EU Water Initiative: Finance Working Group

DFID Preliminary Thoughts for July 9th and August Meetings

The following is a compilation of thoughts and issues to be discussed during the informal meeting of the FWG on 9th July in London. In preparation for the next formal meeting of the FWG in Stockholm in August, the scope of the issues to be addressed during the session will need to be identified along with a structure and format to maximize the opportunity for the sharing of ideas and experiences during that meeting.

The context of the water sector and its financial needs have been addressed in the report from the First Work Programme and therefore do not need to be revisited during these discussions. The current discussions are focused on the experiences that different members of the FWG have had with financing mechanisms in-country. It will endeavour to identify the characteristics of those mechanisms that encourage success and those that impede the success of the financing.

The following are a few of the most difficult issues encountered by local governments and actors in the water sector in developing countries, which should be addressed within the context of the FWG's experiences with financial mechanisms and the access of the poor to water and sanitation services. The establishment of these categories is intended to provide a structure for discussion, but not to limit the scope of the discussion.

1) Insufficient institutional integrity

Funding needs to arrive at its intended destination and provide the desired benefit. This is often not the case, with the recent country dialogue in Zambia identifying all too clearly the leakage of funds away from the intended destination. This need for institutional integrity is increased by the fact that budget funding (backed up by PRSPs) is now one of the preferred mechanisms for many donors to provide funding.

Lenders and donors therefore apply conditionalities (much resisted by developing countries and NGOs) partly to compensate for concerns the institutional structures cannot or will not deliver the funding and benefits in the desired manner. But, conditionalities are a blunt instrument. In the past, private sector structures were viewed as an effective method of creating a contractual, ad hoc institutional structure that would improve the flow and benefit of funds. Financial mechanisms that address institutional integrity issues can reduce the need for the standard suite of conditionalities often applied to financing.

- Sub-sovereign lending (see list below)
- Micro-finance
- GPOBA

2) Risk of political interference

The water sector is perceived to be particularly vulnerable to short-term political agendas that tempt politicians to inter alia reduce water tariffs or use water companies to provide employment regardless of the company's management needs in order to win votes. Local water entities are often frustrated by reductions in their cash flow or ability to act due to such political requirements. Funding or finance allocated to the water sector can also be captured or diverted by specific interest groups.

Financial mechanisms often seek contractual or commercial structures that insulate or protect local entities and allocated funding from such political interference. Some mechanisms will provide a certain level of protection to financiers.

- Partial risk guarantees from ECAs or MIGA
- IFC umbrella
- Bilateral trade agreements
- Political risk insurance
- Central government guarantees or undertakings

3) Lack of focus on the poor and specific needs of the community

The interests of the poor are rarely a condition precedent to financing, yet the nature of service delivery to the poor often weakens the commercial viability of the enterprise due to the inability to achieve cost recovery from the poor. One solution is for donors and IFIs to require affirmative evidence of pro-poor focus of project and community buy-in before other funding is provided. This then creates conditionalities to funding. And there does not appear to be an globally acceptable set of pro-poor criteria that might be attached to funding.

Another solution is for donors to provide focused pro-poor subsidies and develop capacity in the context of community based solutions that remove some of the cost base of providing services to the poor and render those services cost effective and commercially viable. This may involve subsidizing connection charges for the poor or promoting output based aid with specific outputs to support the pro-poor agenda.

- CLIFF
- GPOBA

4) Insufficient revenues to cover cost of financing

In order to obtain financing, local entities will need to have proven, sustainable revenues at a sufficient level to repay any debt. Reaching out to the poor is often not a commercially viable enterprise, and therefore does not help the entity justify further financing. Assistance is needed in managing revenues (through tariffs, environmental charges, subsidies or grants) and reducing costs in order to merit further financing. These needs can be met by technical assistance funds that provide capacity building in business management, financial engineering and cost efficiencies.

- PAWS

5) Weak or non-existent regulation, legal system or access to justice

Local and non-state service provision is often limited in its ability to obtain financing by the significant risks associated with the lack of a level playing fields, the failure to establish rules to protect the consumer and the poor and enabling the service provider to understand its obligations over time. This is often replicated by strict and lengthy contracts, in an effort to create that certainty. But such contractual mechanisms generally limit the flexibility of the service provision and therefore require periodic renegotiation. In order to ensure community and commercial buy-in, it is often necessary to create other incentive structures. The capacity building necessary to assist in the development of regulatory, legal and justice systems is available from a variety of technical assistance funds. One criticism of these funds is that they focus too often on a limited scope of solutions.

- DevCo
- IFC funds
- EBRD
- World Bank

6) Lack of capacity amongst national or local government representative

The local entity often does not have the experience or resources to understand the detailed implications and requirements of the process of selecting financing mechanisms and managing the negotiation and implementation of the selected mechanism. Some financing mechanisms are available to fund the technical and financial advice needed to select the right financing mechanism. One criticism of such funds is that they are often tied or biased toward a given solution. They are also generally related to one specific project or task, rather than the long-term viability of the sector.

- DevCo/IFC prep funds,
- FIRST
- PPIAF
- EAP Task Force
- PAWS
- Development Credit Authority
- UNDP's PPPUE
- WB/EC Joint Environmental Programme
- GPOBA

7) Existing debt burden on central government

The crisis in the water sector is often partially caused by the inability of the central government to obtain additional debt, due to its existing debt burden or IMF conditionality. This reduces the level of funding available to the Central Government and therefore the level of funding made available by the treasury to the water sector. Effort is therefore needed to encourage the water utility to reduce costs and improve revenues without any additional government funding, or to obtain direct donor funding or soft loans that do not viaolte the relevant conditionalities.

- IDA
- HIPC funding

- Donor grants and soft loans directly to local entity

- Debt swaps for water

8) Sub-sovereign risk

Through programmes of decentralisation, and accident of history, many water and sanitation utilities are housed in or managed by local or municipal government entities or community based organisations. In certain cases, this decentralisation process leads national governments to refuse to provide guarantees or other credit enhancement to the relevant local entity (e.g. India). Financial mechanisms therefore need to be able to provide resources to such sub-sovereign entities.

- EBRD sub-sovereign lending,

- Municipal bond financing

- Donor, BLA or MLA support (insurance/guarantees/risk mitigation) to encourage local markets, like Tlalnepatlan (Mexico) and Johannesbourg, SA.

- Joint credit pools

- CLIFF

- Micro-financing

- Community financing and credit schemes

- Credit ratings to encourage foreign direct investment in such bonds

9) Currency exchange risk

Much of the financing mechanisms available are denominated in US$, Euro and Sterling, little of it is denominated in local currencies. Where the rate of exchange between the currency of debt and the currency of revenue is different, the cost of water services are subject to the risk that changes in the rate of exchange between these two currencies can make the repayment of financing relatively more expensive in local currency.

Recent examples include the effect of the Asian crisis on the concessions in Manila, Jakarta and the Philippines, the effect of devaluation on the Argentine concessions, and in Mexico after the fall of the Peso. Financing mechanisms that manage currency risk are generally more sustainable than those that do not.

- financing in the local market in local currency,

- hedging facilities,

- local currency loans from the EBRD,

- Guarantco

10) Risk

The water sector raises issues associated with risk (including the issues addressed above) often very different from other sectors. Those managing financial mechanisms that focus on a number of sectors or uses will find it easier to provide financing to those other sectors, and not the water sector, where the risks are fewer and easier to manage. Financial mechanisms should set aside funds specifically for the water sector, and apply risk requirements to those funds that are appropriate to transactions in the water sector (i.e. much less strict than would be applied to other sectors). This supports the creation of water funds, such as the EU Water facility and the African Water Facility that address risks in a manner specific to the water sector. Or financial mechanisms could provide risk mitigation specifically for the water sector, in view of the risk intensive nature of this sector. This would call for partial risk guarantees, leveraging of financing with donor grants (similar to the EAIF) and proactive matching of equity, grant and financing based on the needs of specific projects (like the PPC).