

Roundtable on Financing Water

OECD-WWC-Netherlands Roundtable on Financing Water

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Session 4. Background note

Blended finance for water security investments

While more resources are needed to achieve water security, several constraints have traditionally limited private sector participation in the water sector

Water security is foundational to achieving sustainable development and inclusive growth. While water security encompasses several issues¹, one foremost challenge, as represented by SDG 6, is ensuring universal access to safe water and sanitation. Meeting this SDG will require significant financing, more than what public finance alone could provide— annual investments in water supply and sanitation need to increase threefold to USD 114 billion per year, 63% of which will be needed in developing countries (Hutton and Varughese, 2016).

Leveraging contributions from non-traditional sources of water finance with differing risk appetites – such as the private sector – will be key to fill this resource gap. However, traditionally, private sector’s involvement in the water sector has been limited; for instance, in developing countries, private sector typically only accounts for 7% of total spending on water supply and sanitation, while in sub-Saharan Africa, this figure is less 0.5% (WHO/UN Water, 2012). This supply-demand mismatch is due to several sector constraints such as uncertainties in revenues due in part to the potential for political interference and financially and technically inefficient utilities, debilitating regulations which place restrictions on private sector investment in the water sector, or a general mismatch between the private sector’s expectations for risk-adjusted returns and what can be achieved from investments in the water sector.

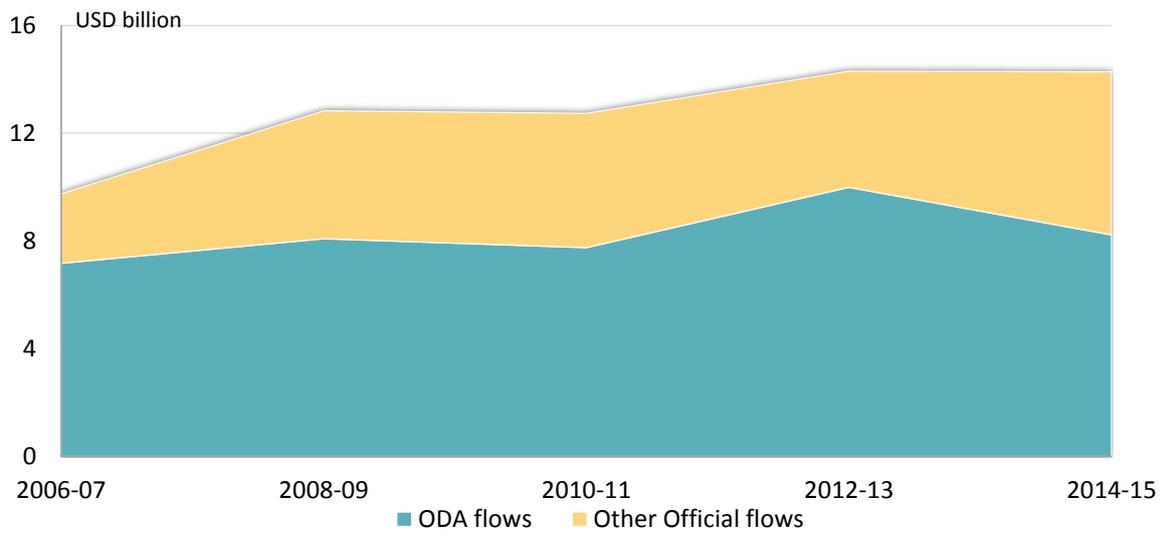
Blended finance can help address the financing gap for SDG 6

Blended finance, defined by the OECD as “the strategic use of development finance for the mobilisation of additional commercial finance towards the SDGs in developing countries” (OECD, forthcoming), can help in mobilising private financing for water supply and sanitation. While blended finance alone cannot address market failures resulting from chronic subpar private investment in the water sector, it can address private sector financing needs for specific projects. This leads to several benefits, which can, through demonstration, have a catalytic effect; indeed, the use of blended finance can improve transparency, help borrowers generating efficiency gains, improving governance, and establishing credit track records, and help lenders have a better understanding of the water sector in the country, etc. (Leigland, Trémolet and Ikeda, 2016).

While many actors engage in blending finance, development finance providers play a critical role, providing the public or private development finance that mobilises the private sector to engage. Official development finance flows to water and sanitation have increased by 5% annually in the last decade, reaching USD 14.3 billion in commitments on average per year in 2014-15 (See figure 1).

¹ Such as water shortage, water excess, inadequate water quality and the resilience of freshwater systems (OECD, 2013).

Figure 1. Trends in aid to water and sanitation, Total official flows from all donors, 2-year average commitments, USD billion, constant 2014 prices

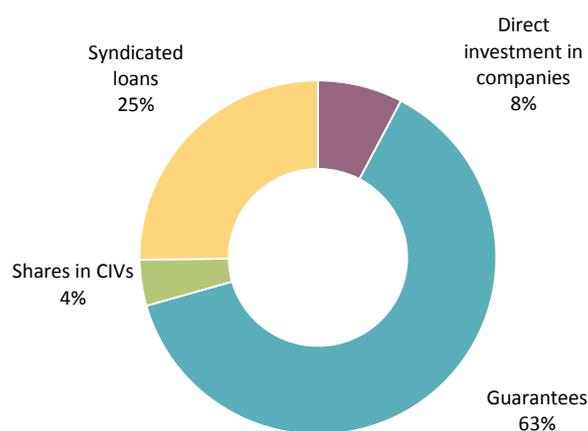


Source: OECD (2017), “Financing water and sanitation in developing countries: key trends and figures”, OECD Publishing, Paris.

Blended finance uses a range of instruments to calibrate the risk-return profile of projects and tackle other barriers to private investment.

Blended finance is not an asset class, rather it uses differing financial instruments. A recent survey from the OECD on amounts mobilised from the private sector by official development finance interventions estimates that official development finance mobilised an additional USD 1.5 billion of private resources in 2012-15 for water and sanitation (USD 385 million on average per year). The survey also reveals that the main leveraging instruments in this sector were guarantees (USD 1 billion), followed by syndicated loans (USD 388 million).

Figure 2. Private finance mobilised by official development finance interventions to the water and sanitation sector, USD million, 2012-15



Source: OECD (2017), “Financing water and sanitation in developing countries: key trends and figures”, OECD Publishing, Paris.

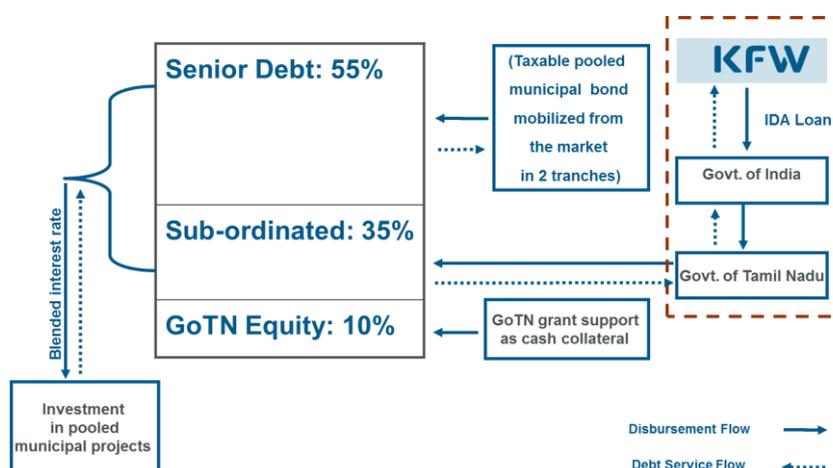
Enabling municipalities to tap capital markets to fund water infrastructure development (OECD, forthcoming)

An example of a blended finance project is the water and sanitation pooled fund of the government of Tamil Nadu in India. The pooled fund helps municipalities in Tamil Nadu access finance for local

infrastructure investments. In 1996, the Government of Tamil Nadu created Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL), an asset manager, jointly owned by the Government of Tamil Nadu and private financial institutions, to access finance from private capital markets for infrastructure investments at the local level.

Even so, tapping capital markets remained challenging, especially for smaller projects. To overcome this challenge, a blended finance fund was created, with the intervention of KfW. KfW disbursed a EUR 10 million concessional loan to the Government of India. The amount was channelled to fund the subordinated tranche (35%) of a Special Purpose Vehicle (SPV) managed by TNUIFSL called the Water and Sanitation Pooled Fund (WSPF) designed to disburse loans to urban local bodies. The KfW funded tranche was combined with the Government of Tamil Nadu’s equity support as cash collateral (10%) to provide an additional cushion against potential losses. The SPV issued two bonds in 2012 and 2013 to mainly institutional investors at the local and state levels, including public and private pension funds. The combination of the KfW concessional loan (interest rate of 0.75%) and interest on the bonds (the first bond issued at 10.6%) permitted on-lending on a revolving basis to municipal projects at a sustainable level.

Figure 3. Structure of the Water and Sanitation Pooled Fund



Source: KfW’s product documentation

In addition to facilitate financing for local infrastructure projects, the intervention achieved meaningful outcomes. The ex-ante assessment projects a strong development impact of local infrastructure projects funded with loans from the WSPF. In terms of longer-term impact, the issuance of bonds via the SPV has enhanced the local bond market. This was measured by high secondary market activity indicating liquidity of the issuances and a positive impact on local currency bond market development.

While blended finance is a well-recognized concept in financing for development, it faces some challenges. More work is needed to shed light on the models and effectiveness of blended finance, including for the water sector

Concerns have been raised about blended finance, including on the associated risks and unintended impacts that could occur if this form of financing is scaled up without appropriate policies, checks and balances in place. While blended finance is increasingly examined, a majority of the work so far has focused on describing the potential for blended finance and case studies. However, less has been written on lessons learned, best practices and challenges in applying blended finance to specific geographies and contexts – for instance the water context – and to what extent applying blended finance has resulted in the intended development outcome. Most of blended finance literature focuses on the financing aspects of blended finance transactions; very little has been written through a policy lens, examining the role of public policy in creating, monitoring and evaluating blended finance projects for development impacts. To address these shortcomings, more evidence-based policy analysis, data and transparency is needed.

OECD is taking this agenda forward

The OECD conducts analysis and evidence based policy dialogue on several areas of note to blended finance for water. It can act as a conduit for policy concerns and recommendations for the private sector and development co-operation providers; and can channel these to policy discussions at highest levels such

as the G20, or to capitals through the DAC. Moreover, through the DAC CRS database, the OECD captures project-level bilateral and multilateral flows of development finance to the water sector, as well as partial information on mobilisation. The OECD is therefore uniquely positioned to provide analysis and an enhanced understanding of blended finance, and is doing so. As part of its ongoing work programme on blended finance, the OECD is developing principles to guide the use of development finance to mobilise private investment, to be endorsed at the DAC High-Level Meeting. In particular, the OECD will look at how these principles are applied in the water context.

Questions for discussion

- What are the key constraints of blended finance in the water sector? Does it work equally in countries with differing income contexts?
- What sources and types of commercial finance should be mobilised for blended finance in the water sector?
- How can we ensure development impact of blended finance in the water sector?
- What are the main policy challenges facing governments and development partners in implementing blended finance for water in developing countries?
- Are you aware of examples of innovative contractual arrangements that contribute to making blended finance attractive and relevant for investments in water security in developed and in developing countries?

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