

Presentation

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WEEK

Using ODA to Leverage Repayable Financing: Recent Trends

A presentation at *World Water Week*
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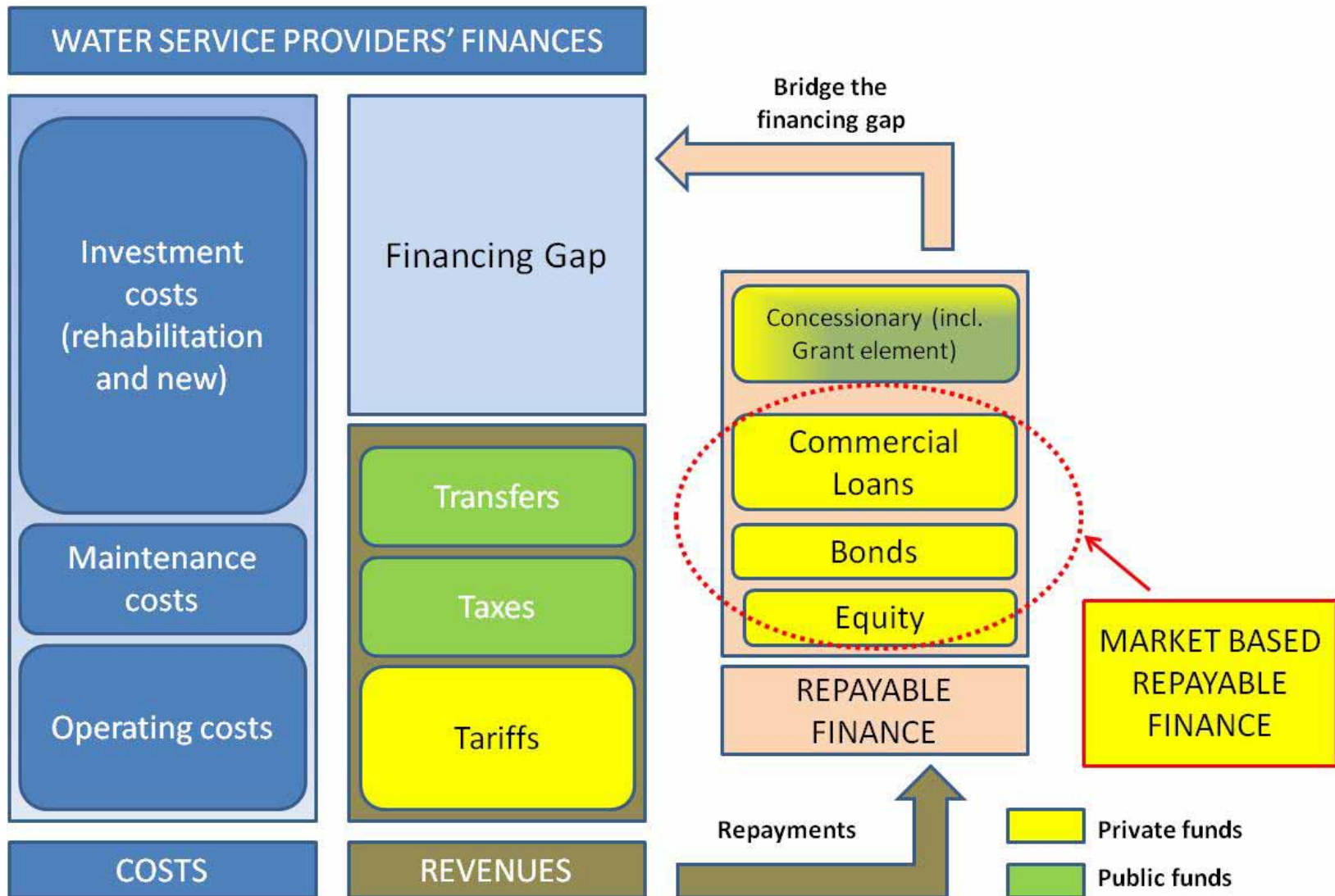
Introduction

- **Key question:** how can ODA (Official Development Assistance) be best used to mobilise repayable finance for water and sanitation services in the current financial crisis?

- **The context**
 - Looking back: six years since the Camdessus report (2003)
 - Looking forward: in the context of the financial crisis, private funds have generally dried up, placing increased pressure on public funds

- **Based on recent work**
 - “Innovative financing mechanisms for the water sector” (in draft), part of the OECD Horizontal Water Programme
 - Focused on leveraging market-based repayable finance in both OECD and developing countries

Financing sources for watsan



Critical mismatches and innovation

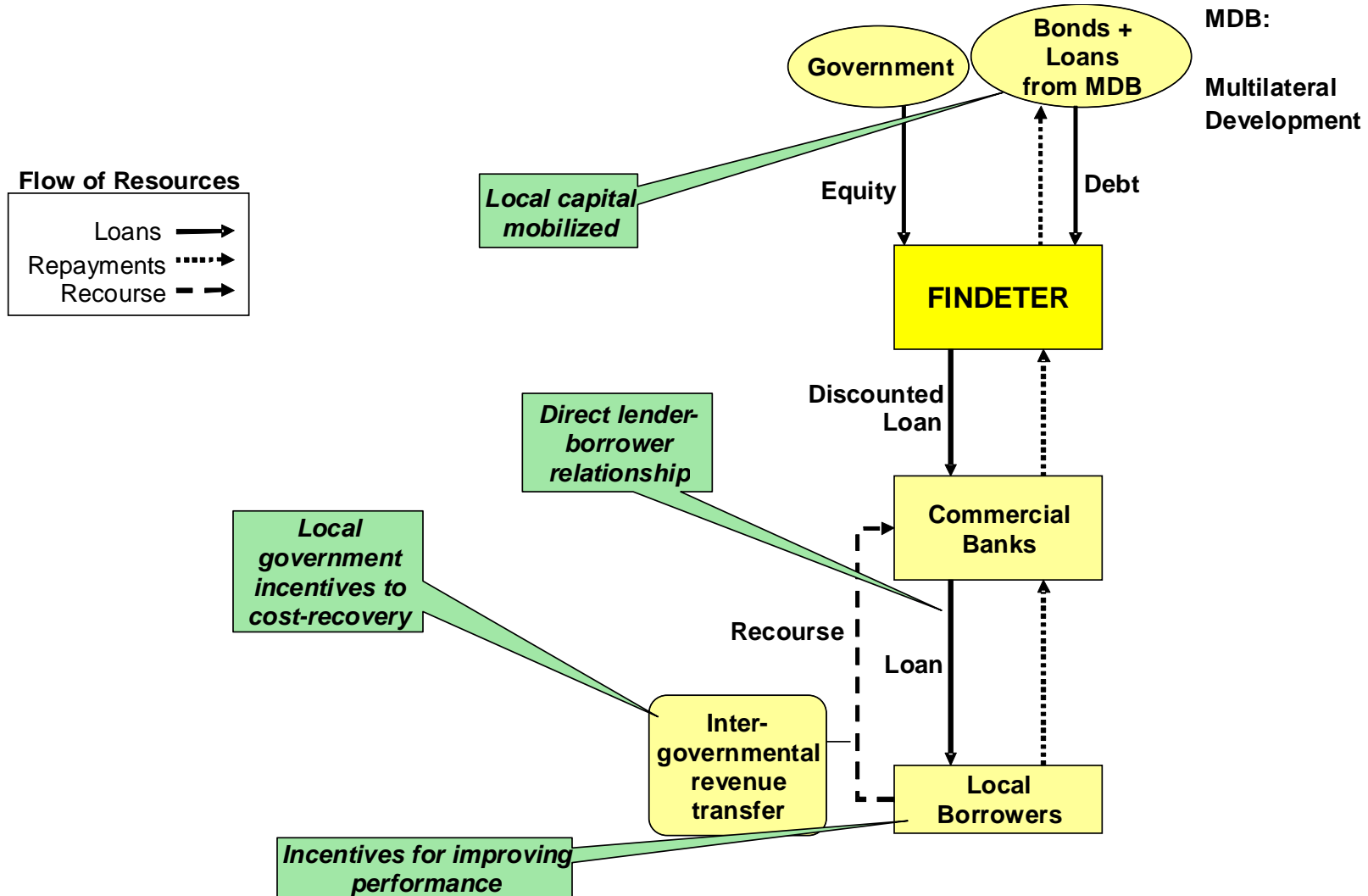
Critical mismatches	Innovative instruments that can be supported by ODA
Affordability constraints	<ul style="list-style-type: none"> • Micro-finance, output-based aid, blending grants and loans
Limited availability of funds for domestic operators and SSWSPs	<ul style="list-style-type: none"> • Micro-finance, Output-based aid and innovative contracts
Risk profile and difficulties in managing certain risks (e.g. political risk, foreign exchange risk)	<ul style="list-style-type: none"> • Guarantees, insurance, devaluation backstopping facility • Local-currency financing, revenue agreements
Lack of funds at decentralised level	<ul style="list-style-type: none"> • Municipal bonds, pooled funds, revolving funds, bond banks • Instruments to increase sub-sovereign lending
Short tenor of available financing	<ul style="list-style-type: none"> • Guarantees and equity contributions
Under-capitalized balance sheets	<ul style="list-style-type: none"> • Raising equity to strengthen the balance sheet, convertible loans, debt-equity swaps
Lack of understanding by external lenders and investors	<ul style="list-style-type: none"> • Blending of public and private finance, credit ratings
Lack of “bankable” projects	<ul style="list-style-type: none"> • Project preparation facilities

Combining types of finance

■ Blending public and private financing

- Blending consists of combining concessionary finance with repayable finance to support a project or comprehensive lending program
- Main purpose is to attract financing that would otherwise not come whilst ensuring that the poor are not excluded
- At project level
 - Lead financier to prepare overall project and combine private and concessionary finance (e.g. EIB in Maputo)
- At “institutional” level
 - ACP-EU Water Facility (leverage ratio of about 1.8)
 - Underlying premise for PIDG facilities – not been very active in the water sector, now considering a concessionary “Water Window”
 - More success with domestic facilities, e.g. FINDETER in Colombia

Blending: FINDETER (Colombia)



Dealing with affordability constraints

■ Micro-finance

- Great potential but limited use in the water sector (lack of awareness)
- Potentially negative impact from financial crisis
- Donors can provide seed finance, blend micro-finance with other financing instruments such as OBA
 - *See K-Rep project in Kenya*

■ Output Based Aid (OBA)

- Growing number of OBA projects in watsan but limited scale-up
- Mostly focused on financing connections
- Reputation for complexity and high transaction costs
- Donors need to recognise pre-financing constraints and mainstream the approach in countries' financing strategies
 - *See OBA facility in Honduras*

Increasing access to long-term finance

■ Guarantees and risk insurance

- Guarantee and risk insurance products widely available from IFIs & donors but limited take-up in water sector – Possible reasons:
 - IFIs have rigid in-house rules about guarantees (leads to high costs)
 - Guarantees from IFIs suited to large transactions
 - Foreign exchange risk remains a thorny issue
- Donors could support the establishment of domestic guarantee facilities to guarantee domestic loans & bonds in local currency

■ Equity injections

- Equity injections can strengthen the balance sheet and leverage other types of finance for investment
- Donors can enter into debt-equity swaps (Senegal) or request equity from operators in PSP deals (IFC in St Lucia) but guidance needed on when donors should contribute new equity themselves

Guarantees: LGUGC (Philippines)

■ Water services underfinanced in Philippines

- Provided by LGUs, water districts (corporatized entities) , private operators or SSWSPs
- Commercial lenders unfamiliar, unwilling to take risks
- Many providers had weak balance sheets

■ Local Government Unit Guarantee Corporation (LGUGC)

- Set up 1998 - owned by public and private owners, initially supported by ADB & Development Bank of the Philippines
- Guarantee mechanism + credit rating services

■ Outcomes

- Supported development of a small but growing LGU bond market (rarity in developing countries): USD 60 mn outstanding 01/09
- Most municipal bonds got LGUGC guarantee
- 9 out of 26 projects guaranteed for the water sector

Lack of funds at decentralised level

■ Grouped financing mechanisms

- Make finance available to small borrowers at much better terms
- Initial model: State Revolving Funds in the US (tax-exempt)
- Used as a way to channel public finance and mobilise market finance (with guarantees provided by private insurers to improve rating)
- Replicated in India, Philippines, Mexico (with USAID support)

■ Instruments to increase sub-sovereign lending

- Some IFIs have started lending without sovereign guarantee: revenue agreements in lieu of guarantees
- EBRD's Municipal and Environmental Infrastructure team leading the way in this (MEI = 48% EBRD lending, of which 56% to water sector)
- World Bank/ IFC Municipal Fund
- Critical area to develop: local currency financing

Improving information flows

■ Credit Ratings

- Limited use of credit ratings for water outside OECD countries
- India: significant development for local government bodies
- Philippines: grading municipal authorities based on credit-worthiness
- WSP /PPIAF supported “shadow ratings” for SSA water utilities
- Possible donor involvement:
 - Support demand for credit ratings
 - Support development of credit agencies (and financial markets)?

■ Project Preparation Facilities

- The lack of “good projects” remains the main constraint
- A few attempts to redress this
 - Mostly international initiatives for a specific region (e.g.PPC for Eastern Europe, FEMIP for the Mediterranean, ACP-EIB Water Project Preparation Facility)
 - Have been useful at regional level: sped up delivery and increased efficiency
 - Establishment at national level could help reduce transaction costs

Impact of financial crisis

■ On availability of repayable financing

- Sharp drop in lending volumes, increased cost of debt, reduced tenor
- Micro-finance institutions suffering as well
- Corporate bond markets “closed” in early 2008 but reopened for investment grade debt, at higher costs
 - Isolated successes: over-subscribed issue for Manila Water with domestic Aaa rating (Oct 08)
 - No high-yield bond issuance in water since SABESP (BB-) in 2006
- Many project finance deals stalled or put on hold
- Listed water companies’ prices went down sharply in 2008, IPOs put on hold (e.g. Maynilad)

Impact of financial crisis on 3Ts

■ **Tariff revenues likely to remain low**

- **Economic crisis:** reduced demand for traded goods (including agricultural and raw material), lower remittances, price inflation
- Increased poverty: 65 million more people < USD 2/day (WB)

■ **Tax transfers to surge only where stimulus packages target water and sanitation**

- Substantial increases in public borrowing limit government transfers (some governments have already cut sector allocations)
- Some “green” stimulus packages include water programs

■ **International transfers will increasingly be needed**

- Research found that ODA usually falls during economic crisis
- IFIs going through a very busy period (fill in the gap)
- Major WB initiative to support infrastructure sector (INFRA)
- Support to all financial market segments e.g. IFC & KfW microfinance

Going forward

- **Concessionary finance will be needed to get credit flowing but limited funds available**
 - Leveraging and targeting of public funds will be key
 - Viable innovations need to be scaled-up with donor support
 - Change financiers' perception of the sector, from a "high risk/low return one" to a "low risk / low but steady returns" one

- **Emphasis should be placed on institution-building rather than on specific transactions or pilot projects**
 - Adapt to the evolving structure of the water market (more local, national and regional operators than international ones)
 - Cut down transaction costs
 - Attract repayable finance for both public and private operators