AFRICAN WATER FINANCE

Global pooled finance initiative for water gets €10m Dutch government backing

A new water financing facility aims to leverage €1 billion of debt finance from local institutional investors. How will it overcome the hurdles which have ended previous attempts to establish sustainable local finance initiatives?

The Dutch government has committed €10 million of grant funding to support a global initiative which is designed to mobilise €1 billion of local institutional debt finance through a series of national pooled water facilities.

The first of these will be based in Kenya, and the inaugural bond under the programme – to be issued later this year – is expected to raise KES 4-5 billion (€46-50 million) of long-term capital from domestic institutional investors to onlend to six water companies for a portfolio of pre-identified projects. By the end of the year, the implementing agencies hope to have identified two further countries to join the programme, with possibilities including South Africa, Indonesia and Vietnam.

"Similar types of transactions have been done in Colombia, Peru and India before, but they've generally been one-off transactions, so they haven't kick-started a broader uptake of this type of model," explained Padraig Oliver, an analyst at the Climate Policy Initiative, which helped develop the concept of a global water finance facility (*see chart below*).

The global entity is expected to be co-financed by other donors up to a threshold of around €100 million, and is designed to provide centralised support and technical assistance to around 8-10 national-level facilities. "One of the reasons behind the global facility was to ensure that pooled water funds can be set up in different countries much more quickly and cheaply than if they were done one by one," he told GWI.

While the basic premise of the programme is to increase access to water and sanitation by extending long-term financing to local water utilities for specific projects, its aims go considerably deeper than that.

"What we're trying to achieve here is to reduce the concentration of funding from donors to the water sector," explained Joost Zuidberg, CEO of Cardano Development, which is responsible for implementing the initiative. "The concept revolves around trying to pool the needs of water companies that are each financeable on a stand-alone basis. The loans would be used for long-term investment in potable water or sanitation services, and the requirement is that they generate sufficient revenue to make debt repayment possible," he told GWI.

While that means that the first batch of projects are likely to focus around the "last mile" of water distribution networks, the emphasis on revenue generation is expected to have manifold benefits. "The factors that go into project selection are not only around achieving universal access goals or climate resilience goals, but also on improving the bankability of the water service provider itself through tackling non-revenue water," said Oliver.

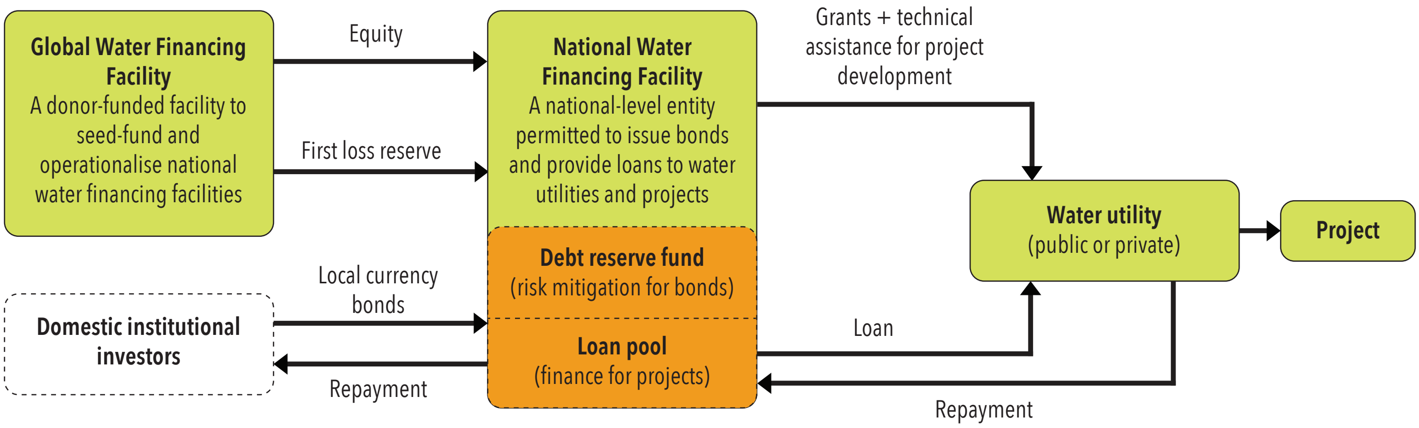
The asset-backed bonds are likely to be issued using a trust structure, with a certain proportion of each utility's cashflows being ringfenced for debt service. Zuidberg estimates that risk mitigation through a planned guarantee structure – which is expected to cover up to 50% of debt service payments initially – should allow local ratings in the single-A or double-A category to be achieved, and he anticipates that as stakeholders become increasingly comfortable with the programme, the guarantees can be tapered down commensurately.

He acknowledged that most projects will inevitably contain non-commercial elements which may require viability gap funding in order to make them bankable, and that Cardano is working with traditional donors such as the World Bank, KfW and AFD to ensure that this is addressed.

While dialogue is underway with ▸

HOW TO MOBILISE LOCAL PRIVATE FINANCE FOR WATER INFRASTRUCTURE

A new self-sustaining programme which aims to leverage local institutional money to fund water projects is planning its first bond in Kenya by the end of the year. Scaling it up globally will hinge on finding donors willing to seed the implementation vehicle.



Source: Adapted from Climate Finance Lab

GCR, a scandal last year where two bank bonds issued in Kenya both defaulted within months of being launched means that the credibility of professional ratings agencies has declined, leading institutional investors to carry out their own due diligence.

Part of the reason that Kenya was chosen for the first facility is testament not only to the maturity of its debt capital markets and the presence of a relatively sophisticated domestic institutional investor base, but also to the robust regulatory framework which has been built up on the back of constitutional reforms undertaken in 2010.

Not only does the sector regulator WASREB require water companies to report a variety of performance indicators each year – enabling it to generate shadow credit opinions on Kenya's 100 or so water utilities – it also has the power to adjust tariffs to cover loan repayments.

"What's been absolutely key to this whole process is that WASREB supports adjusting tariffs to allow for investments to occur," explained Zuidberg. "If the water companies do the right projects, they can ask the required fee for the water to make sure that they can service the loans. The context in Kenya is that water rates are low, with substantial scope for increase, and there is very strong public support for paying more for water, provided that the quality of service goes up," he told us.

The uptake of debt finance is clearly limited by the absorption capacity of the water utilities themselves, but part of the programme's aim is to establish a regular source of wholesale funding that complements existing donor and bank lending. "Our role is to push the envelope and let the capital markets solve the long end of the utilities' funding needs," said Zuidberg. "We want commercial banks to see us not as their competitor, but as a complementary window."

By functioning as a predictable source of long-term finance, the hope is that the pooled finance facility will have the knock-on benefit of improving long-term infrastructure planning. "With the erratic nature of funding that's been available in Kenya, the companies don't really have multiple-year planning on capital investment. If the water companies see us as a regular source of long-term funding, we will encourage much more long-term planning than what is there today. We would then really see the water companies start to be properly financially managed," Zuidberg predicts.

While getting the first bond issue under the Kenyan programme done is the first step towards pushing the concept out to other countries, both Oliver and Zuidberg observe that there are a lot of elements which need to gel in order for the pooled water facility idea to work – not least a robust domestic regulatory environment and a well-developed debt capital market.

"It's important that you find projects that are financially sustainable, but are also pro-poor, in the sense that they service the bottom of the pyramid," said Zuidberg. "We're satisfied that there's good potential in Kenya to scale up, but there are very few successful interventions that have actually achieved scale, and there are a lot of elements that need to be just right before something like this works. We want to have identified two more countries by the end of this year, and we want to be able to start moving substantially next year. The €10 million from the Dutch government gives us confidence, but we need more money, because we can't divide it up between two countries. We want to set up an institution that can become self-sustaining." ■