingly be used to finance low-carbon and climate-resilient elements of wider infrastructure investments. Future policy will be guided by the development of an Energy Policy Framework.

Improving the WBG's performance on climate change was one of our key deliverables for the IDA 17 negotiations and continues to be a priority going forward, with the World Bank and other MOs. We will work to ensure that international discussions on infrastructure planning and funding give due consideration to climate mitigation and adaptation requirements.

Ensuring our investments have the greatest possible impact on reducing poverty and create benefits for girls and women

The link between improved economic infrastructure and long-term opportunities for poverty reduction through inclusive growth is widely recognised (as set out in Section 2). But the precise mechanisms through which this occurs are not well understood, in part due to the long time-lags between economic infrastructure project development and poverty reduction impacts and resulting in difficulties in attribution. DFID will work to enhance understanding of these links and to ensure that the latest evidence informs our programming. Strategic principles are set out below:

- 1. For every economic infrastructure project we will develop a Theory of Change that sets out an evidence-based understanding of the links between our activities and poverty reduction.** The links in our Theories of Change will be monitored through SMART indicators in our logframes.
- 2. We will do more to generate evidence on the long-term impact of economic infrastructure on the poor and on girls and women.** We will do this by commissioning high quality evaluations of our investments in economic infrastructure and influencing our partners to do the same. We will collate the lessons from these impact assessments and

⁴⁷ World Resources Institute (2012) World Greenhouse Gas Emissions 2005. Available at: <http://www.wri.org/chart/world-greenhouse-gas-emissions-2005>

integrate their findings into the design of our projects and our influencing activities with partners^{48,49}.

3. For economic infrastructure programmes staff should consider whether ‘additional measures’ to enhance direct poverty reduction and gender impacts could be introduced without significantly diminishing the programme’s economic development impacts. Guidance is provided in the 2014 DFID Topic Guide *Maximising the Benefits to the Poor from Infrastructure Programmes aimed at Increasing Growth*. Key approaches include measures to extend access to, and increase affordability for, the poor, and early consultation with vulnerable groups to understand their needs. In cases in which DFID is providing support through a Facility or MO which we do not directly manage (such as the PIDG), staff will set out the Facility’s / MO’s approach to poverty reduction and gender and consider opportunities to better monitor and enhance the poverty impact and impact on women and girls. We will also provide a clear justification for how this complies with our commitment in these areas.

Taking into account the needs of disabled people

Over one billion people – 15% of the world’s population – are disabled and disability is closely linked with poverty. The IDC published a report on Disability and Development in April 2014 in which it identifies a need for DFID to step up its work in this area. The IDC has welcomed DFID’s response, which includes commitment to publish a disability framework by November 2014.

Inaccessible infrastructure facilities, particularly buildings, transport and water and sanitation, are a key factor in preventing disabled people accessing economic opportunity, social services and information. We will develop our approach to ensuring our infrastructure programming incorporates the requirements of disabled people in the coming months and set out how we plan to step up in this area in the forthcoming Disability Framework.

Results

DFID is developing indicators on economic infrastructure in order to measure economic development results. At present, DFID’s Departmental Results Framework (DRF) includes infrastructure targets only on water and sanitation⁵⁰. Developing results indicators for economic infrastructure will help to drive ambition in our approach, motivate consistent monitoring and enable us to effectively communicate our impact. Economic Development indicators are due to be published in early 2015.

Fighting corruption and improving transparency

⁴⁸ A recent survey of ‘gender markers’ across our economic development portfolio finds that between 30 – 40% of DFID infrastructure programmes have a principal or significant gender focus – a lower proportion than other EcDev sectors. The survey notes that it is reasonable to expect a relatively low figure in the infrastructure sector as many programmes do not have outcomes that capture direct impacts on at the individual or even household level.

⁴⁹ It is important to note that this type of impact assessment will only be possible where impacts on individuals or households are measures, and this is not always practical for economic infrastructure projects (e.g. PIDG projects).

⁵⁰ We measure access to renewable energy through the DRF but do not have a specific target.

The nature of construction projects and their organisation make the sector highly vulnerable to corruption, with some estimates putting potential losses from corruption as high as \$2.5 trillion per year⁵¹. Corruption is a significant disincentive for investment, can result in poorly constructed works and hampers the development of a vibrant domestic construction industry. The impact on growth is undoubtedly significant.

We will continue to treat combating corruption and improving transparency as a top priority, in our own programming and beyond. The UK Government has a strong focus on transparency at home and abroad. DFID has a strong focus on ensuring money is not lost through corruption in our bilateral programming, including through our accountancy processes and ensuring that all DFID staff have a good understanding of the UK's Bribery Act 2010. We will also consider support to global initiatives that support increased transparency in the construction sector. DFID helped create the Construction Sector Transparency Initiative (CoST) and will consider re-joining and helping to drive the initiative further.

6. Conclusion

Improved delivery of energy, transport, water and sanitation and other infrastructure services is central to the achievement of DFID's objectives on economic and human development. The scale of the challenge and the centrality of infrastructure to economic development, combined with strong demand for the types of support in which DFID has a comparative advantage, creates a powerful case for continued and scaled up engagement.

This Policy Framework has identified four priority areas for action to enhance DFID's impact in infrastructure sectors. These are:

1. **Further enhance the effectiveness of existing tools and peer review** to ensure that we consistently select interventions that have the greatest returns to growth and poverty reduction, and that capitalise on DFID's comparative advantage.
2. **Drive effective influencing of key multilateral partners and in international fora.**
3. **Scaling up of activities in sectors and modalities that support economic development and where we have – or can quickly develop – a comparative advantage.** Areas identified for scaling up are transforming the enabling environment and mobilising private sector finance. Areas identified for developing our offer are urbanisation and regional infrastructure.
4. **Systematically integrate key cross-cutting priorities**, particularly on climate and environment, poverty and girls and women, across all elements of our refreshed approach.

As DFID increases its focus on economic development, acting on these priorities areas will enhance our impact in infrastructure sectors and enable us to respond effectively to changes in global systems and the aid sector.

⁵¹ CoST (2012), 'Openness and accountability in public infrastructure could save US\$2.5 trillion by 2020', October 2012

Annex A: Market Failures in Infrastructure Sectors

The following are typical infrastructure sector market failures:

- The **public good** nature of the infrastructure means that private investor cannot capture sufficient if any share of the benefits owing to the consumption characteristics of the infrastructure service. A service is 'rival' if consumption by one user reduces the supply available to other users. A service is excludable if a user can be excluded from its use. A non-excludable, non-rival service is a definition of a pure public good.
- **Positive externalities** (i.e. wider spillover benefits) mean that private sector will under invest. There may also be negative environmental externalities which mean that a government may rather not leave the infrastructure purely to the private sector.
- **Natural monopolies** occur in technologies for which it is economically most efficient for production to be concentrated in one supplier, mainly due to high capital costs. Examples include water and electricity grids, broadband fibre optic backbones and railway infrastructure.
- **Capital market failures**: which may prevent potential (especially local) private investors from raising the necessary finance or foreign investors if finance is not available on the terms required (especially long tenors)
- **Coordination failures** i.e. one type of infrastructure may only be viable if other infrastructure exists so coordinated planning is required.

The potential for private sector participation (i.e. the 'marketability') of infrastructure varies significantly between sectors, depending to a large degree on the extent to which the above market failures occur in each sector. An analysis of marketability by sector was carried out for the World Bank World Development Report 1994 'Infrastructure for Development' and remains highly relevant today. This is provided in Figure A.1.

Figure A.1. Marketability of infrastructure activities by sector

| Key to marketability rating: | | | | | | | |
|---|--|--|------------------------------------|---|--|-----------------------------|----------------------------------|
| <div> <div></div> = 1.0 (least marketable) <div></div> = 2.0 <div></div> = 3.0 (most marketable) </div> | | Potential for competition ^a | Characteristics of good or service | Potential for cost recovery from user charges | Public service obligations (equity concerns) | Environmental externalities | Marketability index ^b |
| Telecom | Local services | Medium | Private | High | Medium | Low | 2.6 |
| | Long distance and value-added | High | Private | High | Few | Low | 3.0 |
| Power/gas | Thermal generation | High | Private | High | Few | High | 2.6 |
| | Transmission | Low | Club | High | Few | Low | 2.4 |
| | Distribution | Medium | Private | High | Many | Low | 2.4 |
| | Gas production, transmission | High | Private | High | Few | Low | 3.0 |
| Transport | Railbed and stations | Low | Club | High | Medium | Medium | 2.0 |
| | Rail freight and passenger services | High | Private | High | Medium | Medium | 2.6 |
| | Urban bus | High | Private | High | Many | Medium | 2.4 |
| | Urban rail | High | Private | Medium | Medium | Medium | 2.4 |
| | Rural roads | Low | Public | Low | Many | High | 1.0 |
| | Primary and secondary roads | Medium | Club | Medium | Few | Low | 2.4 |
| | Urban roads | Low | Common property | Medium | Few | High | 1.8 |
| | Port and airport facilities | Low | Club | High | Few | High | 2.0 |
| | Port and airport services ^c | High | Private | High | Few | High | 2.6 |
| Water | Urban piped network | Medium | Private | High | Many | High | 2.0 |
| | Nonpiped systems | High | Private | High | Medium | High | 2.4 |
| Sanitation | Piped sewerage and treatment | Low | Club | Medium | Few | High | 1.8 |
| | Condominial sewerage | Medium | Club | High | Medium | High | 2.0 |
| | On-site disposal | High | Private | High | Medium | High | 2.4 |
| Waste | Collection | High | Private | Medium | Few | Low | 2.8 |
| | Sanitary disposal | Medium | Common property | Medium | Few | High | 2.0 |
| Irrigation | Primary and secondary networks | Low | Club | Low | Medium | High | 1.4 |
| | Tertiary (on-farm) | Medium | Private | High | Medium | Medium | 2.4 |

^a. Due to either absence of scale economies or sunk costs, or existence of service substitutes.
^b. Marketability index is average of ratings across each row.
^c. Including cargo handling, shipping, and airlines.

Source: World Bank (1994) *World Development Report: Infrastructure for Development*

The variation in marketability is illustrated in investment patterns. From 1984 to 2008, approximately 42 per cent of investment commitments to infrastructure projects with private participation in the developing world was in telecommunications, 31 per cent in energy, 22 per cent in transport and 6 per cent in water and sanitation (World Bank and PPIAF, 2010).

Annex B: Information on Sub-Sectors: Energy, Transport and Water

B.1: Energy

No country has grown without expanding energy supplies and consumption. Worldwide 1.3 billion people are without access to electricity⁵² and 2.7 billion people still cook on firewood with serious impacts on health, productive time and deforestation. Under the current International Energy Agency scenarios, 48% of Africans will still be without electricity access in 2030. Businesses across Africa and Asia identify energy as one of their top constraints.

Energy is the most 'marketable' of DFID's focus sectors. This is because: (a) it provides services for which user fees are charged; (b) it is 'excludable' because access to them requires a connection to a network; and, (c) it is possible to unbundle activities and create competition. There is therefore significant potential to mobilise additional private finance in the energy sector and DFID will continue to focus on achieving this in ways which promote sustained and sustainable growth and poverty reduction. However, there are significant market failures in the provision of clean energy, particularly the high up-front costs of renewables which makes projects less easy to finance, and 'first mover disadvantage' for new technologies. Public finance has a critical role in helping to overcome these market failures. Publicly supported analysis and intervention is also critical to overcome market failures that span all energy sources, including grid extension, power sector viability, utility reform and energy markets. DFID has a valuable resource in the form of the £3.7 billion International Climate Fund (ICF) which can play an important role in our plans to scale-up engagement in the energy sector.

The energy sector has been identified as a priority area to develop further policy analysis. This work will start in the latter part of 2014. DFID developed a 'Future Fit Sector Analysis' on energy in 2013 and this will form an important input into this work.

B.2: Transport

Access to affordable, reliable, sustainable transport services supports economic growth, poverty reduction and service delivery. Worldwide over 1 billion people lack access to all-season roads, 98 percent of them in developing countries⁵³. In DFID priority countries an average of 43% of the population do not live within 2km of an all season road.

The transport sector is the largest sector lend in the World Bank, and is one of the main sector lends in both the Asian Development Bank and the African Development Bank. This makes a strong case for engaging strategically with the MDBs' Boards and operations on transport.

Market failures vary significantly by transport sub-sector. Rural roads are an example of a pure public good: using the definition given above, they are neither 'rival' nor 'excludable', hence a commercially viable rural road is unfeasible. The role of rural roads in supporting growth and poverty reduction makes a strong case for public funding. In contrast, secondary and tertiary roads are theoretically marketable through the use of tolls. The number of successful toll roads is growing worldwide, but experience has brought to light the many

⁵² International Energy Agency (2011) World Energy Outlook 2011, p469

⁵³ World Bank (2008) *World Bank Group Sustainable Infrastructure Action Plan*. Accessed at: <http://documents.worldbank.org/curated/en/2008/07/9719738/world-bank-group-sustainable-infrastructure-action-plan-fy09-011>

challenges of designing and managing a commercially viable toll road, so caution is necessary. There is significant potential for private sector participation in urban mass transport. Railway infrastructure is a strong natural monopoly due to the very high sunk costs, so developing or maintaining and operating a railway network requires regulation and, in many cases, public finance.

Our transport portfolio is scaling up as demonstrated by the analysis in this Strategy. In the future we will consider how DFID's instruments and ways of working can add most value in the sector. A paper on DFID's comparative advantage in transport is currently under development.

B.3: Water

Water and Sanitation

Worldwide, 748 million people lack access to safe water and 2.5 billion people do not have access to adequate sanitation. The sanitation MDG target is off track globally, and that for water is off track in sub-Saharan Africa. Sanitation and Water remain key issues for the UK development agenda.

The dominant market failure in water and sanitation is the positive externalities associated with clean drinking water and good sanitation facilities, principally the human health benefits. The private sector cannot capture these benefits and so will underinvest in relation to the national good. Piped water and sewerage are also natural monopolies. However, water and sewerage are 'private' goods and so are theoretically 'marketable' to private operators. But there equity concerns; even if markets are working efficiently in low-income countries some households risk not having access to commercially delivered services. Where universal access is a goal, such as in the proposal of the High Level Panel on the Post-2015 Development Agenda⁵⁴, a case for grant funding can be made. A range of modalities, including private sector engagement, are relevant where an investment market exists, for example in urban utility provision.

Water Resources Management

The availability and the management of water resources have profound impacts upon economic development and poverty reduction. It is estimated that, by 2025, 1.8 billion people will live in areas where water is physically scarce⁵⁵. A 2014 survey of global CEOs identified water crises as one of the top three risks threatening global businesses⁵⁶. DFID has a strong reputation in key aspects of water resource management (WRM), including a history of proactive engagement in strategic river basins in South Asia and Sub Saharan Africa. Our mechanisms for delivering support on WRM are primarily technical assistance but public private partnerships are increasingly playing a role.

⁵⁴ <http://www.post2015hlp.org/wp-content/uploads/2013/05/UN-Report.pdf>

⁵⁵ UN Water (2014) Water Scarcity Factsheet

⁵⁶ World Economic Forum (2014) Insights Report: Global Risks 2014

Annex C: Early Stage Strategic Review of Infrastructure Programme Proposals

What is the purpose of this additional review stage?

This is an early stage review by a peer review group consisting of the Economic Development Director General and relevant Directors and Head of Department (HoDs). It will highlight key policy sensitivities and high level design issues that need to be addressed. The review will ensure that strategic programming and influencing decisions are made with due regard to the wider policy context and harness potential synergies across DFID's portfolio. It will take place in addition to other review and approval processes set out in SMART rules. As an early-stage concept review, it is very different in nature to the quality assurance work undertaken by the QAU on near-final business cases. The process will be tested in autumn 2014 and will be reviewed and revised based on the outcomes of these initial trials.

What type of decisions should go through this additional review stage⁵⁷?

Programming or strategic influencing decisions that meet one or more of the below criteria:

- Large infrastructure programmes with the potential for overlap with other programmes that individual Departments may not be aware of.
- Decisions that have the potential to lock DFID into long term, significant financial commitments and as a result, restrict pursuit of alternative options.
- Proposals that affect DFID's overall positioning in relation to the multilaterals and / or other international actors. (This could be programming, for example a decision to fund one of the new Facilities, or strategic influencing decisions.)
- Proposals that are novel or contentious. (Examples include new funding modalities or new approaches to working with major partners.)

What will the early stage strategic review involve?

- The originating team should first consult with a group of 5-10 relevant A-band staff across DFID (e.g. those with expertise in the area/modality being proposed, those who may be working on similar programmes.) The team should select consultees from a broad range of Departments across DFID.
- Following this consultation, the team should develop a 2 pager to bring to the peer review group, structured around a set of framing questions as proposed below.
- Minutes from the meeting at which the proposal is discussed will record issues raised and recommended next steps for the relevant HoD to action.

Proposed Framing Questions

- What is the Strategic Case for this proposal and proposed scale of DFID investment?
- How will the proposal affect DFID's positioning in relation to our multilateral partners and how DFID / the UK is perceived internationally?
- How well does the proposed programme match with DFID's existing comparative advantage or support the development of new areas of comparative advantage, as identified in the Infrastructure Policy Framework?
- How does the proposal support the areas / modalities identified as priorities for scaling up or developing our infrastructure offer?
- How would this interact with existing programming and influencing activities? Are there opportunities to maximise synergies? Does action need to be taken to minimise risk of overlap?

⁵⁷ Proposals with an RC element will also go through the RC governance mechanism. It will be important to ensure that these processes are joined up.