

Roundtable on Financing Water

The Roundtable on Financing Water

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Session 5. Supporting the Mobilisation of Commercial Finance: Managing risk, improving performance and creditworthiness

BACKGROUND PAPER

Background

Water service providers are at the forefront of urban development, making a critical contribution to economic development, environmental and social outcomes. However, many cities in the Asia Pacific region still struggle to deliver adequate and sustained water and wastewater services. Approximately 260 million people in Asia Pacific region still do not have access to a protected source of water (UNESCAP, 2018^[1]). There are significant gaps in coverage and substantial physical losses due to outdated and poorly maintained infrastructure, poor water quality, high commercial losses due to lack of meters as well as billing and collection difficulties. All of these factors undermine operational and financial performance, leading to sub-optimal creditworthiness. Moreover, utilities often lack the capacity to adapt to extreme weather events, which are further exacerbated by climate change. This severely affects the health and living conditions of the poor, who are the most vulnerable population, living in areas where basic services and assets are most deteriorated or non-existent.

In parallel, investments to deliver sustainable water supply and sanitation (WSS) services, including the funds needed to operate and maintain the infrastructure, expand the coverage and upgrade service delivery to meet current and future social and environmental expectations, have fallen well short of needs to date. Financing needs to achieve regional access to safely managed Water, Sanitation and Hygiene (WASH) services through water and sanitation infrastructure, as defined by the Sustainable Development Goals 6.1 and 6.2¹, are estimated to be about USD 53 billion per year by 2030 (ADB, 2017^[2]). Public finance is largely insufficient to meet the Sustainable Development Goal (SDG) 6, thus a greater role for commercial finance will be important to achieve these targets.

Why a robust enabling environment is important for scaling up financing on water

To mobilise additional capital for water-related investments, improving the enabling environment (e.g. policy framework and institutional arrangements) requires urgent attention. Many low- and medium-income countries are dependent on public funds that are insufficient, poorly managed, inaccurately targeted, and often crowd-out commercial sources of financing (World Bank, 2017^[3]).

A robust enabling environment requires well-designed sector regulation (economic and environmental), legislation and policies. Institutional arrangements that provide adequate oversight and governance of the decision-making process related to capital expenditure planning, resource allocation and tariff setting to ensure cost recovery are key elements that contribute to a robust enabling environment.

Authorities also need to ensure that service providers can generate sufficient revenue to cover the costs of service provision and adequate maintenance of assets. In addition, well-designed regulatory frameworks are fundamental to monitor performance and service quality of providers and enforce guidelines for tariff setting. These are key elements required to access commercial finance (OECD, forthcoming^[4]). Designing regulatory institutions cannot take a one-size-fits-all approach and must be adapted to a specific country context.

¹ Within SDG 6, targets 6.1 and 6.2 focus on drinking water, sanitation and hygiene.

Providing human resources that supply institutions with adequate skills, technical proficiency and a managerial and performance focus is crucial. Governments need to provide the incentives to attract and maintain well-trained, skilled staff and qualified managers. Some of the countries with the highest WSS investment gaps actually face the challenge of low or insufficient capacity among staff to manage and maintain sector infrastructure investments. Training and capacity building are thus essential to drive water sector strategies and policies.

To scale up financing for water-related investments, a robust enabling environment can also help to ensure risk sharing among public and commercial actors, as well as encourage the engagement of water service providers. Strengthening the enabling environment for investments in the WSS provides incentives for the sustainable management of water resources, minimises overall investment needs and reduces the risk of investments failing to deliver expected benefits over time.

Definition of creditworthiness and commercial finance

Mobilising commercial finance in the sector requires not only strengthening the enabling environment (policy framework and institutional arrangements), but also improving the creditworthiness of borrowers (e.g. water and sanitation service providers). Creditworthiness is a measure of a borrower's ability and willingness to service its debt obligations. Water service providers are generally creditworthy when their revenues are sufficient to service their debt obligations (World Bank and WASREB, 2015^[5]).

Commercial finance includes public finance, such as sovereign wealth funds or public pension funds, and private finance, which seek market rate returns (OECD, 2019^[6]). In the water sector, the commercial finance ranges from microfinance loans to bonds, which can be offered to service providers, local governments, individual users or communities. The providers of commercial finance may include domestic commercial banks, microfinance institutions or capital market investors (via bonds or equity) (World Bank, 2017^[3]).

Two issues prevent financing for service providers on commercial terms:

Many water and sanitation service providers are not, in fact, creditworthy;

A wide perception from the financial sector that water and sanitation service providers are not creditworthy.

Many water and sanitation service providers are not in fact creditworthy due to weak performance, which is caused by a lack of managerial leadership, financial sustainability and operational efficiency. They fail to generate a sufficient revenue stream to cover operational and maintenance costs (OPEX) because of low rates of cost recovery and operational inefficiencies, which cause inefficient water services for end users and affect users' willingness to pay the service. Initially, service has to be improved before the tariff can be increased for public acceptability. If services are improved and tariffs for WSS services are designed well, a virtuous circle is engaged and the revenues could be used to improve operational performance and increase access to WSS services. In reality, however, many water and sanitation service providers do not fully recover OPEX, let alone capital expenditure (CAPEX) via tariffs (OECD, 2019^[6]). Further, revenues from tariffs may not be ring-fenced and sometime accrue to general government budgets, undermining the confidence lenders will have when assessing the reliability of cash flows.

Transformation of water providers is key to build creditworthiness

Many water and sanitation service providers are not in fact creditworthy due to weak performance, because of operational inefficiency and a lack of financial sustainability. Different factors specific to the geography and history of water and waste water systems in the Asia Pacific region have to be considered. This means that the situation varies across countries and suppliers, however, the analysis applies to a majority of service providers in the region.

Water resources are depleting. Surface water is becoming polluted more and more, while there is generally an over use of groundwater. The Asia Pacific region accounts for 7 of the world's 15 biggest abstractors of groundwater (ADB, 2016^[7]). This context makes it more costly to ensure reliable water services in the long-term, and may require additional investments to secure access to water and treat it before it can be supplied. In addition, existing assets are deteriorating with minimal or no investments to renew and maintain them. Tools to support asset management are lacking. In some contexts, there is no regulation to monitor water service providers' activities, motivate operational performance and enforce regulations and environmental norms at the catchment level.

In this context, limited technical know-how, tools and equipment constrain the progress of the water service providers to improve their creditworthiness. They do not have the managerial and operational capacity to operate in an efficient way and, at the same time, are constantly trying to address emergency requests and complaints from customers, based on short-term plans. They lack a formalised technical and operational diagnosis allowing them to identify sequences of prioritised actions consistent with best international practices and standards. Water service providers also lack of performance-based management practices and adapted business processes to plan for medium- and long-term developments.

The general absence of the integration of climate risk and disaster into investment planning worsens the situation, as it influences the lifecycle of their assets and deteriorates the quantity and quality of water for their development.

Change in the perception of commercial lenders

In addition to the individual performance of service providers, the perception of the industry's creditworthiness by commercial lenders is poor. This results from a poor track record of several service providers, exposure to political risks that affect the capacity to raise tariffs and secure revenues to cover the operation of the service, and at places the potential tensions between the rigour of service provision and management and the perception that water is not a commodity and water services cannot be supplied at a profit. As a consequence, commercial lenders have limited experience with financing the industry, fuelling a vicious cycle of distance and lack of interest.

There are options to break the vicious cycle of poor operational performance and degraded image of the industry for commercial lenders. Indeed, improving the creditworthiness of water and sanitation providers can help to mobilise commercial finance by making the sector more attractive to private lenders, which leads to an increase of financing in the water sector.

Some options to improve creditworthiness include: (i) technical assistance (TA) and output-based subsidies to improve operational and financial performance of operators and sector enabling conditions, and (ii) informational instruments, such as credit ratings, to convey clear and standardised information on the creditworthiness of operators, and (iii)

using levers to mitigate the risk for private capital such as credit guarantees, which can help to mobilise commercial capital for creditworthy or near-creditworthy borrowers.

Options to mobilise commercial finance

Information-based instruments to encourage performance improvement

Producing and sharing reliable information on the performance of service providers are a first step to assess creditworthiness and target areas for improvement. Countries in the region and globally can rely on benchmarking as a powerful tool to stimulate progress and converge towards the best performers. A variety of tools and mechanisms exist, which build on a relevant set of indicators (tailored to the priorities in a particular country or basin) and robust data collection mechanisms. The International Benchmarking Network for Water and Sanitation Utilities (IBNet) is a global mechanism. Others exist at smaller geographical scales, which can inspire regulators in the region.

Another example of an information-based instrument is AquaRating – an international standard for assessing water and wastewater systems. This system provides lenders with critical information on creditworthiness to enhance the commercial financial flow to the water sector. It helps water and sanitation service providers to know their current status, identify opportunities for improvement and implement actions toward best international practice in the short term. AquaRating evaluates utilities based on key performance indicators and the adoption of best practices grouped into eight areas that include different stages and processes in the value chain (IDB, 2018^[8]).

Managerial transformation

Improving water service providers and utilities requires managerial transformation following an operational methodology adapted to the context. In a nutshell, it is very important to secure first the soft components (or quick wins) as regulatory aspects, customer service database and complaints management, and to address operational efficiency as reducing water losses, energy and others OPEX. With more than 50% of water lost in average in Asia is either from leaks or illegal usage, reducing water losses is a key pillar of water services' creditworthiness. It also reduces in parallel energy usage necessary to produce and distribute the water to customers. A performing customer cycle has to be developed in parallel including metering, billing and collection cycle. Transversal to these actions, advanced asset management practices should be built as the pillar of managerial strategy and decisions, to define optimised CAPEX replacement process.

To achieve and support such transformation, utilities need to be arranged at the right geographical scale. Fragmented service providers do not have the capacities to invest in the technologies, management and personal skills required to operate services at the appropriate standard. Where adequately defined, agglomerating service providers can trigger economies of scale, bundle loss-making services (in peri-urban or rural areas) with more profitable ones (in urban areas) and exploit synergies for investment and asset management.

Without improvement in the level of services delivered, the creditworthiness mechanisms are stopped because tariffs' increases are not accepted by end users and the expected financial returns cannot be met.

Blended finance approaches to de-risk investments

In addition, to scale up commercial finance in the sector, blended finance can be used to de-risk investments while maintaining affordability for customers in a practical and transitional way. Blended finance - the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries (OECD, 2018_[9]) - can enable commercial investment by altering risk-return balance of investments. By deploying development finance in a way that addresses investment barriers preventing commercial investors from providing capital in WSS services, the blended finance can operate as a market building instrument that provides a bridge from reliance on grant and other donor financing towards commercial finance. (OECD, 2019_[6]).

Blended finance includes a range of instruments and mechanisms. Notably, guarantees are a commonly used instrument and can be effective in mobilising commercial finance through the mitigation of financial risk resulting in lower cost of capital. An illustrative example is the Philippines Water Revolving Fund (PWRF), which was set up with both primary and secondary guarantees resulting in a combination of public and private actors. A credit risk guarantee provided participating banks with a partial guarantee from the Local Government Unit Guarantee Corporation (LGUGC) – a private entity – that covered an 85% maximum of the bank’s exposure against a 1% guarantee fee. This primary guarantee was supported (up to 50% of the LGUGC’s exposure) (OECD, 2019_[6]) by a co-guarantee from the USAID Development Credit Authority.

Building on the success of the PWRF, the Philippines has been working on the Unified Financing Framework, which aims to (1) align lending and financing policies to crowd in commercial financiers; (2) rationalise government financing to non-creditworthy water service providers; and (3) establish an independent economic regulator and set pricing policy for wastewater management services. (OECD, 2019_[6]).

A key role for various actors

The following action points can be useful to government, institutions, borrowers and banks² to mobilise the commercial finance.

Government and regulators

Public stakeholders, ministries, regulators and local government should clearly understand the benefits and downsides of commercial finance in the water sector.

In particular, the ministry (or government agency) responsible for the delivery of water supply and sanitation services and local government need to clearly confirm their buy-in and support of commercial finance in the sector. They are responsible for setting the framework of investment and financing in the sector (in many cases with the Ministry of Finance), and will play a role in any guarantees and oversee any required legal changes. Commercial financing should be seen as complementary funding for the sector, neither as a replacement for sector funding nor as a driver towards private operation of services. In order to foster a significant change in the existing funding in the water sector, commercial financing needs to be a component of a blended finance approach to leverage public funds.

² The section highlights, in part, key findings from World Bank (2017), *Introducing commercial finance into water sector in developing countries*.

Regulators can play a major role in capacity building for the management of water service providers through training and reporting requirements, and by developing efficient models to build independent and accountable organisations that strive for performance. Regulators often provide tools such as technical and operational management benchmarking analysis and publications.

The regulator's capacity is essential to commercial financing. The regulator needs to have transparent guidelines for setting tariffs. Ideally, tariffs or charges for water services should cover the operation, maintenance and renewal costs of infrastructure and a progressive proportion of capital costs, where possible (Leflaive and Hjort, forthcoming).³ For utilities that commercially borrow, tariffs should also include the cost of debt service.

Borrowers

Service providers (borrowers) will need to have a basic understanding of the commitments, liabilities, and benefits of commercial finance, and have an interest in pursuing commercial finance. As noted above, some of the specific and actionable ways to improve creditworthiness for borrowers is through the use of TA. TA can help water service providers design and implement internal controls to be considered creditworthy, apply for loans and manage projects once funded (World Bank, 2017_[10]).

Similar to what is expected from the private sector, water service providers need to operate and manage their businesses in a sound manner with good governance and financial performance to borrow. Key elements to assess is to verify whether service providers make a profit, or at least break even in their operating costs.

To ensure cost coverage, a managerial transformation need to be made in the water service provider organisations, in parallel with financial reinforcement, following a step-wise procedure, developed in the long-term with clear thresholds. This progressive approach is key: realistic paths have to be defined in order to manage expectations in the long term and clearly define necessary steps.

Banks

Commercial banks have capabilities to assess the creditworthiness of corporate borrowers and projects. They will understand the legality and regulatory restrictions of lending to new clients, including water service providers. However, it is unlikely banks will be familiar with the water industry, and water and sanitation projects specifically, and hence lack the knowledge to assess the technical merits of a project proposal.

In providing loans to the water sector, banks would need to commit to lending on cash flow collateral, as opposed to fixed asset collateral, and rely more heavily on:

- Due diligence on the creditworthiness of the water service provider
- Legal control over the cash flows of the company
- Risk mitigation products to reduce lending risk.

³ Full cost recovery would also include accounting for the resource costs (opportunity costs arising from resource abstraction) and negative environmental externalities of resource use.

Conclusion

Scaling up financing on water-related investments requires a robust enabling environment that can encourage mobilisation of commercial finance. Strengthening the enabling environment requires not only improving policies and institutional arrangements, but also concerted engagement of service providers to improve their creditworthiness and the level of service they deliver. To accelerate the process, the role of key actors such as governments, regulators, borrowers and banks, are essential. Only when these actors play their roles in a practical and systematic way, can the financing on water related investments be realised to meet the SDG 6.

An innovative and grounded methodology can be further defined, following the Roundtable meeting, to develop in parallel financial strength of water providers, and operational efficiency, including up-to-date technology and practices. The success and failures of water providers rely on their capacity to enhance service quality in an efficient way, in order to start a virtuous circle of customers' satisfaction, reasonable tariff revisions, and efficient use of finances, assets, energy and water resources.

Questions for discussion

1. What are the key actions that should be prioritised to improve the creditworthiness of water service providers?
2. What lessons from experience in the region could be valuable for other countries to strengthen the enabling environment and improve the creditworthiness of operators?

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