High Level Seminar on Key Elements of Competitiveness of the European Industry in Infrastructure Projects outside Europe
8 October 2014

Transcript of video message by Prof. Dr. Dieter Helm, Oxford University

Thank you for the invitation to address this High Level Seminar, I'm very sorry I can't be there in person with you.

The topic we are addressing is one of incredible importance for Europe. Europe is at a cross roads now, we've had several years of financial crisis, we've had the euro zone crisis, economic growth is very low to almost nonexistent and Europe faces serous competitive challenges in world markets. So in thinking about a growth strategy for Europe and in thinking about how to invest for Europe the questions come in droves as to how to go about that. One question is how major European companies and SMEs can compete in world markets bearing in mind that the availability of contracts, the scale of the opportunities on world scale vastly dwarfs the internal one within the EU. The problem is this: out there, there are these large contracts and Europe has to bid against other players and the playing field is not leveled. In a first best textbook world we would have competitive markets, everyone playing by the rules, there would be no tie ins, no links to domestic companies, finance would be provided by the world markets and we'd all go in and do our best to win contracts. But that is not the world we find ourselves in, we are in a second best world where other people don't play by those competitive rules and Europe has a choice: it can either play to win like they do or it can play pure competitive markets and play to lose. That is the choice in front of Europeans when they look at these international opportunities. It's not just that other countries and their national banks support their contractors, it's that they go about it in a way which addresses the many dimensions in which these sorts of contracting opportunities differ from what you'd expect in a normal competitive market. It's not just about finance, or about the linkages to subcontractors, although those are both key and important elements, it is also about how the bidding costs are covered, how the exposure and risk of going for these markets feeds back into domestic companies. It is about the supporting skill sets, supply chains and all those that as economists we'd call "externalities" or spillover effects that come from this kind of contracting opportunity.

So if we look at these markets and Europe decides to play to win like its competitors do, what do we in Europe have to do which matches what other countries are up to? The first thing is pretty straight forward: just be serious about it, be clear that we are going to do almost whatever it takes to match what the others are up to. Credibility matters. If you are not credible, if the buyer abroad thinks that you will weaken on key points, others are going to win anyways and indeed European companies will not find it worthwhile to actually do the bidding for the necessary contracts. Why put in the time? Why invest in bidding costs when Europe will not back you in the way Japanese, Korean and Chinese governments and their banks do? First thing is to make it absolutely clear that this is crucial to Europe, we are going to play to win and we are going to be at the table.

Now of course it is easy to say Europe could have a policy to address these issues. But this policy needs to be filled in; it needs the ability for the buyers to see it as genuinely credible, as opposed to just another European declaration or statement of intent. How do you make this sort of intervention serious and credible? First of all, there is finance. Any of these large projects have the characteristic of having large, up front, fixed capital expenditures and these need finance which many of the host countries simply cannot provide. What terms is that finance going to be provided upon? These are always risky projects: large energy projects, large construction projects. They take time. There are all sorts of risks about what future markets look like, there is the behavior of the incumbent government once the assets are constructed, particularly with infrastructure; there are a host of risks which any normal pension fund, large sovereign fund etc. will look at very critically and say: "which bits are political and which bits are genuinely commercial equity risks?"

The truth is quite a lot are political; that is why guarantees are essential. And for the Europeans it's pretty straightforward: are the Europeans prepared to provide the kind of guarantees which competitive countries provide to their major companies when they go after these markets? Are we going to play to win when it comes to the guarantees behind these contracts? And the answer is pretty straightforward: either we are and then we are in the game or we are not and we might as well pack up and go home. That is the nature of the second best game we are in and there aren't really many other options. Any outside private investor, any of the pension funds, life funds and so on are going to look at these and ask that question: who is going to guarantee the financial structure of these deals? Now if we do decide to play to win and we do decide to provide guarantees, this isn't a blank check. Guarantees need to be sophisticatedly designed so that they address the core market failures and the core behavioral aspects of our competitors, of other nation states.

Which bits should be guaranteed and which bits should be left to the private sector? The answer to that question is in large measure: which bits of the risk are genuinely political? If you're going to go and build a large dam, a major power station, a major water treatment works in another country, these are large, fixed and sunk costs and the marginal costs are typically substantially below the average costs. As with any infrastructure project anywhere in the world there is always the exposure that once the project is finished the investors get expropriated. It is what we in economics call "time and consistency". So what guarantees are there that the host country is going to abide by the rules given that, for example, in Europe there are lots of cases where investors invest in things like renewables and invest in all sorts of infrastructure projects and then regulators come to the scene afterwards and try to claw back what investors thought were the legitimate investments. The financial guarantee bit has to address that particular aspect of infrastructure and provide the underpinning for it.

Then there is project risk itself, the risk of the cost of the construction. It's all very well to think that's just a normal thing for equity investors to take on board but you know even in Europe we don't really do that. Take for example the project to build a new nuclear power station in Hinkley in Somerset in England. There are Treasury guarantees from the UK government in support of the financing of the project itself, as well as a long term contract afterwards. Indeed the British government offers something like 50 billion of government backed guarantees to the market. These need not necessarily be cheap guarantees, these can be charged commercial rates but they are nevertheless guarantees. And if we turn to Europe, who is going to do that bit? Well the answer to that is we do have our own European bank and it does have a remit to look after concerns of the European economy more generally and that is the EIB. The EIB has been involved deeply in infrastructure investment projects within Europe; it has been heavily involved in the renewables, in the climate change side of investments across the European community and this is essentially a prospect of extending that remit not just to projects within the EU but into the wider context of the global market that European companies compete for. Finance is absolutely essential if Europe wants to play to win. The EIB is central to that and the EIB would need a clear series of guidelines, principles and rules as to how, where and to what extent to provide such financial guarantees to harness the private sector.

The other bit of the game which is important for the European economy is the subcontracting issue. Finance helps to win projects but what our rivals do is to ensure that the subcontracts from these major competitions go only to their domestic SMEs and their own domestic companies. Of course the route to growth is in part through SMEs and the route to expansion of SMEs in skilled terms and in terms of employment and innovation is heavily correlated with the winning of contracts. You can't develop many skills; you can't innovate unless you've got work to do and you can't get work unless you win contracts. So the question is: can we tie these bids to contracts for European companies only? Again, in a perfectly competitive text book model you just contract with anyone, you chose to contract and European SMEs would have to fight for market share alongside everyone else. But we are not in that world. This isn't a first best world but a second best one in which others play by different rules. So if we want to play to win and we want to get the benefits for European SMEs and indeed other companies, larger ones across Europe, we need too to put some contingency into this framework and indeed we can link the financial guarantees directly to the subcontracting issues. If we do this, if we provide the finance, if we tie in the SMEs and other European contractors then we have a chance of winning a substantially better share of this world contracting market.

So, the choice is pretty straightforward. Europe can stay with its low growth, stay with its high unemployment, stay with the consequences for stymying the growth of our smaller and medium sized businesses, we can allow our competitive edge to be slowly eroded; that's the risk and indeed it is actually the reality of where we are in Europe today. Alternatively we can play to win, go after this prize, start to sort out the opportunities in these world markets for European companies and therefore put another building block in place of the investment for growth strategy which the incoming European Commission is rightly putting at the forefront of the next term and the next Commission's life.

So, play to win and win. Or don't play, play by the rules that others have brought to the table and therefore play to lose, waste the bidding cost and lose the opportunities. That ladies and gentlemen is the choice in front of us and if we want to win this competition, then what we need to do next is to define precisely and clearly what the rules of engagement are for the EIB, what the EIB should and should not be doing and how that relates to the contract structure which Europe needs to have in place.

Thank you very much indeed.

***