

# Mobilizing market finance for water and sanitation services

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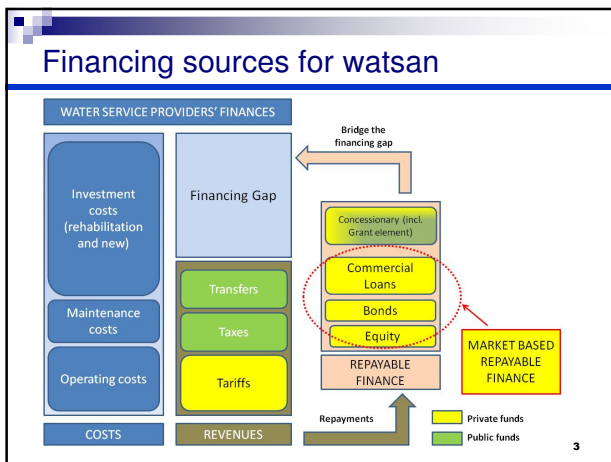
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## Introduction

- **The problem**
  - Water and sanitation (WATSAN) are essential services
  - High investment needs
  - BUT
  - Notoriously difficult to finance
  - Perceived to be a highly political sector: high risks / low returns
- **Question:** how can public funds be best used to mobilise repayable finance for water and sanitation services?
- **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

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## Critical mismatches and innovation

Critical mismatches	Innovative instruments that can be supported by public sector
Affordability constraints	• Micro-finance, output-based aid, blending grants and loans
Limited availability of funds for domestic operators and SWSPPs	• Micro-finance, Output-based aid and innovative contracts
Risk profile and difficulties in managing certain risks (e.g. political risk, foreign exchange risk)	• Guarantees, insurance, devaluation backstopping facility • Local-currency financing, revenue agreements
Lack of funds at decentralised level	• Municipal bonds, pooled funds, revolving funds, bond banks • Instruments to increase sub-sovereign lending
Short tenor of available financing	• Guarantees and equity contributions
Under-capitalized balance sheets	• Raising equity to strengthen the balance sheet, convertible loans, debt-equity swaps
Lack of understanding by external lenders and investors	• Blending of public and private finance, credit ratings
Lack of "bankable" projects	• Project preparation facilities

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## Financial innovation in England&Wales

- **Institutional and regulatory contexts**
  - Full privatisation via sale of assets in 1989
  - Incentive-based regulation (RPI-X, 5-year periodic reviews)
  - EU directives drive huge investment program (£80bn 1990-2010)
  - CoC key component of revenue requirement
- **Financial innovation to drive down CoC**
  - Switch from equity to debt finance (e.g. Glas Cymru, 100% debt)
  - Grouping of small companies with guarantees from monoline insurers: enabled them to access bond markets
- **Impact and replicability**
  - Access to longer term finance (pension funds)
  - Overall increase in gearing (from 20% in 1995 to 66% in 2008) whilst maintaining investment grade rating reduced CoC
  - Financial crisis: demise of monoline insurers and private equity

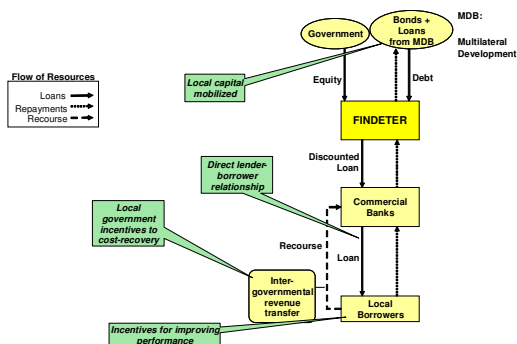
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## Combining types of finance

- **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)
    - Limited success at international level (e.g. PIDG facilities)
    - More success with domestic facilities, e.g. FINDETER in Colombia

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## Blending: FINDETER (Colombia)



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## Dealing with affordability constraints

### Micro-finance

- Great potential but limited use in the water sector (lack of awareness)
- Potentially negative impact from financial crisis
- Public financiers could 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 would need to recognise pre-financing constraints and seek to mainstream the approach in countries' financing strategies
  - See OBA facility in Honduras

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## 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 could 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

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## 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

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## 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

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## 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

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## 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)

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## 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 public 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

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