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Cover photo: A worker on site where the Lake Turkana Wind Project are building concrete foundations for 365 wind turbines in Marsabit County, Kenya. Sven Torfinn/Panos
Acknowledgements

Thanks are owed to the interviewees and workshop participants in Kenya, including government officials and representatives from donors and civil society organisations, who generously gave up their time to contribute insights to this report.

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<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADF</td>
<td>African Development Fund</td>
</tr>
<tr>
<td>AfD</td>
<td>Agence Française de Développement</td>
</tr>
<tr>
<td>AfDB</td>
<td>African Development Bank</td>
</tr>
<tr>
<td>AGA</td>
<td>autonomous government agency</td>
</tr>
<tr>
<td>BADEA</td>
<td>Arab Bank for Economic Development in Africa</td>
</tr>
<tr>
<td>CSO</td>
<td>civil society organisation</td>
</tr>
<tr>
<td>DAC</td>
<td>Development Assistance Committee (of the OECD)</td>
</tr>
<tr>
<td>DFI</td>
<td>development finance institution</td>
</tr>
<tr>
<td>EDF</td>
<td>European Development Fund</td>
</tr>
<tr>
<td>EIB</td>
<td>European Investment Bank</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FCCL</td>
<td>Fiscal Commitments and Contingent Liabilities</td>
</tr>
<tr>
<td>FISEA</td>
<td>Fonds d’investissement et de soutien aux entreprises en Afrique</td>
</tr>
<tr>
<td>FMO</td>
<td>Netherlands Development Finance Company</td>
</tr>
<tr>
<td>GDC</td>
<td>Geothermal Development Company</td>
</tr>
<tr>
<td>GDP</td>
<td>gross domestic product</td>
</tr>
<tr>
<td>GESIP</td>
<td>Green Economy Strategy and Implementation Plan</td>
</tr>
<tr>
<td>GHG</td>
<td>Greenhouse Gas</td>
</tr>
<tr>
<td>GoK</td>
<td>Government of Kenya</td>
</tr>
<tr>
<td>IAD</td>
<td>Institutional Analysis and Development</td>
</tr>
<tr>
<td>IDA</td>
<td>International Development Association</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPP</td>
<td>independent power producer</td>
</tr>
<tr>
<td>JICA</td>
<td>Japan International Cooperation Agency</td>
</tr>
<tr>
<td>KenGen</td>
<td>Kenya Electricity Generating Company</td>
</tr>
<tr>
<td>KeNHA</td>
<td>Kenya National Highways Authority</td>
</tr>
<tr>
<td>KeRRA</td>
<td>Kenya Rural Roads Authority</td>
</tr>
<tr>
<td>KPLC</td>
<td>Kenya Power and Lighting Company</td>
</tr>
<tr>
<td>KRB</td>
<td>Kenya Roads Board</td>
</tr>
<tr>
<td>KRC</td>
<td>Kenya Railway Corporation</td>
</tr>
<tr>
<td>KSh</td>
<td>Kenyan shilling</td>
</tr>
<tr>
<td>KURA</td>
<td>Kenya Urban Roads Authority</td>
</tr>
<tr>
<td>LCPDP</td>
<td>Least Cost Power Development Plan</td>
</tr>
<tr>
<td>LIC</td>
<td>low-income country</td>
</tr>
<tr>
<td>LMIC</td>
<td>Lower middle income country</td>
</tr>
<tr>
<td>MDA</td>
<td>ministry/department/agency</td>
</tr>
<tr>
<td>MDB</td>
<td>multilateral development bank</td>
</tr>
<tr>
<td>MoEP</td>
<td>Ministry of Energy and Petroleum</td>
</tr>
<tr>
<td>NDF</td>
<td>Nordic Development Fund</td>
</tr>
<tr>
<td>ODA</td>
<td>official development assistance</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OOF</td>
<td>Other official flow</td>
</tr>
<tr>
<td>OPEC</td>
<td>Organization of the Petroleum Exporting Countries</td>
</tr>
<tr>
<td>PFM Act</td>
<td>Public Finance Management Act 2012</td>
</tr>
<tr>
<td>PPP</td>
<td>public–private partnership</td>
</tr>
<tr>
<td>PPP Act</td>
<td>Public Private Partnerships Act 2013</td>
</tr>
<tr>
<td>RDL</td>
<td>Railway Development Levy</td>
</tr>
<tr>
<td>RSIP</td>
<td>Road Sector Investment Plan</td>
</tr>
<tr>
<td>RVR</td>
<td>Rift Valley Railways</td>
</tr>
<tr>
<td>SAGA</td>
<td>semi-autonomous government agency</td>
</tr>
<tr>
<td>SDG</td>
<td>Sustainable Development Goals</td>
</tr>
<tr>
<td>SGR</td>
<td>Standard Gauge Railway</td>
</tr>
<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
</tr>
<tr>
<td>SREP</td>
<td>Scaling Up Renewable Energy Program</td>
</tr>
</tbody>
</table>
1. Introduction

1.1. Background and motivation for this report

The development finance landscape has been changing over the past 15 years, driven by both supply-side and demand-side factors.

In terms of supply, there are many new actors in the development finance landscape. These include non-Development Assistance Committee (DAC) donors, such as India and China, and philanthropic organisations that have expanded their international grant-making, such as the Gates and the Ford foundations. Complex new finance tools have also been developed to foster the involvement of the private sector, such as public–private partnerships (PPPs).

On the demand side, most partner country governments now have more financing options available to them to support their national development strategies than at the beginning of the last decade. They are now in what Prizzon et al. (2016) and Greenhill et al. (2013) have defined as an ‘age of choice’ for development finance. In addition to the finance flows mentioned above, countries also access finance by issuing international sovereign bonds, even countries that previously benefited from debt relief. Most partner countries have also achieved record high growth rates, and several of them have graduated to middle-income country status. Over the medium term, the composition of a country’s external financing will change after graduation, from concessional loans to non-concessional resources from multilateral development banks (MDBs) and bilateral development partners. These agencies have been reviewing their financial efforts and the nature of their engagement with middle-income countries, with the aim of concentrating their resources on the poorest and most fragile countries.

Primarily implemented at the national and subnational levels, the Sustainable Development Goals (SDGs) – also known as ‘Agenda 2030’ – set out a range of ambitious international development goals and targets. To achieve these goals, financial resources will have to be scaled up, especially financing for infrastructure. Among all the sectors covered by the SDG agenda, infrastructure development has the largest funding gap to be filled (Schmidt-Traub, 2015). For instance, the World Bank has estimated that $1 trillion to $1.5 trillion a year will be needed until 2020 (GDP in low- and middle-income countries was around $25 trillion in 2014) to meet the demand for infrastructure investments in emerging markets and developing economies (World Bank, 2013). The Addis Ababa Agenda for Action back in July 2015 placed a lot of emphasis on infrastructure development and financing, and included the establishment of a ‘new forum’ to bridge the infrastructure gap.

There is evidence of a lack of strategic management of sources (and providers) to finance the infrastructure sector, despite the large volume of funds channelled and priority attributed to this sector in national development strategies. When traditional sources of finance were limited, the main participants had an established coordination structure. But as sources of funding – including traditional and non-traditional sources and agencies and the private and public sectors – have become increasingly diversified and complex, the global and regional opportunities for collaboration and coordination are now less clearly defined (Gutman et al., 2015).

On top of this, few studies have used sector-specific frameworks to analyse the changing finance landscape and the challenges it poses to recipient country governments (see for instance Pallas et al. (2015) on health; Addison and Anand (2012) on infrastructure; and Mogues and Rosario (2015) on agriculture).

Bilateral and multilateral banks (most notably the World Bank) conduct comprehensive sector reviews in individual countries. These studies, however, do not look in depth at the financing options at a sector level beyond aid or at how these financing options have changed for the recipient country governments as a result of new financiers and instruments.

This study on the infrastructure financing landscape in Kenya – together with a companion report on Ethiopia (Jalles d’Orey and Prizzon, 2017a, 2017b) – aims to fill this gap by identifying the approaches and strategies that recipient country governments have in place when negotiating with different finance providers and what lessons can be learnt from the country case study. More specifically, the objectives of this research paper are as follows.

- Help to fill the research gap in the analysis of negotiation, access and management of development finance flows in the infrastructure sector, from the perspective of recipient countries.
- Provide an evidence base on how partner country governments can better leverage the comparative advantage of these players in terms of both financial resources and knowledge-sharing.
• Understand the interests of stakeholders and institutions and their incentives for operating within the infrastructure sector and analyse relationships between development partners, central government and line agencies at sector level.

• Identify priorities for the terms and conditions of development finance in the infrastructure sector.

The study analyses flows that, potentially: (i) are under direct influence, if not control, of the government; (ii) are accounted for, in principle, in government budgets, independent of their level of concessionality; and (iii) have an impact on government budgets (such as contingent liabilities). We consider the broad spectrum of development finance flows, both cross-border and domestic.1

Applying these criteria, the flows used to finance infrastructure that are considered in this report include: domestic taxation and domestic debt markets, bilateral and multilateral official development assistance (ODA), other official flows (OOFs) from DAC/multilateral development partners, non-DAC sovereign donors (both ODA and OOF equivalent), climate finance for low-carbon infrastructure, international sovereign bond issuances and PPPs. PPPs are an exception – being an instrument not a source; however, they illustrate well how government, development partners and the private sector can work together. In this report, a non-traditional donor is a sovereign financier that is not a member of the DAC.

We exclude foreign direct investment and personal remittances from this analysis.2

In this analysis we concentrate on financing for three infrastructure sectors: railways, roads and energy. These three sectors dominate sub-Saharan African governments’ budget allocations to infrastructure. For instance, in 2013 Malawi, Namibia and Zambia allocated 70% of infrastructure expenditure to the transport sector, and Ghana and Tanzania allocated around 50% to the energy sector.2

1. The framework described in Prizzon et al. (2016) concentrated on external flows only.

2. While their amounts and terms can certainly be influenced by, for example, tax incentives or better macroeconomic conditions for investment, they are excluded simply because the government has only indirect responsibility for these flows (and they are mainly for a private/for-profit motive); the same applies to export credits, which primarily target the private sector.

1.2. Research questions and methodology


The key insight from Fraser and Whitfield (2008), in contrast to much of the literature on the political economy of aid, lies in seeing the engagement between a recipient country government and a donor as one of negotiation, since it is assumed that their objectives may diverge. Fraser and Whitfield also focus on the importance of both the economic and political contexts in shaping country–donor negotiations, and thereby negotiation outcomes. Drawing on the IAD framework, we also emphasise the importance of the arena in which negotiation takes place, but rather than taking this as a given, we ask whether governments seek to engage with different kinds of providers of development finance in different fora. We focus particularly on arenas related to in-country aid coordination (e.g. sectoral or technical working groups, regular high-level donor–government meetings), as these are often key fora in which donors and government engage in discussion of sectoral strategies, project identification, policy dialogue and conditionalities.

The theoretical framework for the sector-level analysis is primarily based on that of Moncrieffe and Luttrell (2005). It takes into account the characteristics of the sector under investigation, the relationships between central agencies, relevant line ministries and state-owned enterprises (SOEs), including different roles, mandates and responsibilities – as well as the relations with different providers of funding – and the composition of financing in terms of external and domestic resources.

Section 2 reviews the main elements of Kenya’s country context, and highlights the economic, political and aid management factors that determine how much negotiating capital the Government of Kenya (GoK) holds vis-à-vis the various providers of development finance. It also outlines the overall strategy and main institutional arrangements in each of the sectors under investigation (roads, railways and energy). Drawing on this theoretical framework, Sections 3 to 6 seek to answer the following four sets of research questions:

• Composition and volumes of flows and financing instruments at the country level (Section 3): How has the composition of financing to the infrastructure sector (railways, roads and energy) evolved over the past 10 years? Who are the main financiers? What are the terms and conditions of the different financing options? What are the main financing instruments?

• Arenas of negotiation (Section 4): In which fora does the GoK seek to engage with providers of development finance in the infrastructure sector, and what strategies

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1. The framework described in Prizzon et al. (2016) concentrated on external flows only.

2. While their amounts and terms can certainly be influenced by, for example, tax incentives or better macroeconomic conditions for investment, they are excluded simply because the government has only indirect responsibility for these flows (and they are mainly for a private/for-profit motive); the same applies to export credits, which primarily target the private sector.
does it employ to negotiate with them? How do these differ from the fora and strategies in which the GoK engages with traditional and non-traditional donors?

- Priorities and characteristics of development finance flows (Section 5): What are the GoK’s priorities for the different types of development flows that are received for the infrastructure sector? How do the priorities differ between line and central agencies? What are the advantages and disadvantages of the different flows?

- Negotiation outcomes (Section 6): What are the outcomes, i.e. does the GoK manage to achieve its priorities while negotiating with finance providers and, if so, how?

In other words, we analyse the evolution of development finance to the infrastructure sector, the arenas where such negotiations take place, the priorities for the types of development finance the GoK would like to access to support infrastructure development, and the extent to which the GoK has been successful in achieving those objectives. The evaluation of debt sustainability implications will be particularly relevant for the infrastructure sector at it is largely funded by loans.

**A mixed-methods approach.** The methodology for carrying out this country case study comprised a desk-based review and a country visit with semi-structured interviews and data gathering. First, the desk-based analysis consisted of a review of key documentation3 and data collection. Second, a two-week country visit was made to conduct semi-structured interviews with 35 stakeholders (a list of stakeholders who permitted their name to be mentioned in this report is included in Annex 1). The consultations with central and line agencies, SOEs, development partners and civil society organisations (CSOs) took place between 3 and 13 May 2016. The case study was supported by Njeru Kirira, a local public finance consultant.

### 1.3. Rationale for Kenya case study

There are several reasons why Kenya was chosen as one of the case studies for this project (together with Ethiopia). First, the high priority attributed to public infrastructure development in Vision 2030, especially for roads, railways and energy, has translated into a substantial increase in public investment in infrastructure development in Kenya, leaving the country with one of the highest shares of infrastructure spending as a proportion of GDP in sub-Saharan Africa. Second, Kenya is one of the few sub-Saharan African countries that have recently issued international sovereign bonds, partly to finance infrastructure development (power transmission). Third, Kenya is one of the top recipients of Chinese support for infrastructure, as well as receiving funding from a diverse mix of other non-DAC and DAC donors. Fourth, Kenya has ongoing PPPs in infrastructure. Finally, Kenya is one of the countries that have already been investigated for an earlier phase of this project (see Prizzon et al., 2016), so the priorities that emerge at the sector level in this case study can be compared with those identified in the first case study. In this case study, we concentrated our analysis on the national government only. This is because most of the county budgets are financed by the national government via transfers (which are determined by a block grant formula).

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3 These include Paris Declaration survey chapters and Busan commitments progress report, national development cooperation reports (if available), aid management strategies and country assistance strategies of the main development finance providers, national development strategies and sector plan, recent budget documents, debt management strategies, IMF Article IV documents, PPP and sovereign bond issuance policies, if available, and the country strategies of the largest development partners to the sector.
2. Country and sector contexts

In this section, we review key elements of Kenya’s country context in terms of the economic and governance/political environment that can influence the country’s negotiation capital and strategies vis-à-vis different providers of development finance. We then shift the perspective of our political economy analysis to the sector level (roads, railways and energy), highlighting the GoK’s priorities and the main institutions involved.

2.1. Country context

Kenya has maintained macroeconomic stability and achieved a high growth rate over recent years. Kenya is the largest and most diversified economy within the East African Community, and its annual growth rate has averaged 6% since 2010 (World Bank, 2016). In 2014, it achieved lower-middle income country (LMIC) status, partly due to a rebasing of its economic growth. It is still listed as an IDA-only (International Development Association) country by the World Bank, although interviewees indicated that the transition to blend status was expected to happen soon.

Growth has been supported by public investments in infrastructure projects, particularly in road construction and geothermal energy generation (National Treasury, 2016a). Infrastructure is a key pillar of the government’s Vision 2030 strategy, with the government seeing its programme of externally financed infrastructure investments as improving prospects for growth in output and exports.

Public debt has been increasing, particularly over the last two fiscal years, partly due to debt-financed government investments in large-scale infrastructure. At the end of June 2015, public debt stood at 49.6% of GDP, the highest level seen since 2004 (National Treasury, 2016a), and external debt has increased by 86.3% in the past four years (PBO, 2016). The government has continuously revised the debt ceiling. Debt is now close to the 50% of GDP limit set by the fiscal convergence targets of the East African Monetary Union Protocol, which forms Kenya’s policy target. However, the International Monetary Fund (IMF) has assessed that Kenya remains at low risk of debt distress, despite the upward public debt trajectory, which is expected to continue through 2018 (IMF, 2016). The GoK emphasises that continued infrastructure investment is necessary to maintain growth and export performance (IMF, 2016), but there are growing concerns within Kenya that increased public borrowing will threaten debt sustainability (PBO, 2015).

Kenya has seen a rise in ODA over the past decade, though its high GDP growth has led to a reduction in its aid dependency. However, almost all recurrent spending is funded domestically, due to restrictions on borrowing for recurrent spending under the Constitution and the Public Finance Management Act 2012 (PFM Act) (sections 15(c) and 107(a) and (d)). Donors are also reducing the level of concessionality of their financing in light of Kenya’s rising level of income. Between 2004 and 2013, the value of loans increased from 30% of annual ODA to 41%.

Beyond-ODA flows have been growing in importance over the past decade. China has emerged as one of Kenya’s main development partners, with annual lending on a par with that from the large multilateral agencies, such as the European Union (EU) and the African Development Bank’s African Development Fund (AfDB/ADF) (Prizzon and Hart, 2016). Expansion of PPPs to leverage private sector financing and know-how is a priority of the GoK in helping to address major infrastructure gaps. The GoK has therefore actively sought to improve the PPP investment climate, including developing a coherent policy framework and a straightforward process for implementing PPP projects. However, while PPPs have been successfully used in the energy sector, especially in regards to energy generation, it has been less of a success in the other infrastructure sectors. Section 3 provides greater insight into the relative importance of different types of development flows for infrastructure financing.

Kenya has suffered from several corruption scandals in recent years. Kenya has been criticised for public sector corruption for decades. Tensions rose in 2013 during the International Criminal Court’s prosecutions of Uhuru Kenyatta (now president) and William Ruto (now deputy president) following the 2007 election violence. However, initial reservations and credibility issues waned as the

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4 The GoK has reviewed the external debt limit twice since 2013; increasing the ceiling from KSh800 billion to KSh1.2 trillion in January 2013, and further increasing it to KSh2.5 trillion in November 2014 (EIU, 2014).
In May 2016, the Ministry of Transport and Infrastructure was restructured to include transport, infrastructure, housing and urban development, for the realisation of the Vision’s three pillars: economic, with both energy and transport identified as key drivers.

Infrastructure is one of the key priorities in Vision 2030, with both energy and transport identified as key drivers for the realisation of the Vision’s three pillars: economic, social and political. This is based on the recognition that infrastructure constraints are inhibiting growth and development. The second Medium-Term Plan, which puts Vision 2030 into operation for the current period, prioritises huge investments in transport (roads, national railways, urban transport) and energy infrastructure.

2.2. Sector context

Infrastructure is one of the key priorities in Vision 2030, with both energy and transport identified as key drivers for the realisation of the Vision’s three pillars: economic, social and political. This is based on the recognition that infrastructure constraints are inhibiting growth and development. The second Medium-Term Plan, which puts Vision 2030 into operation for the current period, prioritises huge investments in transport (roads, national railways, urban transport) and energy infrastructure.

2.2.1. Roads

The GoK recognises that the attainment of Vision 2030 will depend heavily on the quality of its road network, through the reduction of transport costs, and the improvement of accessibility and road safety. While roads are the dominant transport mode in the country – accounting for 93% of both domestic freight and passenger traffic – just 7% of the total road network of approximately 161,000 km is paved, as shown in Table 1 (European Union, 2015a; MoR, 2009).

<table>
<thead>
<tr>
<th>Type of road</th>
<th>Paved</th>
<th>Unpaved</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>National roads: A, B and C</td>
<td>6,783</td>
<td>6,904</td>
<td>13,687</td>
</tr>
<tr>
<td>Rural roads: D, E and unclassified</td>
<td>2,268</td>
<td>127,799</td>
<td>130,067</td>
</tr>
<tr>
<td>Urban roads</td>
<td>2,140</td>
<td>10,409</td>
<td>12,549</td>
</tr>
<tr>
<td>National Parks/Game Reserves roads</td>
<td>6</td>
<td>4,577</td>
<td>4,583</td>
</tr>
<tr>
<td>Total</td>
<td>11,197</td>
<td>149,689</td>
<td>160,886</td>
</tr>
</tbody>
</table>


At the national level the responsibility for the development, maintenance and management of the roads network falls under the Ministry of Transport and Infrastructure. Implementation of roads projects, however, is the responsibility of state corporations and relevant departments under the Ministry; the Kenya National Highways Authority (KeNHA) is in charge of national trunk roads; the Kenya Urban Roads Authority (KURA) oversees the development and management of roads in urban areas; and the Kenya Rural Roads Authority (KeRRA) manages roads in rural areas. The Kenya Roads Board (KRB) is charged with managing the funds realised from a levy collected on fuel and the allocation of those funds to roads agencies. It also oversees the classification of roads in the country. County governments also have responsibility for developing roads in the counties, leading to a lack of clarity around their responsibilities vis-à-vis those of central ministries and agencies.

In 2010, the GoK developed a Road Sector Investment Plan (RSIP) 2010-2024. The RSIP, the first comprehensive road investment plan since independence, was prepared by an inter-ministerial committee established in 2007. The objective of the RSIP is to develop an investment programme for Kenya’s entire road network for the next 15 years, as required by the Kenya Roads Act 2007.

5 In May 2016, the Ministry of Transport and Infrastructure was restructured to include transport, infrastructure, housing and urban development, and maritime and shipping affairs as well as public works, and is now referred to as the Ministry of Transport, Infrastructure, Housing and Urban Development.
It envisages an expenditure of close to KSh130 billion annually on roads, which is KSh30 billion higher than the approved annual road sector allocation in 2012/13 and 2013/14 (KRB, 2013; GoK, 2015a). The RSIP is intended to justify road investments based on overall road network priorities and, thereby, facilitate a paradigm shift from the past, when government and development partner-funded road investments had been planned and justified on a project-by-project basis (MoR, 2010). The RSIP is therefore expected to guide decisions on the priorities for investments by the GoK and the development partners in national road development and maintenance, enabling yearly expenditures to be determined for the road network and annual road works programmes to be prepared and implemented by roads agencies. The first phase of the RSIP expired in June 2015, and the GoK is in the process of preparing its second phase. The government is also seeking to develop an Integrated National Transport Master Plan that will integrate all transport modes to ensure that investment and location of the transport infrastructure and services are consistent with other public policies (GoK, 2012).

2.2.2. Rail transport

In contrast to roads, rail transport has been neglected until recently. In fact, prior to the construction of the new Standard Gauge Railway (SGR), there had been no GoK investment in railways for more than 30 years (AfDB, 2015) and the Kenya Railway Corporation (KRC) had been unable to keep up with necessary maintenance. The track therefore became dilapidated and there was insufficient rolling stock (locomotives and wagons). In an effort to rectify this, the GoK signed a 25-year concession agreement with the private Rift Valley Railways (RVR) in 2006, which took over management and operation of railway services from the KRC. However, the RVR incumbent failed to raise the necessary financing, and the track continued to deteriorate. Cargo train derailments, worker strikes and shareholder disputes also hindered new investment and improvements in operations. As a result, the ownership of the concession was restructured and a new majority shareholder was introduced to replace the incumbent failed to raise the necessary financing, and the RVR can be moved by both the SGR and the narrow metre-gauge line operated by RVR, and whether rehabilitation of the existing railway rather than building a new one would have been a more cost-effective way to achieve the objectives of the SGR (AfDB, 2015; Oirere, 2016). More generally, this suggests there is an urgent need to develop the abovementioned Integrated National Transport Master Plan in order ‘to ensure optimal transport infrastructure investment to position Kenya as the most efficient and effective transport hub of the East and Central African region and promote national aspirations for socio-economic reconstruction and development’ (GoK, 2012: 15).

Nonetheless, despite the lack of a Transport Master Plan, the GoK views the SGR as critical to the growth of both Kenya and regional economies. Regarding Kenya, the increased railway capacity is expected to enable 50% of freight cargo (25 million tonnes) from the port at Mombasa to be handled by rail. Regarding regional economies, Kenya’s SGR lies at the core of the East African Railways Master Plan. This plan is essentially a proposal for rejuvenating existing railways serving Tanzania, Kenya and Uganda and for extending them, initially to Rwanda and Burundi and eventually to South Sudan and Ethiopia. In 2013, the governments of Kenya, Uganda and Rwanda signed a tripartite agreement committing them to fast-track the development of the railways to their respective capital cities. Regional economic interests have therefore worked in favour of the project. The GoK is also committed to subsequent phases of the SGR project as demonstrated by the second phase launch in October 2016. However, there is disquiet among several stakeholders at the government spending large sums on such projects when more could be done to support the existing network (AfDB, 2015).

2.2.3. Energy

Enhancing national power generation and supply is also a key priority in Vision 2030. Electricity generation capacity has increased rapidly in recent years, but only 29% of households have access to the grid and the connection rate in rural areas is around 15%. The inadequate, low-quality and highly priced energy supply also contributes significantly to the prevailing high cost of doing business in the country. The GoK has therefore committed to
improving the infrastructure network and promoting the development and use of renewable energy sources to create a reliable, adequate and cost-effective energy supply regime.

A strategy is in place for modernising the energy infrastructure network, increasing the share of energy generated from renewable energy sources and providing energy that is affordable and reliable to businesses and homes. With the new plan of adding at least 5,000 MW of installed electricity generation capacity, the GoK aims to increase total installed capacity to 6,762 MW by 2017, up from 1,765 MW as at 30 June 2013, so an almost fourfold increase over a four-year period (MoEP, 2013). The GoK also aims to increase access to electricity through upgrading and expanding the national power transmission and distribution network to improve supply and reliability, reduce losses and connect 2 million new customers by 2017. The implementation of the Ministry of Energy’s five-year Strategic Plan is currently estimated to require a total of KSh.544.4 billion between 2013/14 and 2017/18, which is slightly more than double the total allocation over the previous five years.

The electricity sector has been unbundled into generation, transmission, distribution, and oversight and policy functions. Some of these remain government-owned and controlled, some are private, and some have private shareholders but with a majority government stake. The key actors are as follows:

- The **Ministry of Energy and Petroleum** is in charge of policies to create an enabling environment for the efficient operation and growth of the sector. It sets the strategic direction for the growth of the sector and provides a long-term vision for all sector players.
- The **Kenya Electricity Generating Company** (KenGen) is the main player in electricity generation, accounting for 1,238 MW (76%) of installed electricity generation capacity for the national transmission grid as at 30 June 2013. It is a limited liability company listed on the Nairobi Securities Exchange; the GoK’s shareholding is 70%, while the rest is privately owned.
- The **Kenya Power and Lighting Company** (KPLC) is the power off-taker from power generators on the basis of negotiated power purchase agreements for transmission, distribution and supply to consumers. KPLC is a limited liability company; the GoK’s shareholding is 51%, while the rest is privately owned.
- The **Rural Electrification Authority**, which came into operation in July 2007 and is wholly owned by the GoK, is charged with implementing the Rural Electrification Programme.
- The **Geothermal Development Company** (GDC) is a fully owned government special purpose vehicle that undertakes surface exploration of geothermal fields, appraisals, drilling and steam production and enters into steam sales agreements with investors in geothermal electricity generation.
- **Independent power producers** (IPPs) are private investors in the power sector involved in generation, either on a large scale or through the development of renewable energy under the Feed-in-Tariffs Policy. IPPs account for 22% (391.2 MW) of the country’s installed capacity, using thermal, geothermal and biomass (bagasse) generation. Some IPPs operate under a PPP model (see below), while some renewable energy producers are purely private enterprises and simply sell to the grid through the Feed-in-Tariff.

Over the years, the GoK – through the Ministry of Energy and Petroleum – has also undertaken long-term electricity planning through the annual 20-year rolling Least Cost Power Development Plan (LCPDP). The purpose of the LCPDP is to guide stakeholders with respect to how the energy sector plans to meet the nation’s need for energy for subsistence and development at least cost to the economy and the environment. At the sector level, there are close linkages between the various forms of energy, which necessitates the use of integrated energy planning, to improve coordination and ensure that projects are implemented in a timely manner and within budget. The LCPDP is now updated biennially. The currently available report is an update of the LCPDP of 2011-2031 and covers the period 2013-2033. The main objective of the update is to take into account updated assumptions, new technologies and market dynamics that may impact on future power expansion plans. However, this plan neither references external financiers nor outlines a financing strategy for the sector.
3. Government expenditure on infrastructure

3.1. Infrastructure financing in Kenya: an overview

Infrastructure-related spending by the GoK (both domestically and externally financed) has increased by roughly 8.5 times in 10 years, from KSh50 billion in 2005/06 to KSh426.3 billion in 2014/15 (World Bank, 2014: 13; OCB, 2015: 9). It has also increased as a share of total government expenditure. Representing 20.2% of the revised gross budget and an increase of 75% from KSh244.2 billion allocated in 2013/14, the allocation to infrastructure became the largest share of the budget in 2014/15, overtaking that for education.

In terms of the significance of each infrastructure sector, further analysis shows that although government spending on infrastructure has largely been channelled to roads and energy, spending on railways increased significantly in 2014/15 (Figure 1). With the start of the construction of the SGR, rail transport accounted for 38% of the sector’s spending in 2014/15, compared with 3% in the previous year (GoK, 2015a).

In terms of the sources of financing, Kenya’s infrastructure sector changed dramatically between 2005/06 and 2014/15, as follows:

- A large share of planned government expenditure in each of the three sectors is reliant on external sources of finance. For example, 50% of roads development, 77% of planned government expenditure in the rail sector and 65% of the energy sector spending has been reliant on donor financing in recent years.
- In absolute terms, external finance flows for energy, roads and railway projects (comprising aid/aid-like flows from traditional and non-traditional donors, proceeds from international sovereign bonds and multilateral climate investment funds) have experienced a more than 18-fold increase over 10 years, from KSh15 billion in 2005/06 to KSh280.8 billion in 2014/15.
- Traditional donor funding has declined in importance in all three sectors, particularly from 2008/09 onwards due to the rise of China as a development partner. China is by far the largest non-DAC bilateral partner in general, as well as in all three of the infrastructure sectors considered in this report, surpassing even the DAC bilaterals in the three sectors in the latter half of the period.
- In contrast, the remaining non-DAC bilaterals are considerably smaller donors. In these three sectors, Arab donors finance road and energy projects, while India only finances energy projects. Like the traditional DAC bilateral and multilateral donors, assistance from these non-DAC donors is provided mainly in the form of concessional loans.

![Figure 1: Changing spending priorities in the infrastructure sector, 2012/13 to 2014/15 (share of total spending on infrastructure)](image)

Source: GoK (2015b).
*Marine transport, air transport and the ICT sector.

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7 These estimates include expenditure on roads, energy and railway projects, as well as spending on marine transport services, air transport services and Information and Communication Technology (ICT).
The GoK has become increasingly reliant on commercial financing, particularly international sovereign bonds, to finance road and energy projects (see Figures 3 and 7). Kenya successfully issued its debut international sovereign bond at the end of June 2014. At 5-year and 10-year maturities, the GoK raised $2 billion in June and a further $750 million in December 2014. The $2 billion issuance was more than four times oversubscribed, with a strong response by foreign investors, reflecting Kenya’s good debt management practices. The prospectus for the sovereign bond clearly stated that the purpose of the bond issuance was for general budget support, including funding of infrastructure and the repayment of a syndicated bridging loan (the latter amounted to $604 million/KSh53.2 billion). The National Treasury used the vast majority of the proceeds to fund the development budget in 14 ministries/departments/agencies (MDAs), with the Ministry of Transport and Infrastructure and the Ministry of Energy and Petroleum receiving 43% of the total releases for the financial years 2013/14 and 2014/15.9

In addition, the GoK has issued eight domestic infrastructure bonds since 2008/09. In recognition of the role that infrastructure plays in economic development, the GoK embarked on the first issuance of infrastructure bonds in February 2009, to mobilise resources to finance specific projects in the roads, energy and water sectors. The first infrastructure bond attracted huge market appetite owing to its attractive features10 and the public confidence arising from the ownership of development projects being within the country. By June 2014, six infrastructure bonds totalling KSh188 billion had been issued, raising KSh156.73 billion (successful bids at cost), while two additional infrastructure bonds were issued in 2014/15 with an offer amount of KSh65 billion. However, unlike the international sovereign bonds, there is no publicly available information on the value of exchequer releases funded by the proceeds of these infrastructure bonds by sector.

Kenya was the third-largest recipient of private participation in infrastructure in sub-Saharan Africa over the period 2005-2012 (Gutman et al., 2015). Specifically, PPPs have played an important role in the energy and railways sectors, with a total current project value of $3.13 billion in the former (National Treasury, 2016b).

Financing from multilateral climate funds, on the other hand, has been negligible, and used only in the energy sector, representing on average only 1% of the energy sector’s annual external financing between 2012/13 and 2014/15.

The remainder of Section 3 provides a more detailed overview of financing trends in each sector. For each sector it examines the total (planned) government expenditure (domestically and externally financed) (Figure 2) and then looks at the trends in the sector’s external financing. The lack of disaggregated data on the composition of domestic financing by sector prevents a similar analysis for this financing source. We conclude by looking at PPP arrangements in the sector, which is an instrument rather than a source of financing.

3.2. Roads

3.2.1. Total government expenditure on roads

The total annual budget for the road sector has increased almost threefold, from KSh46 billion in 2006/07 to KSh136.2 billion in 2014/15 (MoR, 2010: v; OCB, 2015: 61). The share of expenditure funded by donors has also increased. On average, donor commitments accounted for 45% of total government expenditure on roads between 2012/13 and 2014/15, compared with an average of 32%

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8 Amounting to $600 million, the syndicated loan was incurred in 2011/12 and was to mature in August 2014.

9 The remaining 12 recipients included the State Department for Planning, the State Department for Water and Regional Authorities, the State Department for Agriculture, the Ministry of Lands, Housing and Urban Development, the State Department for Science and Technology, the State Department for Education, the Ministry of Information, Communication and Technology, the Ministry of Industrialisation and Enterprise Development, the Ministry of Sports, Culture and Arts, the State Department for Livestock, the State Department for Fisheries and the State Department for Commerce and Tourism.

10 Incentives include the ability to use the infrastructure bond as collateral for bank loans, which banks could count as regulatory reserves (Gutman et al., 2015). In addition, all infrastructure bonds are tax free, as provided for under the Kenyan Income Act.

Notably, loans from donors can only be used to finance development expenditure (such as roads development) and not recurrent expenditure (such as road maintenance). Roads development is currently reliant on both domestic financing11 and support from development partners, the latter financing close to 50% (Kaunda, 2014: 11).

The following subsection focuses on the changes in the amount and composition of external financing received for roads. All donor flows are based on donor commitments, while flows from the international sovereign bonds comprise releases from the exchequer to the State Department for Infrastructure funded by proceeds from the bond issuances.

3.2.2. External financing of roads

The three external sources of financing for roads between 2005/06 and 2014/15 include traditional donors (DAC bilaterals and multilaterals), non-DAC bilateral donors (China and Arab donors) and, most recently, the proceeds from international sovereign bonds.

As shown in Figure 3, while traditional donors have historically been the main provider of external financing for roads, their share of external finance has declined (from an average of 84% of total external finance between 2005/06 and 2007/08 to an average of 60% between 2012/13 and 2014/15). This reduction has been due to two key factors: the issuance of Kenya’s first international sovereign bonds, and the rise of China as a development partner. In fact, while the World Bank and AfDB/ADF remained the largest donors over this period, China emerged as the largest bilateral donor in the road sector (see Figure 5).

DAC donors to roads

Between 2005/06 and 2014/15, 10 traditional donors provided financing for road projects in Kenya: four were multilateral/regional organisations and the rest were bilaterals (France, Germany, Sweden, Japan, UK and South Korea). However, only four of the six DAC bilaterals were active in the road sector between 2012/13 and 2014/15: Japan, France, Germany (KfW) and the UK12 (as shown in Figure 4). Some of the smaller donors had largely phased out their support, while the major donors increased their support, for two related reasons. First, over the years the GoK has sought to reduce the number of donors active in each sector to improve coordination (GoK, 2007). Second, given that some major actors (the World Bank and the EU) were more active in this area, smaller donors (such as Sweden) decided to redirect their support to other areas, where they had a comparative advantage (GoS, 2009). Between 2012/13 and 2014/15, the largest traditional donors financing roads remained the multilaterals, specifically the IDA (World Bank) (40%) and AfDB/ADF (29%). Over the same period, the largest donors among the DAC bilaterals included Japan (8%) and France (3%).

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11 Domestic sources of financing include government revenues, domestic infrastructure bond proceeds and the Road Maintenance Levy Fund, which mainly comprises a fuel levy and transit tolls. The fuel levy is charged at the rate of KSh9 per litre for petrol or diesel imported into the country, while transit tolls are charged on foreign-registered commercial trucks exceeding 2 tonnes.

12 Based on National Treasury data, UK only provided financial assistance for roads in 2013/14.
Furthermore, there is a clear division of labour between the bilateral and multilateral donors in terms of the types of road project they support.

In terms of instruments, the vast majority of donor financing is provided through concessional loans. The EU institutions (European Development Fund and European Economic Community) are the only donors that provide all of their assistance in the form of grants. Historically, the AfDB/ADF has also provided a small amount of grants to finance feasibility, environmental and design studies for the Isiolo–Moyale road project13 (linking Kenya to Ethiopia) and the feasibility study for the Nairobi–Thika Highway Improvement Project. However, most of AfDB/ADF annual financing of roads over this period was provided through concessional loans, with its annual loan commitments to roads increasing almost fivefold between 2008/09 and 2012/13.

Non-DAC donors to roads
Between 2012/13 and 2014/15, China emerged as the largest bilateral donor for roads, surpassing even the DAC bilateral. The Arab donors (Organization of the Petroleum Exporting Countries (OPEC), Arab Bank for Economic Development in Africa (BADEA), Saudi Arabia, Abu Dhabi and Kuwait), on the other hand, were relatively small donors. As shown in Figure 5, China’s assistance to roads on average accounted for 17% of annual donor financing (DAC bilaterals, multilaterals and non-DAC) between 2012/13 and 2014/15, while Arab donors represented 2%. From 2009/10 onwards, China’s assistance significantly surpassed that of the other bilateral donors, including the DAC donors, due to three road projects: Nairobi–Thika Highway Improvement Project (LOT 3), Nairobi Southern Bypass Project and Nairobi Eastern and Northern Bypass Project, all financed by concessional loans.

13 This was a component of the Mombasa–Nairobi–Addis Ababa Road Corridor Project.
Among the remaining five non-DAC donors, Abu Dhabi and Kuwait are the newest. Together with BADEA, Saudi Arabia and OPEC, these two Arab donors are co-financing the Nuno–Modogashe road via loans. BADEA and OPEC are also co-financing the Emali–Oloitokitok road. Generally, all road financing from Arab donors involves co-financing and is in the form of loans. The only exceptions have been grant financing from BADEA for two feasibility studies in 2005/06.

International sovereign bonds
As shown in Figure 3, international sovereign bond proceeds accounted for 23% and 54% of the total external financing of roads in 2013/14 and 2014/15, respectively. The Ministry of Transport and Infrastructure received the largest share of the bond-financed exchequer releases relative to other MDAs in both 2013/14 and 2014/15: 72% of proceeds (KSh15 billion or $174 million) in 2013/14 and 39% (KSh49.4 billion or $561 million) in 2014/15 (National Treasury, 2015a).

### 3.2.3. Public–private partnerships

There are currently no PPPs (completed or ongoing) in the road sector. Various policy documents (for example the RSIP 2010–2024) indicate the GoK’s support for PPP arrangements in road construction and/or maintenance on Nairobi bypasses and other major roads. Two schemes have been proposed, but these suffered a number of setbacks, which suggests that PPPs may not be appropriate for certain sectors.

- **The first proposed scheme comprised a series of toll roads.** A feasibility study was conducted which confirmed the viability for a 106 km toll road on the Northern Corridor in the Greater Nairobi region, and initially received support from the World Bank in the form of a partial risk guarantee. However, the Bank withdrew support for the project in 2011 due to a breach in compliance procedures and as a result the deal did not reach financial close (CEPA, 2015). The implementation of toll road schemes has also been hampered by concerns about the political impacts of tolls, particularly on roads that are already in use, and partly because motorists are already paying a road maintenance fuel levy.

- **The second proposed scheme was a road annuity programme.** The objective was that the private sector would design, finance, build and maintain roads for 10 years, with the government paying over this 10-year time period. The GoK invited tenders from private companies to undertake the work, but announced in October 2015 that it was dropping this programme on value for money grounds, as the bids that came in were far more expensive than conventional procurement (Prizon and Hart, 2016). Some interviewees indicated that this was partly due to the perceived risk of default by the GoK, leading to high premiums being added by the private sector. Others indicated that the financing was primarily domestic, thus requiring high interest rates, which was pushing up the cost of the project.

Overall, there was a mixed response across interviewees regarding the feasibility of PPPs in the road sector. The most optimistic noted that various reforms were still needed before PPPs could become a reality for Kenya’s roads, while others expressed little enthusiasm for this type of financing instrument for this sector.

### 3.3. Rail transport

#### 3.3.1. Total government expenditure on rail transport

Until recently the GoK had not undertaken any major development of the railway network, whether through rehabilitation and modernisation of existing infrastructure or construction of new lines. Indeed, it had accumulated a substantial backlog of investments in both rehabilitation and upgrading of its infrastructure prior to the concessioning of operations in 2006 (MoT, 2009). This partly informed the rationale for the RVR concession, with the private operator becoming responsible for making new investments in the railways.

More recently, the GoK has significantly increased its expenditure on railways from KSh7 billion in 2013/14 to KSh159 billion through the construction of the first phase of the SGR (from Mombasa to Nairobi). Phase 1 began in 2014/15 and is scheduled for completion and commissioning in 2017. Its estimated cost is $4 billion; the GoK is expected to finance 10% of the amount for this phase, and the remaining 90% ($3.6 billion or KSh343.3 billion) will be financed by China Exim Bank through two separate loans, to be disbursed over three years. Given that the Mombasa–Nairobi line is only the first phase of the project, it is likely that the rail transport sector will benefit from considerable investment over the next 10 years, with the planned extension of the SGR. The line will initially be extended from Nairobi to Naivasha, before two segments are run to Kisumu and the Ugandan border.

In terms of the impact of SGR Phase 1 on annual budgetary allocations, the rail transport programme under the State Department for Transport had a revised allocation of KSh159.9 billion in 2014/15, surpassing the revised road allocation of KSh136.2 billion (OCB, 2015: 60). As shown in Figure 6, external financing via a Chinese

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14 Toll revenue could be treated as a source of revenue for government, and remitted from toll operators back to government. It could then be allocated as part of the Consolidated Fund or ring-fenced for a specific purpose, such as remunerating concessionaires in the road sector.

15 The gross expenditure estimate was initially KSh24.3 billion (OCB, 2015).
An ‘age of choice’ for infrastructure financing? Evidence from Kenya

A loan of KSh123.5 billion (IMF, 2016) accounted for 77% of project financing in the 2014/15 budget, while KSh22.9 billion was to be raised through the Railway Development Levy (RDL) in addition to the amounts already collected under the RDL Fund (Rotich, 2014). Based on donor commitment data from the National Treasury (2016c), there were no other donors financing government expenditure in the rail sector in that year.

The following subsection focuses on the changes in the amount and composition of external financing for rail transport. All donor flows are based on donor commitments.

### 3.3.2. External financing of rail transport

External financing of government expenditure in the rail sector in Kenya is solely reliant on donor funding, specifically from China in 2014/15 and, prior to that, from the World Bank (IDA) and Germany. In contrast to the roads and energy sectors, proceeds from the international sovereign bond issuances have not been used to finance this sector.

**DAC donors in rail transport**

The rail transport sector is a small component of the DAC infrastructure portfolio, with only two donors involved in this sector: IDA and Germany. IDA has provided loans to the KRC as part of the East Africa Trade and Transport Facility Project, amounting to KSh8 billion between 2007/08 and 2013/14. This project aims to improve railway services in Kenya and Uganda, and includes a component for supporting the concession. Between 2005 and 2008, Germany provided grants and loans totalling KSh341 million for the general overhaul of Kenya Railways’ locomotives. It is worth noting that none of the past support provided by traditional donors was used to finance the actual construction of a railway line. More recently, donors and development finance institutions (DFIs) have provided financial support to the railway concessionaire, RVR (discussed in the subsequent section), and not to the GoK directly.

Notably, DAC donors have only funded the RVR line, while China is only investing in the new SGR, meaning that DAC and non-DAC donors are literally running on parallel tracks in this sector. Generally, government interviewees were circumspect in providing definite reasons for this division of labour, though several potential explanations were offered by various stakeholders. First, for reasons of speed, Chinese financing of the SGR was more attractive than traditional donor financing; the social and environmental safeguards built into traditional donor financing meant that, had it been used, it would have been highly unlikely that the project could have been completed within the same time frame. Second, DAC donors may have wanted to focus on rehabilitating the existing railways, having invested in them previously. Third, traditional donors probably lacked the funds needed to finance such a large project, and, for reasons of visibility, they preferred to spread the resources they did have over several sectors, rather than concentrate on one. Fourth, there are structural issues that made some traditional donors reluctant to enter the sector. One such issue relates to whether there is sufficient demand to make a new railway economically feasible given the RVR concession. Finally, there were concerns regarding the SGR’s impact on the country’s debt sustainability. Ultimately, there was no clear consensus among interviewees regarding the reasons for the current division of labour in the railways sector between DAC donors and China, and considerable uncertainty regarding how the two railways will coexist.

**Non-DAC donors in rail transport**

China is the only non-DAC bilateral donor that is financing rail transport in Kenya, through its support of the development of the Mombasa to Nairobi SGR line. The GoK signed an agreement with China in 2014, featuring $3.6 billion in semi-concessional loans from China Exim Bank to finance construction of the first phase of the regional railway, which is estimated to cost $4 billion. The contract comprises two loans: a 15-year $2 billion loan from China Exim Bank at Libor plus 3.6%, and a 20-year $1.6 billion loan from the Government of China at 2% (IMF, 2014). The loans are contracted by the government and are on-lent to the KRC. Future revenues from the SGR will be used to repay the loans. At the end of August 2015, some $2.5 billion had been disbursed out of the Chinese
loans contracted, and implementation has been reported to be ahead of schedule\(^\text{16}\) (IMF, 2016). In December 2015, Kenya contracted a further $1.5 billion, over and above the first $4bn loan, to be disbursed in coming years, for the second phase of the SGR (Nairobi–Naivasha).

Although the initial loans did not pass the GoK’s normal 35% grant element threshold (as a package, the two loans have a grant element of around 25%), they were justified due to the importance the government places on the project. The GoK only expected to receive sufficient financing for such a project from China, and considered the terms far better than could be accessed on the capital markets (where the yield was 6% to 7%) (Prizzon and Hart, 2016). The government intends to repay these obligations with resources from KRC’s dividends and proceeds from the existing 1.5% railway levy on imports.

### 3.3.3. Public–private partnerships

To date, the RVR concession is the only PPP-like arrangement in the railways sector. As mentioned in Section 2.2.2, the operational performance and management of the railway during the first few years of the concession resulted in the concessionaire recording huge losses, which eventually led to a restructuring of the ownership of the concession in 2010. Since this restructuring took place, a significant investment programme has been under way, which has attracted financing from traditional development partners, DFIs and commercial banks. RVR managed to raise $287 million to finance a five-year capital expenditure plan from the AfDB/ADF, KfW, IFC, FMO, IFC Debt Pool and the Belgian Investment Company for Developing Countries (BIO) (AfDB, 2015). Proparco has also supported this operation by making a $10.7 million equity investment in the RVR holding company via the Investment and Support Fund for Businesses in Africa (FISEA). While these investments could result in significant service improvements along the line, it is unclear what impact the new SGR line – which, as noted, covers some of the same route – will have on the demand for RVR’s service.

Another proposed PPP project in the rail sector involves the rehabilitation and expansion of the Nairobi commuter rail service. Like the SGR, this is a Vision 2030 flagship project. It has been in development since 2006 but is unlikely to become operational in the near future. The project, which is expected to cost $325 million, involves the rehabilitation of 65 km of railway line, and the construction of 5 km to 7 km of new line to link the city with the airport, with stations and other facilities also being rehabilitated. Although a joint development agreement for the project was signed by the KRC and InfraCo Africa in 2009, stakeholders believe that financial closure is unlikely to be reached in the near future (CEPA, 2015). One of the primary reasons for this was the introduction of the Public Private Partnerships Act (PPP Act) in 2013, which resulted in conflicts regarding who should be responsible for the procurement process: KRC or InfraCo, with the Act requiring the former to be responsible.

### 3.4. Energy

#### 3.4.1. Total government expenditure on energy

As for roads, government expenditure in the energy sector increased considerably between 2005/06 and 2014/15. This was as a result of heavy investment in renewable and clean energy, especially geothermal and wind energy, and the construction of high-voltage power lines. For development expenditure, the total approved allocation of KSh74.3 billion in 2014/15 was slightly more than eight times that of the 2005/06 allocation of KSh8.8 billion (OCB, 2015: 61; MoEP, 2013: 45).

Regarding the split between domestic and external sources, donor financing accounts for a rising share of the GoK’s total approved budgetary allocations to the Ministry of Energy, increasing from roughly 40% between 2005/06 and 2007/08 to about 65% of the annual allocations between 2012/13 and 2014/15 (National Treasury database; OCB, 2014, 2015).

The following subsection focuses on the changes in the amount and composition of external financing for energy projects. All donor flows are based on donor commitments, while flows from the international sovereign bonds comprise releases from the exchequer to the Ministry of Energy and Petroleum funded by the proceeds from the bond issuances.

#### 3.4.2. External financing of energy

There were four external sources of energy project financing between 2005/06 and 2014/15: traditional donors (DAC bilaterals and multilaterals), non-DAC bilateral donors (China and Arab donors) and, most recently, the proceeds from the international sovereign bond and funds from multilateral climate funds (to a lesser extent). As shown in Figure 7, while traditional donors have historically been the main provider of external financing in this sector, the share of this source of external finance declined throughout the period (from an average of 89% of annual external finance between 2005/06 and 2007/08 to an average of 63% between 2012/13 and 2014/15). This was due to two key factors: the rise of China as a development partner and the issuance of Kenya’s first international sovereign bonds. In fact, as in the road sector, China has emerged as the largest bilateral donor in the energy sector, becoming the second largest donor overall, after the World Bank (IDA), in recent years.

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\(^{16}\) The SGR Phase 1 is 70% complete and is set for commissioning in June 2017 (National Treasury, 2016d).
Between 2005/06 and 2014/15, there were 12 traditional donors providing financing to the energy sector, but the number has dwindled to seven donors over the last three years. Despite this reduction in the number of donors, commitments from the remaining seven DAC bilaterals and multilaterals more than tripled between 2010/11 and 2014/15, from KSh8.5 billion to KSh29.9 billion. Of these seven donors, the top multilaterals included the IDA, AfDB/ADF and the European Investment Bank (EIB), while the largest bilateral donor was France, followed by Spain (as shown in Figure 8).17 Japan is a relatively new donor, first financing energy projects in 2011/12, but has only provided comparatively small amounts (based on government estimates).

It is worth noting that three of the five inactive donors in the energy sector were relatively small and, as in the road sector, may have chosen to focus on areas where they would have a greater presence, while Germany and Finland appear to have increased lending to the energy sector since 2014/15. In fact, the three currently inactive donors (the Nordic Development Fund, the Netherlands and the United Nations Development Programme) generally committed small amounts of financing in only one year, based on the planned development expenditure estimates. In regards to Germany and Finland, alternative data sources, namely the OECD’s Credit Reporting System (CRS) database and the GoK’s budget for the subsequent fiscal year (2015/16), suggest that these two donors have recently resumed financing energy projects, accounting for 8% and 0.6% of total donor commitments to energy projects in 2015/16, respectively (GoK, 2015a).

In addition, due to the magnitude of the financing requirements of projects in the energy sector, co-financing by different European and other donors has been common practice (European Union, 2015b). The EIB and France (Agence Française de Développement (AfD)) are co-financing the Mombasa–Nairobi and Suswa–Isinya transmission lines. In the field of distribution, AfD and the EU are also financing the Scaling Up Energy Access Project (Stima Loans) under the Africa, Caribbean, Pacific (ACP)-EU Energy Facility. In the field of generation, the EIB, AfD and Germany are jointly funding the expansion and maintenance of the Olkaria geothermal power plant by pooling €329 million through a pilot scheme of the Mutual Reliance Initiative. This initiative allows the implementers of investment projects to benefit from a larger project finance capacity through a structured division of labour. In the case of this project, AfD has played the role of lead financier among the EU DFIs, while other non-EU financiers of the project include the World Bank and the Japan International Cooperation Agency (JICA). The IDA is financing a part of all of the components. The other four external partners are all financing the generation component because of its large size and its importance to the success of the overall programme of electricity access expansion and improvement in security of supply. Furthermore, all the donors have appraised

17 Based on the OECD-CRS dataset and gross disbursements, the largest DAC bilateral donors in the energy sector between 2012 and 2014 were: France, Japan and Germany.
the components jointly, harmonised their procedures and reporting requirements as much as possible and followed the World Bank’s environmental and social guidelines.18

In terms of instruments, the energy sector is almost entirely financed by loans (roughly 98% in most years between 2005/06 and 2014/15). It was noted that loans for the energy sector included a smaller grant element than did loans for other sectors, such as health, because of the energy sector’s higher economic returns. However, three donors have provided small amounts of grant financing between 2012/13 and 2014/15: EIB, AfDB/ADF and France.19

Non-DAC donors in energy

The number of non-DAC donors active in Kenya’s energy sector has increased over the years, to stand at six in 2014/15: China, India, Saudi Arabia, OPEC, BADEA and Abu Dhabi. All non-DAC donors provide financing to this sector in the form of loans. China is not only the largest bilateral donor, it is also roughly on par with the largest multilateral donor, the World Bank (IDA).

Among the six non-DAC donors, India is the second largest provider of finance to the energy sector (18% of non-DAC commitments and 5% of total donor commitments, as shown in Figure 8). A relatively new donor, India has financed three energy projects since 2012/13: KETRACO Transmission Lines, the Turkwell–Ortum–Kitale Project, and the Suswa Project. As in the road sector, Arab donors are relatively small donors, generally operating through co-financing arrangements.

International sovereign bonds

The Ministry of Energy and Petroleum was allocated 12% (KSh3 billion or $34 million) of the bond proceeds in 2013/14 and 11% (KSh18.1 billion or $206 million) in 2014/15. As shown in Figure 7, these bond proceeds accounted for 4% of the energy sector’s total external financing in 2013/14 and 27% in 2014/15.

Climate finance

Kenya receives relatively little climate finance from multilateral climate finance windows. As a result, climate finance accounted on average for 1% of the energy sector’s annual external financing between 2012/13 and 2014/15.

Table 2: Climate finance projects in the energy sector, 2011-2015

<table>
<thead>
<tr>
<th>Year approved</th>
<th>Fund</th>
<th>Name of project</th>
<th>Implementing agency</th>
<th>Funding approved ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>Scaling Up Renewable Energy Program for LICs (SREP)</td>
<td>Menengai Geothermal Development Project (ADB/ADF)</td>
<td>ADB/ADF</td>
<td>25 (incl. 7.5 loan)</td>
</tr>
<tr>
<td>2013</td>
<td>Global Environment Facility (GEFS)</td>
<td>Sustainable Conversion of Waste into Clean Energy for GHG Emission Reduction</td>
<td>UNIDO</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Climate Funds Update (2016).

18 EU lenders have adopted the World Bank’s policies for land acquisition and involuntary resettlement as the framework for implementing the Resettlement Action Plan.

19 The EIB provided grants to the Geothermal Development Company for exploration and drilling. The ADB/ADF mobilised grants from the Scaling-Up Renewable Energy Program (SREP) to contribute to the Menengai Geothermal Development Project. France provided grants to finance technical assistance to the Ministry of Energy and Petroleum.
According to Climate Funds Update (2016), $83.61 million of climate finance was approved for Kenya between 2006 and 2015, of which $34.5 million was for energy sector projects (Table 2). All the finance was to be provided as grants, except a $7.5 million loan (which was combined with a $17.5 million grant) from AfDB/ADF for the Menengai Geothermal Development Project. Only the 2011 project is included in the GoK’s budget estimates for 2012/13 to 2014/15 and is thus the only climate finance shown in Figure 7.

Despite the relatively low amounts of multilateral climate fund financing, Kenya is receiving large amounts of mainstream ODA to invest in green energy. In fact, the Geothermal Development Corporation, which was established in 2008 to develop geothermal energy sources, has received more than $600 million in financing from sources such as MDBs and bilateral DFIs. As a result, in 2015, geothermal energy accounted for most of Kenya’s installed energy generating capacity, and Kenya now produces the second largest amount of geothermal energy in the world, after Iceland.

3.4.3. Public–private partnerships

In stark contrast to the road sector, there are several PPPs in the energy generation sector. These are all build-own-operate power generation plants with long-term (typically 20 years) power purchase agreements between IPPs and Kenya Power. IPPs first began to be introduced in Kenya in 1996; there are currently 10 active IPPs, with a total project value of $3.13 billion, and a further five IPPs are planned, with a project value of $3.19 billion (National Treasury, 2016b). Generally, the GoK must pay annual fixed capacity payments and is liable for a termination/default payment. In fact, to increase investor confidence and accelerate the financial closure of these private sector investment deals, the GoK has in the past used multiple instruments of support; in particular, binding letters of support. Some interviewees reported that the GoK is seeking to expand PPPs into transmission and distribution (and that one has been tried so far in distribution), although others were more circumspect on this point.
4. Arenas of negotiation

This section describes the main arenas in which the GoK seeks to engage with different providers of development assistance in the three infrastructure sectors. We also review the extent to which providers of development finance beyond ODA (notably non-DAC donors and philanthropic organisations) participate in these sectoral arenas.

Across all three sectors there are some common processes for negotiating and approving sources of finance, as follows:

- Line ministries identify projects according to the strategic plans for the sectors (see below for details). Line ministries also identify costs. The National Treasury’s Resource Mobilization Department then has a key role in approaching the most appropriate donor to fund specific projects. All donors, including traditional and non-traditional ones, are managed in the same way via the National Treasury. This is unusual compared with other countries, in which relationships with traditional and non-traditional donors are managed in quite different ways. In the case of China, it was reported that the National Treasury maintains the lead and that other ministries, such as the Ministry of Foreign Affairs and the Office of the President, are not directly involved.

- The National Treasury is involved in determining whether financing for projects is provided at an appropriate rate. It was reported in interviews that the National Treasury does refuse to approve financing if concessionality thresholds are not good enough, pushing the line ministry to ask for better terms from the financier.

- It was also reported that informal discussions between donors and line ministries take place, without the involvement of the National Treasury, but this is not something that the National Treasury supports.

- In the case that PPPs are the chosen financing modality, feasibility studies are carried out by the line ministries, while the National Treasury does the financial risk analysis, with the help of international transaction advisers (funded by donors such as the World Bank).

- The overall ceiling for loans is approved by Parliament, although loans are not individually approved. Guarantees do, however, require parliamentary approval.

4.1. Roads

Project identification in the road sector starts with the Road Sector Investment Plan (RSIP), which is linked to Vision 2030. Individual projects are identified from the plan and costs estimated. As noted above, the National Treasury’s Resource Mobilization Department seeks to find a funder for each project. Across the National Treasury, line ministries and donors, there was common agreement that donors have a fairly clear division of labour, with the National Treasury and line ministry able to approach donors (both DAC and non-DAC) based on an agreed understanding of their priorities. In some cases, these priorities are explicitly set out in donor strategy papers. It was also reported that the private sector can feed in its priorities to the sector.

While an Infrastructure Sector Working Group exists, interviewees indicated that this does not play a strong role in coordinating external support, including from donors. Instead, there is a Transport Sector Donor–Government Coordinating Group, chaired by the Permanent Secretary of the Ministry of Transport and Infrastructure, and occasionally co-chaired by a donor, on a rotating basis. This group meets at least quarterly, with ad hoc meetings held when needed. China previously attended some of these meetings, but no longer does so, and Arab donors involved in the road sector were reported as not attending as they have no country presence.

There are also individual negotiations with donors, which involve the Ministry of Transport and Infrastructure, the National Treasury and the donor. The process is the same for China and for other donors. Each project also has a Steering Committee and a Project Implementation Committee, which involve the Ministry, donor and the National Treasury. These processes were reported to involve all donors, even those not involved in the donor-coordination committee meetings.

Other sources of finance for the road sector are channelled via the National Treasury, for example funding from domestic infrastructure bonds and sovereign bonds. The National Treasury appears to be in the driving seat when it comes to such funding decisions. The National Treasury decided to issue a Eurobond, and a share of the funds raised was channelled to the road sector. Domestic infrastructure bonds have also been managed by the National Treasury, with the Ministry of Transport and Infrastructure providing a list of roads that needed financing, and the proceeds from the domestic infrastructure bonds being spread across these projects.
Unlike in the energy sector, autonomous and semi-autonomous government agencies (AGAs/SAGAs) in the road sector cannot borrow commercially, so all funding for these agencies comes directly through the Ministry of Transport and Infrastructure. Funds are borrowed by the National Treasury and then on-granted to the Ministry and the AGAs/SAGAs.

From the interviews it appears that proposed PPPs are heavily driven by the National Treasury, with a mixed degree of support from the Ministry of Transport and Infrastructure.

4.2. Railways

Unlike in the road sector, there does not appear to be an active donor coordination process for railways, possibly because of the small number of donors involved and limited interest from the traditional donors in funding the railways sector. During the interviews, conflicting accounts were received regarding the amount of donor funding to the sector, which may also indicate a lack of coordination between actors (although it could also be due to interviewee selection). In addition, as noted above, traditional and non-DAC donors have taken very different approaches in the railways sector, with traditional donors supporting the Rift Valley narrow-gauge railway and China being heavily involved in the SGR.

Another reason for lack of coordination in the railways sector may be because project development is undertaken by KRC, a state agency, rather than by the Ministry of Transport and Infrastructure itself. However, negotiations with the China Exim Bank were led by the National Treasury, which has on-lent the funds to KRC.

Parliament appears to have been heavily involved in discussions about the SGR, possibly because of the very large size and high-profile nature of the loan as well as the need to raise the external borrowing ceiling to fund mega infrastructure projects such as the SGR. Generally, loans are not individually approved by Parliament, but the SGR loan was specifically discussed. It was also reported that there were public hearings involving different stakeholders, including on the displacement of households (particularly in slum areas), and that some adjustments were made as a result of parliamentary pressure. Parliamentary committees on both transport and the environment were also involved in the discussions, which reportedly led to some scrutiny of the terms and conditions of the loan and an adjustment to minimise the impact of the SGR on the Kenya National Park.

4.3. Energy

As in the road sector, decisions on financing in the energy sector are led by the sector plans, including the Least Cost Power Development Plan (LCPDP), the medium-term sector plan and associated investment prospectus, and the Last Mile Connectivity Programme. At least some of the AGAs and SAGAs involved in the sector also have their own plan; for example, KPLC is reported to have its own five-year development plan, which is linked to the LCPDP.

When it comes to negotiation with donors, as in the road sector, there is an energy sector donors coordinating group, co-chaired by the Ministry of Energy and Petroleum and the World Bank, which meets every quarter. AGAs and SAGAs in the energy sector also attend, along with the National Treasury for some meetings. It was reported that at these meetings, the Ministry of Energy and Petroleum presents its priority projects to donors, and donors choose which projects to finance. However, the Ministry is also aware of donor interests (for example JICA’s interest in geothermal energy) and uses this to steer the discussion. Not all donors attend these meetings: China and the Arab donors do not attend, but instead engage in separate discussions with the Ministry. However, none of the interviewees reported that this poses any challenge to overall coordination. Donors also conduct individual missions, which help with project identification.

There is also reportedly a Sector Working Group which meets quarterly, co-chaired by government and development partners, which discusses sector priorities and implementation of programmes. Relevant county departments and representatives from the Council of Governors are also reported to attend these groups. However, interviewees noted that the Sector Working Group is more focused on allocating the government budget, and does not cover PPPs or other forms of private finance.

Decisions on whether to initiate PPPs for energy projects are taken by the Ministry of Energy and Petroleum. However, the PPP Act indicates when the National Treasury needs to be consulted. The National Treasury reviews the relevant documentation and authorisation is given for further work. Interviewees did report that the National Treasury had sometimes refused to approve PPP projects when expected rates of return were not high enough.

Larger PPP projects are then contracted through a competitive process, which is the default process for selecting private contractors under the PPP Act. However, there is also an alternative process, conducted using ‘privately initiated investment proposals’, or so-called unsolicited proposals. Under exceptional circumstances, the Cabinet Secretary can approve these. Private partners can submit proposals directly to the Ministry of Energy and Petroleum. However, both the Ministry and the PPP Unit have to approve projects in order for them to continue under such a provision. The Ministry of Energy and Petroleum indicated that there have been examples of privately initiated investment proposals that it has refused, e.g. in wind power generation.

Parliament is not involved in PPPs unless PPPs or concessions relating to natural resources are being issued. However, any guarantees associated with PPPs have to be approved by Parliament. The Public Debt Management
Office of the National Treasury is also involved in tracking contingent liabilities.

Finally, in the energy sector, unlike the road sector, AGAs and SAGAs are also able to raise their own financing directly, including from commercial banks, domestic bonds or the IFC. However, the National Treasury requires them to have either a guarantee or a ‘letter of support’ from the Treasury in order to be able to borrow.

As with the road sector, other sources of financing, including from international sovereign bonds, are channelled directly from the National Treasury to the Ministry of Energy and Petroleum.
5. Priorities for the terms and conditions of development finance

This section sets out the GoK’s priorities for the terms and conditions of development finance for the infrastructure sector – specifically, the qualitative aspects that the government seeks to achieve in negotiating with the providers of development finance for roads, rail transport and energy projects. The findings are based on a review of relevant policy documents as well as the interviews conducted for this study (see Annex 1).

The GoK has expressed a series of priorities for the terms and conditions of development finance for infrastructure projects. These infrastructure-specific priorities tend to overlap with the general set of priorities identified in the previous Kenya case study (Prizzon and Hart, 2016), with a few exceptions. In both cases, maximising concessional financing, diversification of sources of financing, alignment with national priorities and speed were highlighted as important. On the other hand, the importance of harmonisation and coordination were not mentioned when we looked at infrastructure specifically. Debt sustainability did not emerge as a separate government priority, except in relation to the need for concessional financing, although a number of stakeholders outside the executive expressed concerns about debt sustainability in Kenya.

Maximise concessional resources. Despite the emergence of less concessional sources of financing, both interviews and official policy documents strongly emphasised that maximising the volume of concessional financing is a key priority of the GoK’s financing strategy, particularly in light of the very significant infrastructure financing needs of the country. Kenya’s Vision 2030 makes the case for increased ODA, aiming for donor support to rise steadily to ‘about 4% of GDP by 2012/13 and remain above that level through 2030’ (GoK, 2012: 11). The most recent Medium Term Debt Management Strategy explicitly states that the government ‘intends to continue maximising borrowing from external concessional and semi-concessional sources’ (National Treasury, 2016a: xi). This priority is understandable given Kenya’s rising income level and graduation to ‘blend’ status within key multilaterals, combined with its very significant infrastructure financing needs. Moreover, interviewees emphasised the importance of a grace period and a low interest rate when financing infrastructure projects such as power substations, which, though profitable, may take some time to start generating revenues. As such, the GoK appears to have a very high level of demand for concessional financing from donors such as the World Bank and the AfDB.

There are, however, exceptions. The previous Medium Term Debt Management Strategy (2015) stated that financing from non-concessional windows will be limited to projects with high expected risk-adjusted rates of return, including critical infrastructure projects, that would otherwise not be undertaken due to lack of concessional financing (National Treasury, 2015b: xi), especially in the energy sector (ibid.: 3).

Diversification of sources of financing. The GoK has recognised that the quantum of financing available from concessional ODA falls significantly below its ambitious infrastructure programme for roads, railways and energy. Moreover, there are some areas where concessional ODA loans cannot fund, such as routine road maintenance (a recurrent activity, which, under GoK regulations, cannot be funded by borrowing) and government deficit spending (as funds from China and the MDBs tend to be tied to specific projects rather than funding the deficit overall). Moreover, concessional loans typically require counterpart funding.

Thus other new financing mechanisms need to be explored. This is reflected in the sector plans for both roads and energy. For example, due to the shortfall for routine and periodic maintenance and the maintenance backlog, the then Ministry of Roads (2010) identified the need ‘to identify additional sources of financing such as infrastructure bonds, Public-Private Partnerships, weight distance charges, road licenses, traffic fines and upward revision of road maintenance levy fund charges’. It was also reported that the Thika superhighway was built with finance from the AfDF and China, with the GoK using infrastructure bonds to provide counterpart funding.

The importance of leveraging the private sector specifically is also mentioned for all three infrastructure sectors. For roads, the RSIP states that ‘some components
of the RSIP will be delivered through concessioning and other PPP methods’ (MoR, 2010: vi), although, as noted above, there has been no success in actually delivering PPPs in the road sector and the process appears to be on hold at present. For railways, the GoK will ‘encourage private sector investment in railway development and rehabilitation on a competitive basis’ (MoT, 2009: 74), although again it is unclear how this chimes with the GoK’s prioritisation of the rival SGR. For energy, the GoK has put in place a Feed-in-Tariffs (FiT) Policy for electricity generated from renewable energy sources. Under this policy, KPLC enters into power purchase agreements with firms for a period of 20 years, and guarantees priority purchase. In this way, purely private providers can operate in the renewable energy sector, earning revenue by selling into the national grid: no PPP is required. The GoK is also considering revising the FiT policy from the current first-come-first-served allocation process, to a renewable energy auction process in an effort to reduce consumer retail tariffs.

In terms of commercial finance, the GoK intends to maintain its presence in the external sovereign bond markets. Moreover, alternative sources of financing, through the sukuk market, the Samurai market, Panda bonds and diaspora bonds are contemplated over the medium term (National Treasury, 2016a).

Flexibility and alignment with national priorities are also top priorities. Government officials noted that all externally financed projects had to be aligned with the national priorities in Vision 2030 and the second Medium Term Plan (2013-2017). The relevant strategic plans, namely the RSIP and the LCPDP, were mentioned frequently in meetings. Government officials also emphasised the need for financing to be flexible, such that it could be channelled to the GoK’s priority areas.

Speed was also seen as important. Prizzon and Hart (2016) found that the GoK valued speed of delivery, so that projects can generate benefits as quickly as possible. There is a particular political emphasis on delivering visible infrastructure projects quickly, particularly given that a general election was scheduled for 2017. Some informants noted that speed is closely related to concessionality; slow implementation raises the costs of financing, eroding concessionality and potentially making concessional funds as expensive as non-concessional ones. One non-governmental interviewee linked this to the strong social media presence in Kenya, which puts pressure on the GoK to deliver quickly. Several interviewees, particularly from the donor side, noted that project delays are commonly caused by government: this is not just a donor phenomenon.

Support for domestic financial markets. Some interviewees indicated that external financing sources, such as the Eurobond market, had been tapped in order not to crowd out domestic private investment. It was also indicated that the sovereign bond issuance could help to test the market, expanding the potential of local businesses to borrow internationally too. Other government interviewees also indicated that there is a growing emphasis on domestic debt financing, in order to support the development of domestic debt markets.

There were mixed responses on the importance of debt sustainability. Most governmental stakeholders did not place significant emphasis on this issue, but other interviewees highlighted several concerns. It was reported that the maximum debt threshold has been debated between the National Treasury and Parliament, with the Treasury proposing to increase the debt threshold and Parliament pushing for a lower threshold. The Parliamentary Budget Office has raised concerns that the change in Kenya’s financing mix – with greater reliance on Chinese and sovereign bond funding – could jeopardise debt sustainability given the more limited options for debt cancellation or rescheduling offered by these financing sources.

As in the previous Kenya case study (Prizzon and Hart, 2016), there is limited evidence regarding the GoK’s preference for the role of technical assistance or knowledge assistance in the infrastructure sector. In fact, the role of technical assistance was not raised by any of the interviewees. For this reason, we do not have sufficient evidence to evaluate whether there is any specific preference for the type of technical assistance to be delivered to Kenya. In fact, as discussed in Section 3, most financing for each of these sectors is in the form of concessional loans, with very few donors providing grants.

In addition, there was little evidence of the GoK demonstrating a preference for more harmonisation, coordination or co-financing in the infrastructure sector. This issue did not emerge strongly in interviews, which is surprising given that some costs clearly arise due to lack of coordination. This is particularly the case in the railways sector, where parallel donor investments in different railway systems occur. Political interests in promoting ‘prestige’ projects may, however, override concerns around duplication or coordination in this case.
Maximise concessional resources. The GoK has achieved mixed results when it comes to the maximisation of its resources at concessional terms. With the exception of the Chinese loan for the SGR, all road and energy projects are financed by concessional loans or, to a lesser extent, grants. It was reported that it is common for the National Treasury to refuse financing if concessionality thresholds are not high enough, and to attempt to negotiate for better terms. The GoK has also secured concessional loans from India and Arab donors to finance a small number of energy and roads projects. Nonetheless, non-concessional sources of infrastructure financing, such as international sovereign bonds (as shown in Figures 3 and 7) and domestic infrastructure bonds, have been growing in importance in the roads and energy sectors.

Furthermore, the terms of the concessional windows of multilateral creditors are hardening. Transport and energy make up 60% of the World Bank’s support to Kenya, and is mostly at standard IDA terms, i.e. 38 years repayment, an eight-year grace period and a 0.75% interest rate. However, the GoK is up to its limits in terms of IDA. Moreover, most of the traditional providers of grant financing have reduced or plan to reduce their grant funding of roads and energy projects, specifically the EU and the AfDB/ADF. Historically, the EU has been the main provider of grants in the road sector, but this is changing. Within the EU there has been a paradigm shift away from using purely grant financing for roads in countries (such as Kenya) that can afford to finance projects through concessional loans. Thus, going forward, the EU plans to blend grants with loans for roads in Kenya under the Africa Investment Facility, which started operating in November 2015. The AfDB/ADF is also no longer providing grants to Kenya since it is currently a blend country (effective from 2015), and there are other road projects and energy projects in the pipeline. Coupled with the hardening of the lending terms for loans provided by traditional concessional creditors and Kenya’s increased reliance on access to international capital markets, Kenya’s financing cost will see an increasing trend over the medium term. Interviewees from both the GoK and donors indicated that Kenya appeared to be supply-constrained when it comes to borrowing from MDBs: it has a high level of demand, which MDBs are currently unable to meet given their borrower thresholds.

To a large extent, the GoK has successfully increased and diversified its sources of infrastructure financing, although there are a few areas in which less progress has been made (PPPs in roads and climate finance). As shown above, the composition of the development finance in these three sectors has changed quite dramatically since 2005/06, with the GoK reducing its dependence on ODA from traditional donors by accessing capital markets and approaching non-traditional donors, especially China. Though the size of their financial commitments is comparatively small, the number of non-traditional donors has also expanded beyond China. India has been financing energy projects since 2012/13, while an increasing number of Arab donors are co-financing roads and energy projects. The GoK is also currently negotiating a road project with Brazil.

Kenya’s debut international sovereign bond issuance in June 2014 was oversubscribed and performed well compared with regional peers. Following issuance, the bond yield in the secondary market has declined less than comparable securities, such as Zambia’s and Ghana’s. Roughly 40% of the proceeds from the oversubscribed international sovereign bond allocated to MDAs were used to finance projects in the Ministry of Transport and Infrastructure and the Ministry of Energy and Petroleum (National Treasury, 2015a). Following the successful issuance of the sovereign bond, the GoK plans to launch the M-Akiba Infrastructure Bond, the world’s first purely mobile phone-based government security. Though planned for early 2016, its launch was delayed because of unfavourable market conditions, specifically volatile interest rates.

The experience with domestic infrastructure bonds has been mixed. The GoK’s primary objective in issuing infrastructure bonds was to set precedents for SOEs and local authorities with strong balance sheets to tap into the capital markets to finance their capital requirements and deliver on their mandate effectively. However, not much activity has been registered and the GoK has been the main issuer. In fact, only KenGen has followed suit, successfully tapping into the huge potential in the local capital market to mobilise KSh25 billion ($335 million) of local currency finance through the issuance of a 10-year infrastructure bond in 2009. KenGen previously financed its expansion projects (including geothermal) through concessional lending from international financial institutions. In order to diversify its sources of finance, as well as being restructured as a part-privatised parastatal, KenGen began to access the local capital market, first with an initial public offering and subsequently through the public infrastructure bond offer. This bond benefits from:
• classification as an infrastructure bond and so is subject to tax incentives
• a letter of support from the Ministry of Finance, as well as a near monopoly position
• timing to coincide with strong investor appetite, particularly for infrastructure bonds.

In general, investors have an appetite for lending to parastatals because they are high profile, with implicit sovereign guarantee, and have significant and strong cash flows. The KenGen experience demonstrates that private sector finance can be attracted to infrastructure investments that are well structured and bankable.

PPPs in the energy sector are also largely seen to have been a success, benefiting from both a history of privately financed transactions and a strong pipeline of projects going forward. The Feed-in-Tariffs Policy, in particular, has facilitated resource mobilisation. This policy has provided investment security and market stability for investors by allowing investors to sell electricity from renewable energy sources to a distributor at a predetermined fixed tariff for a given period of time. It is also purported to have reduced transaction and administrative costs and delays by eliminating the conventional bidding processes. It was also reported that some guarantees are issued to support PPPs. Both the World Bank and the AfDB/ADF have provided partial risk guarantees to cover energy projects. Until recently only the World Bank issued guarantees, but the AfDB/ADF has now joined it in order to mobilise additional funding. The current Country Strategy Paper states that ‘although the Bank’s contribution to Kenya’s overall development financing is small in relation to the country’s needs, its support can be catalytic and help mobilise funding in addition to its own resources from the AfDB windows’ (AfDB, 2014: 20).

In stark contrast, there has been no tangible progress in regards to initiating PPPs for roads projects, despite approval being given for seven projects roughly three years ago. Barriers include the setting of appropriate tariffs, with stakeholders noting that individuals who have to pay road tolls are likely to question why they are being charged for some roads and not others, especially if no significant improvements are made to the roads that they pay for. The tradition of providing roads free at the point of use means that the freedom to use the highway has become entrenched in public attitudes. Therefore, there can be strong popular resistance to the introduction of road user charges (CEPA, 2016). A public information campaign would be required to raise awareness of the choices that have to be faced to fund the road sector before road tolling can be introduced. Such a campaign would require support from across government and a strong ‘political champion’ in order to make an effective case for tolling to road users. Furthermore, given the infancy of the sector, the toll roads being developed in Kenya are likely to require guarantees to increase the likelihood of private investment.

Climate finance has also not been successfully mobilised, either to support the infrastructure sector or more broadly. The Green Economy Strategy and Implementation Plan (GESIP) stated that ‘at the international level, Kenya may be underutilising international donor funds available for low-carbon development’ (GoK, 2015b: 8). This was also the sentiment expressed by interviewees.

Ownership and alignment with national priorities. According to the most recent Public Expenditure Review, donor priorities are well aligned with government priorities, with 57% of the portfolio allocated to infrastructure (World Bank, 2014). Moreover, while ‘off budget’ funds undermine strategic prioritisation, this is less of a concern for the three infrastructure sectors considered in this report. This may be because external sources of infrastructure financing are mostly in the form of loans and thus have to be negotiated through the National Treasury. In the energy sector, interviewees confirmed that there are no projects being implemented that are not in the sector plan, including privately initiated investments. Government officials further noted that they have refused projects that are not in the energy sector plan. Similarly, for roads, it is government that approaches donors with potential projects. The donors then decide among themselves which projects to support. Although the non-traditional donors are not part of these donor coordination group discussions, they too rely on government to identify potential projects that need support. While government is clearly aware of the particular interests and priorities of different donors, and is able to approach the relevant donor for funding accordingly, the overall impression given by interviewees was that of relatively strong government leadership and donor alignment in these sectors. What the government does not yet appear to have done, however, is to proactively channel donors into their own priority areas or alter the composition of the donor portfolio.

In regards to leveraging private sector finance to support national priorities, Kenya’s PPP Act states that the default process for selecting private contractors is a competitive one. However, there is also an alternative process, using ‘privately initiated investment proposals’, or unsolicited proposals, which can be approved by the Cabinet Secretary under exceptional circumstances. In these cases, the private partner can submit proposals to the contracting authority (the line ministry). However, both the contracting authority and the PPP Unit still have to approve such projects. Government interviewees indicated that even privately initiated investment proposals must still sit within the sector plan, and it was reported by one interviewee that projects have been refused if they are not consistent with the plan.

Speed. The GoK is dissatisfied with the speed of donors’ activities (slow start-up and disbursement), with a few exceptions, namely China and the AfDB/ADF. Although the budget outlay for infrastructure has increased, execution has declined in recent years, standing at 43% in 2013/14,
down from more than 70% in 2011/12 (World Bank, 2014). Development expenditures for 2014/15 were also well below target (by KSh175.8 billion) due to a slow take-off in domestically financed programmes (KSh54 billion below target) and lower than programmed execution of externally funded programmes (KSh121.8 billion below target) (National Treasury, 2015c). The underperformance in development expenditure reflects low absorption of domestically financed development by MDAs, delay in procurement and low absorption of external funds from development partners. Interviewees stressed that the World Bank and AfDB/ADF must give ‘no objections’ to projects being implemented, which can cause delays. In the absence of any concrete numbers, there was a view that China and the AfDB/ADF were quicker than other donors. In the case of China, this advantage stems from the less stringent conditions and environmental safeguards attached to its finance. In fact, the SGR has proceeded faster than expected, resulting in a frontloading of development spending of about 0.8% of GDP (National Treasury, 2015c).

Although donors’ extensive project preparatory phases and onerous disbursement procedures were identified as reasons for slow project implementation, the GoK’s weak public investment management system has also been recognised as an area of concern (PBO, 2016). Interviewees also noted that delays in the acquisition of rights of way can hinder projects in the energy sector, particularly given the abolition of laws on compulsory purchase of land.

**Debt sustainability.** While few governmental interviewees considered debt sustainability to be a particularly high priority, non-government stakeholders did raise it as an issue of concern. Debt levels are already rising rapidly and are likely to continue to do so given Kenya’s decreasingly concessional financing mix. Parliament has reportedly already raised the total debt threshold slightly to allow borrowing to take place for new priorities, such as energy, ports and the SGR. It is likely that, going forward, Kenya will either breach the East African Community’s 50% debt/GNP ratio or will need to curtail borrowing. A further area of concern is around contingent liabilities, which are not fully captured in the debt analysis. As an example, one interviewee reported that the proposed road annuity programme, which effectively commits the GoK to a stream of payments over a 10-year period, would not be recognised as debt under the current cash budgeting system, although it would be under an accruals-based system.

Moreover, it was reported in a number of interviews that the GoK prefers to offer ‘letters of support’ to companies, rather than formal guarantees, as guarantees would have to be approved by parliament. Letters of support commit the GoK to maintaining the current legal framework and compensating the company if the law is changed. It appears that such letters of support are not captured within the tracking of contingent liabilities, even though they do potentially place a financial burden on the government if the law is changed.

It was also reported that, while officially there was a three-year moratorium on borrowing by counties, which in any case needs to be guaranteed by central government, in practice counties have overdraft debts as well as expenditure arrears. This could also put pressure on overall debt levels in Kenya.
Overall, Kenya is a fast-growing economy with access to a growing range of financing options. The GoK has clear plans for the infrastructure sector and a clear prioritisation of this area. This is reflected in the high and rising share of government and external financing being channelled to infrastructure. The GoK has been successful in mobilising a range of external financing sources and in diversifying its sources of financing for infrastructure development. It has met many of its objectives in this regard.

7.1. Main findings
From our original research questions (see Section 1.2), the following conclusions can be reached.

7.1.1. Composition and volumes of flows and financing instruments

- Infrastructure spending by the GoK, both domestically and externally financed, has grown very rapidly in recent years. It increased roughly 8.5 times over 10 years, from KSh50 billion in 2005/06 to KSh426.3 billion in 2014/15.
- This growth has been supported by a very rapid increase in external financing for infrastructure, which increased more than 18-fold over 10 years, from KSh15 billion in 2005/06 to KSh208.8 billion in 2014/15.
- Chinese support to Kenya has grown particularly rapidly, both in absolute and relative terms. As of 2014/15, Chinese support for the SGR represented 44% of total external development finance for infrastructure in Kenya. China is the largest bilateral donor to all three infrastructure sectors; it finances more than 77% of government expenditure in the railways sector; and in the energy sector it is roughly on par with the largest multilateral donor, the World Bank (IDA), in recent years.
- Kenya issued its inaugural international sovereign bonds in 2014, raising $2 billion in June and a further $750 million in December 2014. Of these proceeds, 43% was allocated to infrastructure with the proceeds from the international sovereign bonds funding more than 50% of externally financed government expenditure in the road sector in 2014/15. Domestic infrastructure bonds have also been issued to finance road and energy projects.
- Kenya has a strong track record on PPPs in energy generation, but limited success in other infrastructure sectors. In regards to the former, the GoK appears to be using the Feed-in-Tariff mechanism effectively, to stimulate the generation of renewable energy that is sold into the grid at a fixed price. However, PPPs have been less successful in the railways sector, in particular in the RVR concession, and have been very slow to develop in the road sector.
- The picture on climate finance is mixed. Kenya appears to be investing heavily in green energy projects, and the donor community is supporting some of this. However, it does not appear to have been very successful in accessing funding from multilateral climate funds. There was also some confusion among interviewees as to the opportunities to mobilise climate finance and the process for doing so, and to coordinate the climate finance internally.

7.1.2. Arenas of negotiation

- In the roads and energy sectors, Kenya appears to have well-functioning coordination committees. Decisions on financing are driven by sector plans. The National Treasury seeks an appropriate financing source for each project. Donors appear to be well aligned behind the GoK plans.
- In the railways sector, a different picture emerges, with no overall coordination process. It is unclear whether this is a cause or a consequence of the very uncoordinated approach to external financing, with DAC and non-DAC donors financing alternative railway lines, which in some places are literally on parallel tracks.
- Kenya’s experience also demonstrates that the process of prioritising between financing sources is more complex than might have been envisaged. The GoK is not making a straight choice between different financing options for individual projects. Even donor-funded projects require counterpart financing, and so in some cases the GoK is raising domestic financing to cover the GoK’s share of project costs, for example through domestic infrastructure bonds. Also, donor borrowing cannot be used to fund recurrent spending, and so again the GoK is seeking alternative financing sources for recurrent
costs, particularly road maintenance. Deficit financing also needs to be covered by bond issuances rather than donor borrowing, which is largely for specific projects. This also explains the GoK’s continued emphasis on diversifying sources of finance.

7.1.3. Priorities for the terms and conditions of development finance

• Kenya’s priorities for the ‘terms and conditions’ of external financing appear to be:
  • maximise concessional resources
  • diversify sources of funding
  • flexibility and alignment with national priorities
  • speed of delivery
  • support for domestic financial markets.

7.1.4. Negotiation outcomes

• The GoK has broadly been successful in achieving its priorities, although external finance is becoming less and less concessional, particularly with the recent loan for the SGR and sovereign bond issuances. This is a trend that is likely to accelerate in the coming years.
• When it comes to speed of delivery, Kenya uses this as a criterion for choosing donors, but the GoK also needs to recognise that some of the delays in project disbursements are due to challenges on its side relating to procurement and the compensation of project affected persons.
• While the GoK does not appear to place a high priority on coordination between traditional donors and China, this lack of coordination is certainly having an impact in the railways sector, particularly in relation to the GoK, and the traditional donor-funded Rift Valley Railway and the Chinese-funded SGR.
• Debt levels are rising rapidly in Kenya, and it is not clear that existing debt management systems are fully capturing all contingent liabilities. This is a particular concern given that 50% of Kenya’s external development finance is now on non-concessional terms. Borrowing terms from key multilaterals are likely to continue to harden as Kenya’s income continues to grow. It is likely that Kenya will either have to curtail its ambitious investment plans or risk debt distress, unless further concessional sources of financing are forthcoming.

7.2. Recommendations

7.2.1. Recommendations for Kenya

• Maintain debt sustainability and improve tracking of contingent liabilities. The GoK, in collaboration with the World Bank, has established a Fiscal Commitments and Contingent Liabilities (FCCL) unit within the Directorate of Public Debt Management. The role of the unit is to implement the FCCL framework for managing and evaluating these fiscal risks for the GoK. According to interviewees, the National Treasury is tracking FCCLs, but these commitments and liabilities are yet to be integrated into the debt management process.
• Improve coordination and leadership in the railways sector, particularly to maximise synergies and minimise duplication between the narrow-gauge Rift Valley Railway and the SGR.
• Either build capacity and awareness on the management of PPPs, or consider alternative financing sources. Ensure that all PPPs are contracted through competitive processes, rather than ‘contractor facilitated financing’.
• Improve the speed of project execution, including procurement.

7.2.2. Recommendations for the international community and development partners

• Consider expanding the supply of MDB finance or other concessional resources for infrastructure, given that Kenya currently appears to be supply-constrained when it comes to such forms of external financing. The shortage of such resources appears to be driving Kenya to borrow at less concessional rates, posing risks for debt sustainability.
• Recognise the potential limits and constraints involved in PPP-type projects. In Kenya, PPPs appear to be running very successfully in the energy sector, but the road sector has faced considerable challenges. It may be important to consider in which sectors and countries PPPs can be effectively used. As illustrated by the Kenyan experience, infrastructure sectors such as roads, where utilisation will not be paid directly by users, are highly unlikely to attract PPPs.
• Improve access to multilateral climate funds.
• Improve the speed of delivery of external finance, and continue to provide support in the roads and energy sectors that is well aligned with government priorities. Consider improving alignment in the railways sector.
8. References


Oxford: Global Economic Governance Programme.


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# Annex 1: List of interviewees

<table>
<thead>
<tr>
<th>Name</th>
<th>Organisation</th>
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<tbody>
<tr>
<td>Mr Anthony N. Mugane</td>
<td>Ministry of Environment, Water and Natural Resources</td>
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<tr>
<td>Daniel Wanbua</td>
<td>Kenya Rural Roads Authority (KERRA)</td>
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<tr>
<td>Felister Kivisi</td>
<td>National Treasury</td>
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<tr>
<td>Glen Tubei</td>
<td>Kenya National Highways Authority (KENHA)</td>
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<tr>
<td>Engineer Isaac N Kiva</td>
<td>Ministry of Energy and Petroleum</td>
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<tr>
<td>Jackson Kinyanjui</td>
<td>National Treasury</td>
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<tr>
<td>Hon. Jackson Kiptanui</td>
<td>Parliament and Vice Chair of Committee on Energy, Information and Communication</td>
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<tr>
<td>Joseph Mdirangu</td>
<td>Parliamentary Budget Office</td>
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<tr>
<td>Joseph Mukui, OGW</td>
<td>Ministry of Devolution and Planning</td>
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<tr>
<td>Kenneth Gitani</td>
<td>Kenya Rural Roads Authority (KERRA)</td>
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<tr>
<td>Eng. Kithinji Kanyaura</td>
<td>KRC</td>
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<tr>
<td>Monica Asuna</td>
<td>National Treasury</td>
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<tr>
<td>Philip Wachira</td>
<td>State Department of Infrastructure</td>
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<tr>
<td>Phyllis Makau</td>
<td>Parliamentary Budget Office</td>
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<tr>
<td>Hon. Dr Reginalda N. Wanyonyi</td>
<td>Parliament and Member of Budget and Appropriations Committee</td>
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<tr>
<td>Reuben Mayienda</td>
<td>Kenya Urban Roads Authority (KURA)</td>
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<td>Eng. Solomon Ouna</td>
<td>KRC</td>
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<tr>
<td>Stanley K. Kamua</td>
<td>National Treasury</td>
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<td>Wohoro Ndoho</td>
<td>National Treasury</td>
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<td><strong>Donors</strong></td>
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<tr>
<td>Dorian Kivumbi</td>
<td>EU</td>
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<tr>
<td>James Maina</td>
<td>IMF</td>
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<tr>
<td>Josaphat O Sasia</td>
<td>World Bank</td>
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<tr>
<td>Dr Klaus Liebig</td>
<td>KW</td>
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<tr>
<td>Patricia Bacchi</td>
<td>US Department of the Treasury, Office of Technical Assistance</td>
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<td>R. Armando Morales</td>
<td>IMF</td>
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<tr>
<td>Remi Fritsch</td>
<td>AFD</td>
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<tr>
<td>Samuel J. Kamara</td>
<td>AfDB</td>
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<td>Dr Steve N. Mogere</td>
<td>JICA</td>
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<td>Yves Boudot</td>
<td>AFD</td>
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<td>Zerfu Teseema Mammo</td>
<td>AfDB</td>
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<td><strong>Other</strong></td>
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<tr>
<td>Hannah Ngugi</td>
<td>Trade Mark East Africa</td>
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<tr>
<td>James Njiraini Gachanja</td>
<td>KIPPRA</td>
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<td>Maria M Karuru</td>
<td>Trade Mark East Africa</td>
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<td>Dr Mark Korir</td>
<td>African Economic Research Consortium</td>
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<tr>
<td>Moses Njenga</td>
<td>KIPPRA</td>
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