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Session 2. Blended finance for water-related investments

BACKGROUND PAPER

U.S. EPA WATER INFRASTRUCTURE FINANCE MODELS

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1. U.S. EPA Water Infrastructure Finance Models

1.1. State Revolving Funds and WIFIA

The United States Environmental Protection Agency ("EPA") currently manages two major water infrastructure finance models; the State Revolving Fund Model which is used for two programs – the Clean Water and Drinking Water State Revolving Funds (the "SRFs") and the WIFIA Model which is a direct federal credit program authorized under the 2014 Water Infrastructure Finance Innovation Act ("WIFIA") that serves all classes of water projects. Each of these models are designed to provide ready access to capital at minimal market or below market rates for high priority projects that address national public health and water quality goals. They are also designed to leverage non-public sources of capital (i.e., they operate with Blended Finance attributes) and "crowd-in" private investment. SRFs achieve this by supplementing their own lending capacity by raising additional capital from investors. WIFIA achieves this by statutorily limiting its' project participation to less than the project funding amount.[1]

1.1.1. The Clean Water and Drinking Water State Revolving Fund Models

The SRF programs are federally sponsored and state administered. In accord with federal statute, each state runs separate programs for the Clean Water and Drinking Water infrastructure investment needs of eligible project sponsors. Federal law permits the joint financial administration and securitization of the two programs, which most states rely upon. CWSRFs have been capitalized with annual federal appropriations since 1989 (DWSRF has been funded annually since its creation in 1996). Federal law requires states to provide a 20% state match against the federal grant awarded from the respective annual federal SRF appropriations. The SRF programs use its resources to provide both technical and financial assistance. Technical assistance is made available by states to project sponsors from grant dollars authorized to be set aside. These dollars are used to assist project sponsors with loan readiness and can be used for project predevelopment needs, including the capacity building needs of the project sponsor. Financial assistance is provided from the balance of federal and state contributions, program net earnings and bond proceeds raised by SRF programs to supplement loan capacity.

As state administered programs, states have successfully built programs to provide below market financing to eligible project sponsors from funding received from federal and state sources as well as private dollars sourced from the capital markets. A key element of the U.S. SRF Model is its integration with U.S. capital markets as demonstrated by those state programs that have accessed capital markets for funds to supplement loan capacity. The credit designs adopted by states, which feature overcollateralization - a by-product of concession level financial assistance targets - have produced triple-A rated financing mechanisms that permit SRFs to borrow at the best financing terms made available by capital market investors. These favorable terms are reflected in the on-lending rates to eligible project sponsors. In fact, a key value has been the superior credit strength of the SRF credit model versus a state's underlying credit. It is this factor that underlies the SRF Model's promise for international application for those nations or subnational governments where sufficient financial resources can be concentrated to produce stable highly

[1] For complete CWSRF information: www.epa.gov/cwsrf. For DWSRF: www.epa.gov/driningwatersrf. For WIFIA: www.epa.gov/wifia.

rated credit mechanisms that can offer favorable market or below market terms independent of a country's own credit strength.[2]

1.1.2. The WIFIA Model

The second U.S. water finance model is the WIFIA federal credit program. The WIFIA Model leverages the U.S. Government's cost of funds (U.S. Treasury Bond Rates) which is shaped by its credit ratings (Aaa: Moody's/AA+:S&P/AAA:Fitch) and by the dollar's position as the dominant international currency. The key value is the statutory authority to on-lend at the U.S. Government's cost of funds (the on-lending rate is based the loan's weighted average life matched against the comparable U.S. Treasury rate). On June 19, the U.S. Treasury 30-year Bond closed at a 2.526% yield. By securing funds at the U.S. Treasury rate, loan recipients avoid higher borrowing costs typically imposed by investors for credit risk - referred to as credit premium. The U.S. Government absorbs the premium and takes the credit risk. The result is effectively the equivalent of a below market concessionary rate that benefits critical water infrastructure and ratepayers within the U.S.

The WIFIA program is designed to provide least cost funding for domestic water projects but is deliberately limited to no more than 49% of total eligible project costs. At 49% of total project costs, the least cost financing terms are intended to improve project affordability while attracting co-funding in the form of private capital. Other program benefits include:

- Debt amortization which can be back weighted allowing higher cost debt to be amortized on an accelerated basis further improving project economics and affordability;
- Loan interest that is only charged against loan disbursements eliminating re-investment risk on borrowed proceeds;
- The ability to close loans well in advance of loan draws allowing a rate lock at no additional cost to borrowers;
- An option to capitalize interest during construction; and
- The ability to prepay at any time without penalty.

Where developing nations have relatively good market access and sufficient debt capacity, a WIFIA-like program could offer significant value. Countries most likely to benefit are those with investment grade ratings that can offer on-lending rates thereby improving financing terms for subnational governments or related entities with identifiable revenue streams. Countries actively seeking to reduce subnational dependence on the nation's resources may also find a WIFIA model to be a useful tool in transitioning to revenue supported lending arrangements, especially those nations that are actively engaged in the development of domestic finance markets (SRF models can also serve in this capacity). Key variables that will drive adoption will be the capital set asides for loss reserves. In the U.S., the federal government determines the risk-to-capital reserve requirement. For targeted developing nations, the general credit quality of the water sector, its capital needs relative to national GNP and the nation's credit stability will be key determinants of loss set aside requirements. Each of these factors will affect rating agency assessments of a WIFIA-like program and its' impact on the national credit rating.

[2] Rating services may cap an in-country credit rating at some level above a country's sovereign credit rating. For example, S&P caps in-country credit ratings at no more than two notches higher.