BLENDED FINANCE FOR WATER INVESTMENT

Closing the financing gap for water in line with SDG ambitions: the role of blended finance

October 4-5 2018, Eschborn, Germany

Conference Outcomes

Water is critical for all of the Sustainable Development Goals (SDGs), especially those on food security, healthy lives, energy, sustainable cities, sustainable consumption and production, and marine and terrestrial ecosystems. SDG 6 specifically reflects the critical importance of water in its own right, ensuring availability and sustainable management of water and sanitation for all.

Water investments have traditionally relied on public finance, with concessional finance playing an important role in developing countries. On the one hand, developing country governments are financially constrained. On the other hand, economic growth has fostered domestic savings and nurture financial industries, in most developing countries. This highlights the urgent need and the opportunities to address the obstacles to mobilize commercial finance for water-related investments.

One promising approach is blended finance, defined by OECD as the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries. Yet, ambitious efforts by governments, bilateral development agencies and development banks to mobilise additional finance have so far remained uncoordinated and have not delivered the substantial mobilization necessary for delivering the needed investments. In particular, there is little dialogue between public sector actors and private sector specialists around effective and innovative applications of blended finance to the water sector.

The GIZ-OECD Conference convened leading experts from both the finance and the water policy communities, including policy-makers, development practitioners, representatives from financial institutions and private sector actors. The discussions highlighted examples of case studies of blended finance for water as well as the enabling conditions that promote the effective use of existing sources of finance.

Key messages and policy recommendations

Several key messages and policy recommendations derive from the discussions:

- The effective use of blended finance can better target scarce development finance to help to mobilise additional sources of finance for water. In addition, encouraging access to commercial finance can strengthen financial discipline of water utilities and promote the development of domestic capital markets. Blended finance approaches should aim to promote local currency financing and domestic resource mobilisation.
- Case studies shared covered examples in Mexico, the Philippines, Jordan, South Africa and India demonstrating that there is scope for blended finance for different types of water-related investments (e.g. bulk water supply, wastewater treatment, water supply and sanitation services, etc.) in different country contexts.

- There is a recognition that substantial inefficiencies in the WASH sector in some countries undermine effective use of available funding. Given that blended finance cannot fix a business model that does not work, efforts to mobilise additional sources of finance must be accompanied by reinforced efforts to maximise the effectiveness of current sources of finance and existing assets. This requires strengthening utility management as well as the broader enabling environment (e.g. the policy framework and institutional arrangements).
- The allocation of development finance should seek to strengthen the enabling conditions to promote sustainable financing arrangements for water-related investments (water supply, sanitation, protection against risks of droughts, floods or pollution management). Development finance should avoid inefficient subsidies, which may channel additional finance into the sector but can crowd out other sources of finance and fail to trigger benefits in terms of water security and sustainable growth. The interlinkages between financing and the broader enabling environment merit closer attention, drawing in particular on experience with result-based financing models.
- For urban water utilities, there is a need to critically evaluate whether subsidies primarily benefit those already connected to the piped network or are targeted at extending coverage and services to previously unconnected households (or both). Meanwhile, rural water needs are critical and blended finance actors are also important in promoting off-grid solutions, where DFIs (including local ones) can play an important role.
- Lack of cooperation among various finance providers in a given market can generate barriers for the broader uptake of blended finance and undermine incentives for creditworthy borrowers to access commercial finance. Development financiers should seek to crowd-in rather than crowd-out private financiers. While there is general agreement about the need for improved cooperation, actions on the ground may remain fragmented. The development of sector financing strategies and national WASH investment plans are among the tools that could help improve co-operation.

Next steps

In terms of next steps, policymakers, development finance providers and private financiers should seek to:

- Develop a common understanding of good practice and lessons learned from blended financing for investments in water (and other sectors) to distil clear guidance on how to tailor **blended finance instruments and mechanisms** to different contexts and for different types of water investments.
- Establish an appropriate **forum of exchange** on such good practices and innovative approaches to improve co-ordination of development finance providers in order to address blended finance market specificities, including competition, levels of concessionality, addressing different demands and improving coordination. The OECD-WWC-Netherlands Roundtable on Financing Water provides a platform to convene the water community and finance community in order toencourage greater co-operation among actors.
- Link **technical assistance**, e.g. capacity building measures and regulatory framework development, more closely with **investments in infrastructure** to ensure that such infrastructure can be operated and maintained sustainably over time.
- Strengthen **transparency** and **accountability mechanisms**, including ex-post evaluations on the sustainability of donor-financed investments into water infrastructure (e.g. water and wastewater treatment plants).
- Develop guidance and evidence on the comparative advantages and **complementing roles of different financiers** in the water sector, including bi-lateral and multilateral development banks, philanthropic investors and commercial banks and investors. This would include the development and the promotion of contractual arrangements that allocate risks and returns across financers, for typical projects.

Detailed overview: Thursday, October 4th

Setting the scene: Blended finance for water investments

In this session, participants learned about blended finance with overviews of recent research in the field. Christopher Clubb from Convergence Blended Finance presented key messages from the recently launched "The State of Blended Finance 2018" report. While WASH is a growing priority for blended finance actors, only 8% of the 300 closed blended finance transactions are targeting SDG 6 (Convergence 2018). Wiebke Bartz-Zuccala and Kathleen Dominique presented the OECD's work in the field including the OECD DAC Blended Finance Principles as well as initial findings on a draft consultation paper on water-related sub-sectors and their "readiness" for blended finance.

Blended finance in the water sector – Lessons from case studies

In this session, participants learned about the case studies shared by JICA (Philippines), Millennium Challenge Corporation (Jordan), Development Bank of Southern Africa (South Africa) and Water.org (India and others). The case studies demonstrate the potential for blended finance for different types of water-related investments (e.g. bulk water supply, wastewater treatment, water supply and sanitation services, etc.):

- Dr. Alex Money, Oxford University presented a case study on piloting new approaches to financing infrastructure in Mexico. With the broad vision to scale investment in water related infrastructure, a platform for stakeholder engagement including private and official investors (PepsiCo, IDB etc.) is currently being set up. The goal is to identify infrastructure projects, create an investment vehicle to access capital markets and invest the funds through an accredited manager and a blended fund structure.
- Kumar Ranganathan, MCC, presented a case where MCC, together with the Government of Jordan, designed a comprehensive program to provide water to the rapidly growing second-largest city in one of the most water stressed countries in the world. MCC's grant funds leveraged private financing and other institutional funding. The compact (large, five-year grants for selected countries that meet MCC's eligibility criteria) focused on increasing the reusability of wastewater and reduction of non-revenue water (NRW), which would add to the fresh water available for use. The investments were both public and blended – MCC (USD 97 million), Private lenders (USD 146 million), and sponsor equity (USD 8.5 million).
- Rich Thorsten, Water.org presented a study on catalysing philanthropic funds to mobilize private financing for improved water and sanitation services for the poor. WaterCredit is an approach where Water.org collaborates with local financial institutions in an identified region to provide affordable loans for water and sanitations to families in need. The microfinance partners are provided with resources (grants), education and outreach assistance (technical assistance) to reach people who need access to water. Through these tools, other private investment is attracted as perceived risks are reduced.
- Matsumoto Shigeyuki, JICA, presented the case of the Philippine Water Revolving Fund (PWRF) established in 2008. The Philippines had a very low coverage of piped water, with a low number of water service providers. JICA gave a concessional loan (ODA) to the PWRF backed by a sovereign guarantee from the government of Philippines. The fund provides access to finance by disbursing loans to water service providers. Additionally co-financing was provided by private finance institutions (PFIs) backed by guarantees from Local Government Unit Guarantee Corporation (LGUGC) which in turn were backed by USAID and DCA which gave a partial credit risk guarantee (up to 85%). Moreover, the Development Bank of Philippines (DPB) provided an additional credit line to cover liquidity risk of the PFIs.The case study highlighted the need for coordination among blending partners and the importance of capacity building for private financial institutions and water service providers.

- Konstant Bruinette, DBSA, presented a case study of how the City of Tshwane dealt with high water losses. DBSA facilitated investments into better water supply services by providing grants for a pre-feasibility study that helped to de-risk the programme to support the city's access to finance.

Overall, this session displayed blended finance models that are already successfully being applied to the water sector and facilitated learning and sharing of good practices.

Water utility finance: Fixing the bucket

In this session, findings of a new study commissioned by GIZ were discussed. The session was centred on the issue of "fixing the leaks in the bucket". It explored how development and commercial finance can be deployed to better strengthen utility management, incentivize performance improvements, and thus accelerate access for the poor. In his presentation, Rolfe Eberhard argued that increased funding from donors, governments, and private investors will not lead to improved coverage, if the utilities receiving those funds do not turn the investments into reliable services for everyone. As a critical factor towards sustainable performance, good governance has been identified, both at the asset owner level as well as at the utility level. Four conditions for improving performance were identified: (1) identifying the "jockey", (i.e. a good utility manager); (2) a revenue model with a tariff that at least covers O&M costs and, ideally, generates a surplus; (3) the effective use of resources, including competence-based recruitment and corruption-free procurement; (4) the mandate and mission of the service provider to serve everyone (Leave No One Behind). A phased financing ecosystem that links up-front technical assistance to sequenced infrastructure finance could help create and sustain those conditions. In four small groups, participants discussed how financiers (whether public or private) can create, support and incentivize the essential conditions for good utility performance.

Risk and returns in the water sector – Understanding the commercial perspective

This session focused on the commercial investors' view on blended finance in the water sector, starting with a kick-off presentation by Lachlan Cameron, Finance in Motion and one from Rachana Lay, Foreign Trade Bank of Cambodia. Lachlan presented Finance in Motion's views on blended finance from the perspective of an asset manager, which are driven by their fiduciary duties and investors' demand for returns and security at the same time. Rachana complemented the views by presenting a successfully closed case study of FTB Bank Cambodia where France (AfD) provided USD 15 million to FTB Bank to on-lend to water and electric sectors. Stefan Pletzer, SEB, Christophe Hug, Tilia GmbH, and Gaia de Battista, Lion's Head Global Partners then engaged in a panel discussion moderated by Christopher Gasson, Global Water Intelligence. The main points arising from the discussion are as follows:

- There has been limited private investment to date in developing country water projects, particularly in utilities, because risk are high and rewards are perceived as insufficient.
- In terms of instruments, guarantees are one way to help mitigate risk providing a potential role for donors. In addition, green bonds can be appropriate for large projects in middle-income countries. However, they are not a good match for small-scale projects that require a lot of technical assistance.
- Strong local funding partners that can on-lend are critical. Therefore, it is important to focus on the local enabling environment for these partners to flourish.
- Private investors are diverse. Some focus on impact, others prioritize portfolio diversification. Most investors are looking for short-term returns, with the exception of some pension funds and insurance companies. At the same time, pension funds have a responsibility to ensure a good return as well – a balance that remains to be met.

Friday, October 5th

Exploiting the full potential of development finance in mobilising additional finance for water

In breakout groups, participants discussed opportunities and challenges for bi- and multilateral development banks and philanthropic investors in investing in water.

In the session on impact loans, Karen Hitschke, Yunus Social Business, and Sietse Wouters, UBS Optimus Foundation, presented a scheme, the Social Success Note, to invest in a social business that enables schools to access clean water. The outcome-based payment scheme rewards the investors based on how many schools have been reached. Topics discussed included the issue of risk mitigation, which can be pursued by putting together a portfolio of entrepreneurs, adding a loss cushion, as well as addressing foreign exchange risk in addition to robust due diligence. Transparency and measurement of impact as the condition for return were also discussed.

Paul Greener, Water Unite, and Matt Eldridge, Urban Institute discussed the potential of solidarity levies to mobilize additional funds for the water sector. This funding addresses the need for impact-oriented, risk-tolerant capital funding for utilities that serve poor areas. These funds could be raised via a solidarity levy and managed in a global fund structure, as proposed by a recent study commissioned by GIZ. This sort of funding should be used to extend and improve services, focusing mostly on "last mile" investments. Selection criteria should prioritize identifying the right local financial intermediary to help manage/track the disbursements.

Stefan Pletzer, SEB, and Edouard Pérard, EIB presented their organisations' approach to green bonds. Green bonds can raise awareness of and access to water financing and provide one innovative source of additional capital. However, they are a fixed income instrument and as such lack characteristics of equity investment as long-term investment horizon. The importance of local currency bonds to match revenues and debt service was highlighted.

The way forward – Identifying the policy implications for effective blended finance in the water sector

In this session, development financiers as Sida, Millennium Challenge Corporation and AfD as well as Aquafed (the association of private water operators) discussed the policy dimensions of blended finance in water. Karin Lindblad, Sida, presented the agency's work on guarantees as a tool to mobilise commercial investment. While she underscored that it will be a long time before Swedish pension funds get into water infrastructure in developing countries, best practice examples by for example PIDG lead the way. At the same time, this shows that infrastructure and vehicles to invest in blended finance do already exist. It is important to make sure that these vehicles are also used for the water sector. Madeleine Portmann, AfD, highlighted that AfD is also exploring the use of guarantees in the sector. AfD also highlighted that policy loans (e.g. Senegal) are a good tool for dialogue on sector reforms. Jonathan Richart, MCC, complemented the discussion by adding that grant funding can play a role in viability gap funding. However, guarantees are not yet accountable as Official Development Assistance, which may limit their broader application.

On the demand side, it was emphasized a robust financing strategy for the water sector is needed within countries along with local governments that also need to take an active role. Finally, foreign exchange risk was identified as a major issue by the panelists. Neil Dhot, Aquafed, raised the need for examples where blended finance can reduce foreign exchange risks. In addition, the discussion on blended finance should be complemented by a discussion on water utility performance. The experiences and best practices with utility turn-around management should be documented and shared.