The role of investors in greening MENA economies

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Although most economies in the Middle East and North Africa (MENA) region rely on natural resources – whether hydrocarbons, fisheries, or agriculture – which account for a considerable portion of their revenues, the interest in green growth has been a relative latecomer. In large part, this is due to the fact that economic growth in the region has traditionally relied on heavy industry and featured little contribution from innovative, high tech or service sectors. This corporate landscape remains dominated by state-owned enterprises and family-controlled firms, as the rate of new firm creation in the region remains the lowest globally, apart from sub Saharan Africa.

Over the past decades, the region's corporate fabric, both in terms of ownership landscape and sectoral orientation, has not been subject to notable shifts in most countries, despite efforts to develop high value-added activities and to diversify local economies, especially in the GCC countries. While the United Arab Emirates (UAE), and notably Dubai, have significantly reduced their dependence on hydrocarbons, they still account for over 90 per cent of government revenues in both Saudi Arabia and Kuwait. Cheap, subsidized energy in the Gulf has supported the development of value chains underpinned by environmentally unfriendly technologies or dependent on cheap fossil fuel inputs.

While the Arab world is heavily dependent on its natural habitat and resources, its environmental track record has generally been lacklustre in terms of carbon emissions, water pollution and depletion, and a number of other critical indicators. Yale's Environmental Performance Index (based on 20 indicators reflecting national-level environmental data for 178 countries), ranks a number of MENA countries, notably Libya, Lebanon, Morocco, and Jordan, quite poorly. Only the UAE, Saudi Arabia, Qatar, and Egypt rank among the top 50 countries, by order of performance, with the UAE ranking first in the region and at 25 globally.

'… THE MENA REGION ALREADY HAS THE WORLD'S HIGHEST LEVELS OF CARBON DIOXIDE (CO_2) EMISSIONS …'

According to the May 2013 article 'MENA Faces up to Carbon Challenge' by Justin Dargin in *Petroleum Economist*, the MENA region already has the world's highest levels of carbon dioxide (CO_2) emissions, both per capita and per dollar of manufacturing output, representing 5 per cent of global greenhouse gas emissions. This situation has a real impact on the economies of the region, not only in terms of their long-term sustainability, but also on the quality of life (relating to such factors as access to clean water and air). For example, according to the 2010 World Bank report entitled 'The Cost of Environmental Degradation: Case Studies from the Middle East and North Africa', it is estimated that environmental degradation costs Jordan 2.3 per cent of its GDP annually. Recent protests sparked by the government's failure to collect and treat waste in Lebanon serve as an illustration of how environmental degradation can spiral into political protest.

What is the urgency?

These examples highlight an urgent need in the region to scale up investment in low-carbon, more energy efficient, alternatives and to shift away from fossil fuel use. While these issues have already been touted in diversification objectives outlined by national governments (especially in the Gulf), investment in energy-efficient alternatives (such as renewable energy, environmentally friendly infrastructure, and sustainable transport systems) lags in most countries, especially in relation to the mounting threat of environmental degradation and the apparent prerogative of economic diversification. The reasons for this underinvestment reflect the diversity of the region's economies.

Increasing levels of urbanization and conflict-driven migration have put further pressure on the already overextended infrastructure, notably energy and water in countries such Jordan and Lebanon where resources are in shortage. Even prior to the Arab Spring uprisings that swept the area, it was estimated that just 3 per cent of the most densely populated areas in the region were home to 92 per cent of its population, while urbanization continued to proceeded at 3.3 per cent annually, according to the World Bank's 2011 book *Poor Places, Thriving People: How the Middle East and North Africa Can Rise Above Spatial Disparities*. Considering the significant migration flows currently being experienced across the region due to ongoing conflicts, population density is projected to grow – as is the demand for energy and water in these areas, resulting in shortages. In part responding to this, the Egyptian government has announced the establishment of a new administrative capital in proximity to Cairo; other countries in the region, such as Lebanon, are looking at this experiment quite closely.

A key reason for the scarcity of basic resources is underinvestment in utilities and network industries, which tend to be dominated by state-owned enterprises, operating either as monopolies or as oligopolies. One example of this is the water sector in Tunisia which, according to the October 2014 OECD report 'Water Governance in Tunisia: Overcoming the Challenges to Private Sector Participation', is faced with deteriorating infrastructure and declining service quality as the water supply and distribution company (SONEDE) and the national sanitation office (ONAS) are both in a tenuous financial situation. This situation is not unique to Tunisia, or to the water sector, and reveals the limits of public sector financing of infrastructure across the region.

The transition to low-carbon, greener economies in the region will require the mobilization not only of public, but also of private investment, which is not encouraged by the current geopolitical climate or existing investment frameworks, which provide few incentives for private capital. It will also require novel approaches to dealing with fossil fuel dependency fostered by subsidies. In recent years, several governments have started to build awareness around the real cost of subsidized energy and the UAE moved in August this year to remove subsidies entirely.

This step was taken by the UAE within the framework of a broader green growth approach established by its Ministry of Environment and Water and implemented through a detailed set of Green Economy Indicators, establishing measurable targets to 2021. While the UAE is the first, and for the moment the only, country in the region to establish a green growth strategy, other countries such as Saudi Arabia have announced less comprehensive, yet specific, goals. This, according to Jeffrey Ball's article 'Why the Saudis Are Going Solar' in *The Atlantic* in July/August 2015, includes the building of 41 GW of solar capacity by 2032, slightly more than that of Germany, today's world leader.

These ambitious plans have been slow to materialize, in large part due to the heavy reliance on government investment, which has been affected by lower than expected oil revenue receipts in GCC countries and fiscal instability in others. Current trends in the region point to the urgent need to scale up private investment in green investment projects, including in priority sectors such as infrastructure and utilities. However, the million dollar question is: what mechanisms can be used by governments to attract private investment in these projects and what kind of investors can be mobilized to support them?

Who are the investors?

Unlike the OECD countries, where pension funds, insurance companies, and mutual funds are the largest investors, the main sources of capital in the MENA region are sovereign investors and family offices. While their capital is mostly channelled into private companies, their investment in listed equity is also notable: according to the forthcoming OECD publication 'The Role of Institutional Investors in MENA Capital Markets' by Alissa Amico and Zeynep Ozcelik, sovereign investors account for approximately 41 per cent, and family offices for 26 per cent, of ownership of listed equity in the region. This is a reflection of the fact that the pensions and insurance industry is relatively underdeveloped in the region, but also a consequence of the history of MENA economies, where sovereign actors and large merchant families have historically acted as key motors of development.

'… THE MAIN SOURCES OF CAPITAL IN THE MENA REGION ARE SOVEREIGN INVESTORS AND FAMILY OFFICES.'

In OECD member countries, institutional investors – especially long-term investors such as pension funds – are increasingly expected to be behind the financing of green growth projects, including those involving infrastructure, although current levels of investment fall substantially short of expectations, according to the 2011 OECD working paper 'The Role of Pension Funds in Financing Green Growth Initiatives' by Raffaele Della Croce, Christopher Kaminker, and Fiona Stewart. In the Arab world, some institutional investors, notably sovereigns, have also invested in green assets and technologies. Examples of this range from Qatar Investment Authority's investment in Fisker Automotive to develop a hybrid sport car, to Taqnia's diverse investments in renewables (Taqnia being a technology arm of the Public Investment Fund, which is officially part of the Saudi Ministry of Finance). The best known illustration of large-scale investment of this kind, however, is Mubadala's subsidiary Masdar, a green city built close to the city of Abu Dhabi.

While sovereign investors have already experimented with 'green investing', these investments have been sporadic and not part of a wider strategy to channel assets to environmentally sustainable activities. An example of an investor which has embraced a more holistic approach is Norges, Norway's sovereign wealth fund (SWF), which is in the process of divesting its holdings from mining and power companies that generate in excess of 30 per cent of their output or revenue from coal. Although MENA SWFs are not major investors in hydrocarbons, considering that most oil and gas companies are held directly by governments or dedicated holding companies, this example is relevant for the region as equity markets are expected to deepen

and the role of sovereign investors is, at the minimum, expected to remain stable.

The example of Norges – which aims to mainstream environmental concerns in its investment approach – is all the more relevant given that motivating sovereign investors to channel funding towards strategic green or greener investments is potentially less challenging than asking the same of private investors. In order for private institutional investors to channel funding to green investments, greater corporate disclosure is necessary to evaluate the opportunities and risks of these investments. Environmental considerations should be integrated in the valuation methodologies since, according to the 2015 Mercer Report 'Investing in a Time of Climate Change', climate change is expected to affect not only the performance of renewable sectors but also other asset classes such as agriculture and real estate.

Integrating criteria that could capture the environmental impact of corporate behaviour in the investment strategies of institutional investors is, at least in principle, straightforward and can be rooted in a broader approach to responsible investing – often referred to as ESG (environmental, social and governance) investing. One example of a tool developed in the region that could support this approach is the S&P Hawkamah Pan Arab Index, which tracks the performance of 50 equities selected on the basis of ESG criteria.

What do investors need?

Disclosure of the environmental impact of corporate activity has developed at a slow pace in the Middle East, arguably rather slower than that of governance or social impact reporting. This is due to the fact that reporting on corporate governance is mandated by virtue of codes, which increasingly use a comply-or-explain approach whereby listed firms are asked to explain any deviations from recommended standards. Reporting on social initiatives is often fostered by firms' intrinsic interest in communicating news of such initiatives to their stakeholders as part their marketing efforts.

'DISCLOSURE OF THE ENVIRONMENTAL IMPACT OF CORPORATE ACTIVITY HAS DEVELOPED AT A SLOW PACE …'

On the other hand, no regulatory requirements on environmental disclosure are imposed by stock exchanges or securities regulators, and motivations for firms to report are less obvious. A number of blue chip firms such as Bank of Muscat, SABIC, and Agility have started to issue voluntary sustainability reports, generally inspired by the Global Reporting Initiative (GRI). These examples do not, however, represent the mainstream: a recent study from the Hawkamah Institute ('Environmental, Social and Corporate Governance Practices in the MENA Region 2007–2012') of the 150 largest listed companies from 11 MENA markets found that only about 10 per cent disclose their greenhouse gas emissions and only 7 per cent disclose water usage statistics.

Considering that most petrochemical and industrial companies in the region are unlisted, their levels of public disclosure are even lower than those in listed firms. In Saudi Arabia for example, environmental impact assessments of Saudi Aramco are required, but the results are not made public; a similar situation prevails in other countries such as Egypt. As a result, the Resource Governance Index, which measures the quality of governance in the oil, gas, and mining sector, ranks MENA countries quite low in terms of reporting practices: Saudi Arabia landing at 43, Tunisia at 47, and Qatar at 54, out of 59 countries examined.

This situation stands in contrast with international developments. Globally, practices around environmental disclosure have evolved, spurred by initiatives such as the GRI, which aims to provide a framework for sustainability reporting. A range of tools and standards on climate disclosure are now available under the Climate Disclosure Standards Board and the Climate Disclosure Project, among others. Some jurisdictions have taken a regulatory approach. For instance, the EU recently amended its Directive on Financial Reporting to require public companies with more than 500 employees to report on non-financial information, including on environmental matters.

What's next?

According to the OECD working paper 'The Role of Pension Funds in Financing Green Growth Initiatives' mentioned above, barriers to institutional investors' participation in green infrastructure may include: a weak business case, an unattractive regulatory framework, a lack of suitable financial instruments, or inadequate data for making an assessment of investments and risks. Although all of these may find an echo in the region, the business case for investing in solar power and in other types of renewable energy appears difficult to challenge in the MENA context, and suitable financial instruments to invest in these opportunities can be created.

In order to transition from ad hoc investments by large sovereign actors to mainstreaming environmentally conscious investing, frameworks for enhanced non-financial disclosure should contain guidance and mechanisms for environmental impact disclosure. Better environmental reporting can be encouraged by securities regulators and stock exchanges through regulatory and

voluntary initiatives. On the one hand, this would allow institutional investors – including foreign institutions which increasingly incorporate ESG in their decision-making processes – to create meaningful benchmarks for screening investment opportunities. On the other, it would help them understand the long-term risks associated with their investments.

As it often the case in the region, the private sector is waiting for the public sector to lead the tango. Given their natural alignment with national development targets and strategies, sovereign investors will need fewer incentives to invest in green growth. According to the 2012 report 'Procurement, Innovation and Green Growth' from the International Institute for Sustainable Development (IISD), not only do sovereign investors and state-owned enterprises have the capacity to influence local equity markets as investors, they are also able to influence firms in their value chain through procurement policies which can include 'green' considerations in the selection criteria.

Governments in the region should seek to attract private investment in green projects by promoting environmental disclosure by corporates as part of their non-financial disclosure. With better disclosure on firms' environmental impact, institutional investors such as pension and mutual funds – whose presence in MENA markets is expected to grow – will be in a better position to evaluate opportunities where green investments are competitive and, equally importantly, to engage with companies whose environmental risks they perceive as excessive. This will not only green MENA economies in the long term, but also help mitigate risks of black swan events – the dramatic consequences of which have already been seen elsewhere.

**The views expressed in this article are those of the author and do not reflect the official views of the OECD or its member countries.*

MENA countries have to bring in the private sector: a perspective from Europe

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Middle East and North Africa (MENA) countries are expected to grow at twice the rate of the North Mediterranean Countries (NMCs) in the period to 2030, at which point they will make up approximately one-third of the total GDP of the Mediterranean region. According to a Observatoire Méditerranéen de l'Energie (OME) projection, over US$790 billion (700 billion euros) will be needed by 2030 to ensure the additional electricity generation capacity required. Although state-level energy policies are still dominant, it is indisputable that MENA countries will not be able to deliver investment of this variety and size solely via public budgets. Therefore new business models need to be introduced to achieve active private sector participation.

The MENA region has historically been poor in attracting private investment. Private Participation in Infrastructure (PPI hereafter, PPP and PPI are used interchangeably) in MENA countries is lagging, both in relative and absolute terms. PPP only represented 3 per cent (around US$27.5 billion) of global investment in the region between 1990 and 2014, making this the lowest performing region globally. By contrast, the best performing region (Latin America and the Caribbean) has been able to attract more than a third of global PPP investment in energy infrastructure (US$303 billion). It is true that investment in infrastructure in North Africa and the Levant is currently recovering from the financial crisis in 2008 and the effect of the social unrest related to the 'Arab Spring' in 2011 (see the figure opposite, 'Total investment in energy in MENA'). But it is also useful to see the investment dynamic registered in different MENA countries and what interesting best practice can be picked up.

'THE MENA REGION HAS HISTORICALLY BEEN POOR IN ATTRACTING PRIVATE INVESTMENT.'

It is notable that private participation in energy infrastructure in the region experienced a 'double dip', both in 2008 (in the aftermath of the financial crisis) and in 2011 (following the outbreak of the 'Arab Spring'). The volume of investment now is just above the pre-2008 level; however, in the years since 2009 PPP investment in energy has only taken place in two countries, Morocco and Jordan. Eleven projects were closed in 2014 (ten in Jordan, one in Morocco) for a total of US$2.9 billion – an increase of 17 per cent on a year-on-year basis. This healthy performance has been achieved with the conclusion, since 2012, of a total of 17 new projects, 15 of which are in renewable generation.