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Session 4. Background paper

The potential for public, purposed, development and hybrid finance to bridge the water infrastructure gap

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Summary

This short paper builds on the outputs from the Roundtable on Financing Water, held in Paris in April 2017. Here, we make the case for four discrete actions: i) to renew the emphasis on public finance; ii) to exploit the opportunities of purposed finance; iii) to optimise the value of development finance; and iv) to explore hybridity and blended finance; to help bridge the water infrastructure gap.

Renew the emphasis on public finance

SDG 6 will not be achieved without **predictable** and **dedicated** flows from the public sector towards meeting the financing requirements of water infrastructure. Delivering universal and equitable access to safe and affordable drinking water for all by 2030 requires a re-affirmation of the centrality of public financing for the next decade.

Traditionally, infrastructure investments have been financed by public funds. In recent decades, however, the emergence of a neoliberal consensus that generally frowns upon public sector indebtedness has helped to support the narrative that alternative sources of financing infrastructure are both necessary and desirable. This narrative has become more strident in the era of fiscal austerity and balance sheet recapitalisation that has followed the credit crisis of 2008-9.

However, in the aftermath of that crisis, the share of infrastructure spending by the public sector actually went *up*, due to the flight of risk-averse private sector capital. This function of 'automatic stabilisation' helps to mitigate the social and economic consequences of a recession. Moreover, public finance accounts for the majority of infrastructure investment in the emerging markets today, and will continue to do so for the foreseeable future. In addition to annual budgetary flows, public finance is increasingly flowing to infrastructure assets via sovereign wealth funds (SWF); where assets under management have more than doubled in the last decade to over US$6.5 trillion[1], and the proportion of SWFs investing in infrastructure has increased steadily, to 62%.

Although it may not be a 'pure' public good, many people may benefit from water infrastructure without directly having to pay for it, while their use of this infrastructure does not prevent others from doing so. This combination of attributes is generally only present in publicly funded infrastructure. What is more, these attributes are fundamental to the concept of universality that is embedded in SDG

[1] 2016 Prequin Sovereign Wealth Fund Review: https://goo.gl/yV9DCv

6. It is therefore difficult to see how this goal will be met, unless public finance occupies a central role.

Economic volatility, the rise of SWFs and the urgency of the SDGs therefore combine in a renewed emphasis on the public sector in financing water infrastructure. Governments are also the core unit of accountability and delivery needed to downscale from general discussion of the infrastructure gap, to the specific needs of a national population.

Exploit the opportunities of purposed finance

Exploiting the expanding universe of specially purposed finance is key to bridging the infrastructure gap. Emerging opportunities emphasise carbon neutrality and sustainable growth. They include **climate finance** (e.g. green bonds); **corporate investment** (e.g. sustainability bonds); and **regional initiatives** (e.g. China's One Belt, One Road).

At COP 21 in Paris, countries committed to mobilising no less than US$ 100 billion per annum in climate finance from 2025. The Green Climate Fund (GCF), the de facto mechanism for aggregating and disbursing this investment, currently has over US$ 10 billion in assets[2]. The relationship between water infrastructure and climate change mitigation does not need to be rehearsed here, but the GCF could – and should – represent an important source of incremental financing for the sector. Meanwhile the global green bond market has grown ten-fold over the past five years, with issuance in 2017 likely to exceed US$ 130 billion[3]. The investment case for 'green' water infrastructure (see 1, above) is strong, and growing. The requirement now is to identify appropriate opportunities.

Corporate sustainability investment is a nascent area that has its origins in corporate social responsibility (CSR), and responsible investment (RI). In order to manage environmental risk and enhance their social licence to operate, companies are increasingly engaging with suppliers, customers and policymakers in markets where they rely on water infrastructure. As their understanding of the risks they face from inadequate water infrastructure improves, companies are considering more innovative approaches to the financing challenge. An example may be their issuance of sustainability bonds, either on their own balance sheet, or through special purpose funding vehicles.

Regional initiatives to boost economic growth and trade often include an element of infrastructure financing. The most prominent current example is China's One Belt, One Road (OBOR) initiative to develop new overland and maritime trading routes: the scale is ambitious, with an estimated US$900 billion of projects already planned or underway.[4] Even where these projects are not directed specifically towards the water sector, the flow of funds lowers investment costs by freeing up otherwise committed capital. Strategic alignment of water infrastructure projects with purposed, regional initiatives such as OBOR provides another avenue to close the financing gap.

Optimise the value of development finance

Development finance (or MLDBs) can play a unique role in convening investors and financiers to collaborate on complex projects that would otherwise be out of scope for any single financing institution. By coordinating **preparation**, **structuring** and **implementation**, MLDBs can materially improve the pipeline of bankable projects.

[2] Green Climate Fund: https://goo.gl/i7EByY
[3] Climate Bonds Initiative, Q2 2017
[4] Fitch Ratings, 2017: https://goo.gl/1dk1hv

Three of the major barriers to private investment in infrastructure[5] are: i) a weak pipeline of viable projects; ii) a perception that the risk is too high; and iii) emerging market infrastructure is not defined as an asset class. To improve the pipeline of projects, MLDBs are increasingly working in partnership with governments and private sector financiers. For example, the Global Infrastructure Facility (GIF) provides grants to governments to fund early-stage project scoping. The grants, typically in the order of several thousand dollars, do not need to be repaid. The GIF also provides up to several million dollars to fund full project preparation and structuring activities (PPSA). As PPSA costs must normally be repaid, it can act as a deterrent to project development. However, the GIF bears full PPSA failure risk, offsetting this by making funding conditional on the deployment of its own technical team who (in principle) can leverage global best practice to maximise the chances of success.

MLDBs can also co-ordinate facilities to provide technical partners with first-loss cover on e.g. construction, regulatory, debt servicing and foreign exchange risks. In addition, MLDBs are in the position to provide conditional refinancing options that reduce the capital requirement burden on commercial financiers considering long term infrastructure loans. Other capabilities that could be developed include tools for project assessment, an asset recycling program and financial benchmarks for investors, such as emerging markets infrastructure debt index.

Through these key functions of convening and co-ordination, MLDBs can play a catalytic role in mobilising private investment into water infrastructure. These functions leverage the unique strengths of MLDBs, whose advisory partners include pension funds, sovereign wealth funds, insurance companies, fund managers, commercial banks and other financial institutions. By making relatively small grants MLDBs can remove the disincentive to developing project pipelines, and in making PPSA funding conditional, there is the scope, at least, to crowd in best practice and build capacity.

Explore hybridity and blended finance

Blended finance has grown in prominence within the sustainable development arena, although empirical data on its use is still limited. New, **hybrid models** of financing infrastructure that are increasingly used by the **private sector** provide some visibility into how blended finance funds and facilities can be deployed effectively.

Blended finance is 'the strategic use of public or private investment with a development objective, including concessional tools, to mobilise additional finance for SDG-aligned investments in developing countries'[6] and should play a key role in bridging the water infrastructure gap. The two hybrid models of funding described below are used in the private sector. They do not have a development focus, but share attributes of innovation that should arguably be present in any well-structured blended finance facility.

First, in 2014, the Blackstone Group, a private equity firm, established a new water investment company. Its objective is to provide leverage finance (i.e. collateralised loans) for companies who wish to develop desalination facilities and large-scale waste water treatment for their industrial customers; and to identify, develop, finance, construct and operate large scale independent water

[5] *Making Infrastructure Rewarding*, World Bank, 2016
[6] *Blended Finance for Sustainable Development*, OECD 2017

development projects globally. In 2015 a deal was announced to develop a facility focused on storage and residual water treatment projects for a large petrochemical company. This model blends external finance from private equity funds with companies' own balance sheets (mitigating policy risk), and combines this with their access to customers (mitigating business risk), and the know-how to build the right infrastructure (mitigating technical risk).

Second, industrial services outsourcing is a fast-growing area of water infrastructure, as regulations on waste water discharge become more stringent. Traditionally, such projects would be developed under a BOOT model, financed by a combination of the operator's balance sheet, and operating leases. However, the growth in recent years of instruments such as non-recourse equity is leading to new models of financing infrastructure for outsourced industrial services. It allows the service provider to co-invest with a fund in a special purpose vehicle, replacing debt with equity. The provider earns revenues from the O&M services that it provides to the industrial client. The capital cost of provision has been shared with the investment fund, placing less debt on the operator's balance sheet, and increasing its return on capital. As an equity investor in the SPV, the fund earns an income from its share of the service provider's profit.

Recommendations

- Re-emphasise the role of public finance in delivering universal access to water and sanitation, for example by benchmarking national projects against the eight targets of SDG 6. Refresh measures of efficiency and accountability to reflect global best-in-class approaches from both the public and private sector.

- Apply a coordinated and lateral perspective to water infrastructure investment, by exploiting the expanding universe of specially purposed financing. Climate bonds, corporate sustainability investment and regional economic initiatives provide new and largely untapped sources of capital.

- Development finance institutions are uniquely positioned to help strengthen infrastructure project pipelines, mitigate risk, and improve the visibility of emerging market infrastructure as an asset class. Technical partners should encourage MLDBs to co-operate with each other in order to optimise the value of development finance.

- Supplement research on principles and policy insights for blended finance with analysis of the new hybrid models being developed by the private sector that mobilise capital for investment in water infrastructure at higher risk adjusted returns. Establish if, when, where and how these innovations could be applied to blended development finance.

[i] ***Author's Note:*** *This paper was prepared for the World Water Council by Alex Money, University of Oxford, in September 2017. It is excerpted from a draft report,* Financing Water Infrastructure: Ten Actions*, that has been commissioned by the World Water Council's task force on financing water infrastructure. Opinions, errors or omissions are the author's own.*