Outcomes of the Side Event:

Becoming Bankable: Experiences and Challenges in Market-Based Finance in the Water Sector

at WORLD WATER WEEK in Stockholm, August 17–23, 2008

Introduction and Background

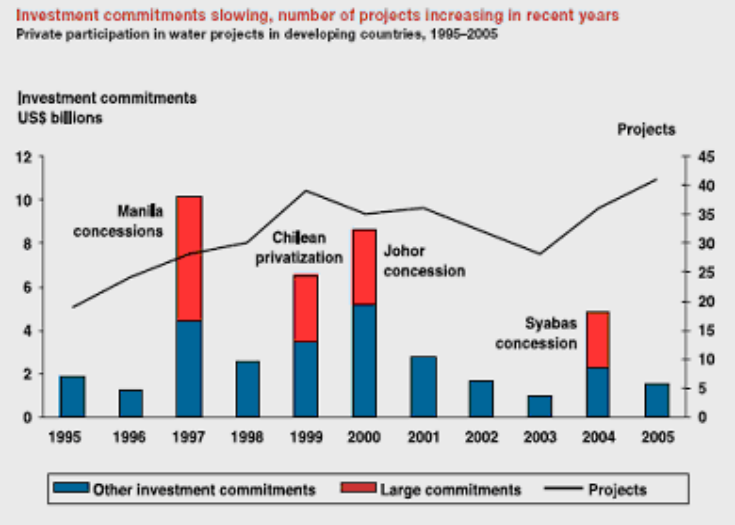
The water sector is chronically under-funded, especially in developing countries. Since the *Camdessus Panel* formulated its analysis and recommendations on *financing water for all*, the need for the mobilization of private sector finance into the water sector and the different approaches by which to achieve this mobilization have more and more come to the foreground of the international *water-supply & sanitation* agenda.

The discussion is by all means a different one than that on the privatization of water. Even though it comprises facets of it, this discussion is primarily not about the ownership of water utilities or water infrastructure, but about the sources of private funding to finance water utilities and water infrastructure, whether private, public or mixed, the essential question being: how can the financial sector and the capital markets, both on international as well as domestic levels, become the dynamic sources of sustainable funding for the water sector as they are for other sectors of the economy?

We will have to also recognize the fact that public-private partnership in the form that we have known in the past (i.e., a conventional build-operate-transfer or a concession) will play a much lesser role in the near term and that publicly owned utilities and their local governments may need financial support and enhancements to tap private sources of debt financing.[1]

The above question remains more relevant than ever: despite the fact that the number of water projects with private participation in developing countries continues to increase (from under 30 in 2003 to over 40 in 2005), private funding contrarily, albeit traditionally marginal, continues to follow a negative trend. The figure below demonstrates this for the case of projects with private participation and entirely private water projects. There are no figures available for the amount of private finance flowing into entirely public water projects (i.e. sub-sovereign finance; corporatized public utilities; etc.).

Figure 1



Source: World Bank and PPFIA, PPI Project Database

[1] *Financing Water Supply and Sanitation Investments: Utilizing Risk Mitigation Instruments to Bridge the Financing Gap,* Aldo Baietti and Peter Raymond, World Bank, 2005

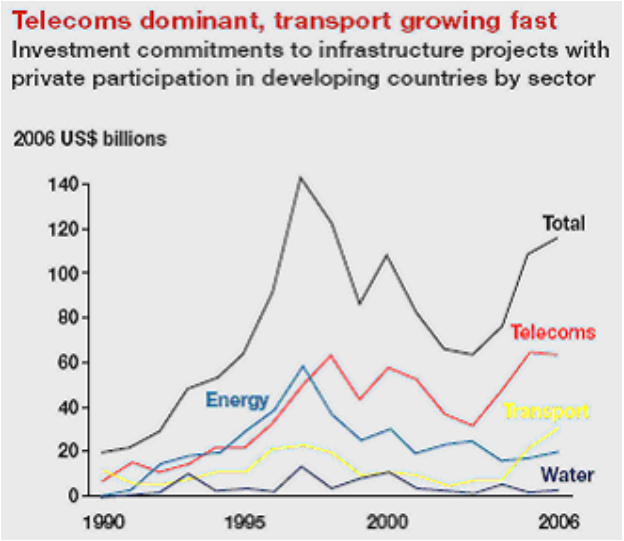
The World Water Week 2008 side-event entitled "Becoming Bankable: Experiences and Challenges in Market-Based Finance in the Water Sector" brought together the perspective of water financiers – both private and public – with that of developing country water operators to discuss how more private finance can be pumped into water projects.

Why then do **private financiers and capital markets actors** lack interest in the water sector? The report of the Camdessus Panel delivers the following answers:

- Project profile: capital intensive with high initial investment and long payback period.
- Low rate of return.
- Foreign exchange risk: mismatch between revenues in local currency and finance in foreign currency.
- Sub-sovereign risk: decentralized water agencies with service responsibility but lacking financial resources and credit standing.
- Risk of political pressure on contracts and tariffs, with weak and inconsistent regulation.
- Contractual risk: projects of long duration entered into on the basis of poor initial information.

But while all of these characteristics may indeed apply to the water sector, they do so too when it comes to other sectors. For instance, transport or energy infrastructure are equally capital intensive and require a high initial investment, their ultimate revenue streams – essentially service delivery bills/charges to end consumers - being usually denominated in local currencies as well; the public institutions behind the energy and transport sectors usually lack the financial resources and credit standing and there is no fundamental reason why the contractual risk components should be more severe in the case of water projects than in the case of energy or transport infrastructure. The question then is why is water stagnant in attracting private investment commitments while transport experiences considerable growth?

Figure 2



Source: World Bank and PPFIA, PPI Project Database

Does the answer reside in the fact that, unlike transport facilities, water is essential for life, not substitutable, and that therefore ideological conflicts are more likely to arise over water issues? Is the resulting political risk of "pressure on contracts and tariffs, with weak and inconsistent regulation" hence really the key deterrent for investors and financiers when it comes to water supply & sanitation? Everything points to that. What can be done about it?

As with every other type of transaction, those into the water sector consist of a "giver of money" (typically lenders or investors) and a "receiver of money" (borrowers or investees can be private or public water utilities, infrastructure developers, public water authorities, etc.) and it makes sense to analyze the above conundrum looking at each side of the coin first.

The Investor Perspective: Combining Bankability with Social and Environmental Sustainability

"Political pressure on contracts and tariffs" is mostly justified on the grounds of social and environmental problems.

In other words: on the one hand investors and financiers want bankable, financially sustainable water projects; on the other hand, apart from financially sustainable water projects, what local communities want are, moreover, water projects which are socially inclusive and environmentally sustainable.

So while investors and financiers may only be able to marginally strengthen the regulatory systems in a given location they may be able to address, on a project-by-project basis, environmental and social issues **mitigating political risks at their very root**. The answer can hence lie in commercial investment and finance styles that take into consideration environmental, social and governance (ESG) issues.

A good example of such a project-based fund focusing on the water sector is the *SNS Reaal Water Fund.* While transactions must yield a minimum ROI of 5% ensuring the profitability of operations on both sides of the coin, with tenors of around 7 years, payback periods are adequate and realistic in terms of the requirements of water projects. The financial as well as social and environmental sustainability of candidate projects is ensured through a holistic and integrated due diligence process that explicitly takes into account the following assessment criteria:

Figure 3

Source: SNS Reaal Water Fund

More precisely, on the one hand, SNS Reaal Water Fund's criteria for financial sustainability include:

- Profit generation *(Value creation)*
- Continuity of investments *(Stability)*
- Safety of investments *(Predictability)*
- Efficiency *(Transaction costs)*
- Reliability & Compliance *(Regulations)*
- Fiduciary role *(Safeguarding and prudently handle funds entrusted)*
- Reputation

On the other hand, its criteria for overall sustainability include:

- Stakeholder approach by project sponsors, accountability, public acceptance of project
- Sustainability: comprehensive options & opinions assessment
- Addressing appropriate solutions on: technology, management, service & financial engineering
- Sustainability with regards to water- and ecosystems and livelihoods
- Recognising entitlements and sharing benefits
- Legal Framework, government, ensuring compliance
- Equality: Sharing water systems/resources for stability, development and security

However, whereas an ESG-inclusive investment / finance style my be of considerable business benefit in mitigating political risks especially in the water sector, the first thing that water projects must fulfill is to be bankable in conventional terms, meaning financially robust – given the rather long tenors needed – also in the medium to long term. The reason is simple: commercial viability of a planned transaction is always the first selection filter in all financial institutions, even those with an explicit ESG-mandate.

Many participants in the workshop argued that there is not a lack of finance in the sector but rather a lack of truly bankable projects. Therefore, how can unbankable projects be made bankable?

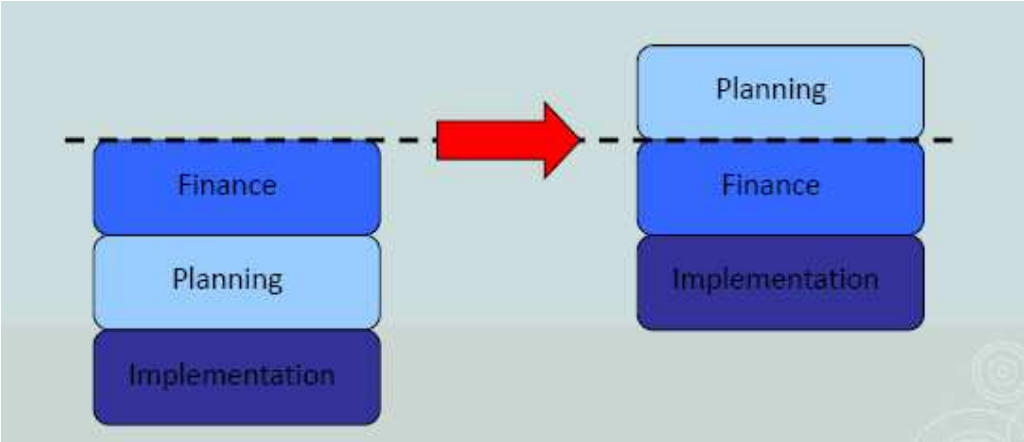
The Sponsor's Perspective: How to Become Bankable?

It is important to understand the historic context of how water supply and sanitation activities in developing countries have been funded in the past to recognize the current weaknesses of the sector and formulate recommendations for the future.

One of the key reasons for the sector's inability to leverage private sector resources was named as its historical reliance on public funds - either from local authorities or ODA donors - that is believed to have lead, given their grant character and the resulting non-necessity of repayment, to inefficient and non-cost-recovering operations being tolerated by the responsible authorities. In other words: "gratis" donor funds are believed to often crowd-out to-be-paid-for private finance.

Furthermore, the reliance on grant funding - which being subject to volatile public budgets and the ODA policies of donors is considered unreliable - lead to a paradigm whereby projects would only be planned after the financing had been secured. Obviously, this is not the way private finance works. One of the first essential steps towards better access to market-finance is therefore the achievement of the following fundamental shift in paradigms:

Figure 4



Source: Water & Sanitation Program

The planning phase must especially include strategies and activities that will ensure the financial viability of the project and its ability to meet repayment and interest obligations (or dividend expectations). Concretely, the financial viability will depend on the project's expected ability to ensure:

1. Water resource efficiency
2. Billing efficiency
3. Tariff predictability and reliability
4. Transparency of financial flows
5. Public acceptance through demonstrable service improvements or/and network expansions

It was furthermore argued that in order to ensure especially points 2, 3 and 4 water utilities should act as independently as possible from local authorities and that it should be organized and structured in a way that private financiers and capital market actors can understand and assess. The concept of *corporatization* was mentioned as a promising way of achieving management efficiency, accountability and independence in water utilities while at the same time avoiding the entire privatization of the water supply and sanitation networks. The effect of corporatization is to convert state departments into public companies and interpose commercial boards of directors between the shareholding authorities and the management of the enterprises. These state-owned enterprises are organized in the same manner as private corporations, with the difference that companies' shares remain, at least partially, in public ownership.

It is precisely the above mentioned donor and public grant funding that should be used for such one-off reform and restructuring processes as well as institutional capacity-building measures (with regards to internal processes such as treasury management for instance); such approaches of blended funds are expected to be most promising, as private finance will only be available for the later (commercial) stages of project development.

Last but not least: the FX issue.

In addition to considerable political risks, water-supply and sanitation transactions are especially exposed to foreign exchange risks, the project's revenue streams relying exclusively on service bills denominated in local currency. It is believed that the downfall of the Peso during the Argentinian financial crisis became the key trigger for the failure of the *Aguas Argentinas* concession in Buenos Aires, as a freeze in tariffs at the time of

the devaluation substantially reduced the real value of tariff revenues and thus made it difficult to achieve the expected targets and fulfill foreign capital service obligations.

Currency crises have demonstrated the limits of contractual agreements, where despite provisions to the contrary, currency devaluation could not be offset by commensurate tariff increases. In many instances, such tariff increases were politically and socially infeasible to effect[2].

The most straight-forward way of dealing with foreign exchange risks is to match the currency of the revenue streams with that of capital (debt + equity) service obligations. The keywords are *local currency lending* and *development of domestic capital markets*. It remains doubtful, however, whether emerging and rudimentary local capital market actors will be attracted by the rather intricate water sector: *in many developing countries, the depth and breadth of domestic financial markets are not sufficient to mobilize long-term financing at affordable rates.*[3]

Public and private international finance institutions can play an important role here. This role my not necessarily imply the direct provision of local currency loans given their internal risk management requirements often allowing them only to do so if either the loans can be appropriately refinanced locally as well or if cross-currency swap markets are available to hedge the foreign exchange exposure.
It may rather imply advisory and managerial services such as the *project structuring to match revenue generation with liabilities, [the] channelling of local savings into water investments, [the] incorporation of local debt holders as stakeholders in projects, [the] introduction of market performance benchmarks to improve risk-and-return ratio for local savings instruments, or [the] development of swap instruments*[4] in the case of their unavailability.

[2+3+4] *Financing Water Supply and Sanitation Investments: Utilizing Risk Mitigation Instruments to Bridge the Financing Gap,* Aldo Baietti and Peter Raymond, World Bank, 2005