

Mobilizing Local Capital for Water Projects

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There is substantial private sector money willing to finance municipal water projects. The subject of this program is financing water supply and sanitation. There is no conceptual reason why this sector is more or less attractive when compared with other sectors which offer similar investment profiles. Money available for investment is agnostic. That is, it is available for investment across a broad category of substantive topics. Investors are concerned with the risks and returns of their investment.

This paper addresses the availability of private funds for lending to municipal water projects through direct loans, bonds or other means. This paper does not address the ownership or investment of private equity funds into municipal water projects or systems. This is not about privatization.

The investment profile of water projects is simple to understand. It is attractive to certain categories of investment funds. The projects are needed. They are of long duration, are stable and are generally not the subject of competition. They are supported by government and are needed by the population as basic to life. Water is ubiquitous in all aspects of personal and business affairs. By the same token, water projects are not subject to rapid growth, speculation or the kind increase in value which makes other sectors attractive to more aggressive categories of investment funds.

We have seen elsewhere in the world that substantial sums of money from private sector institutions, such as pension funds and life insurance companies, find the long term stability of water project investments to be attractive. Experience in the international market and recent experience in India suggests that water finance in India can be similarly attractive. This paper sets forth certain observations about practices in the international financial markets which cause debt instruments (such as bonds) used to finance water projects to be attractive investments.

This discussion is very timely. There is an enormous amount of attention being given to the finance of water projects at the World Bank, the European Bank for Reconstruction and Development, the European Union, the International Finance

Corporation and other multilateral aid organizations. Incident to the Third World Water Forum held in Kyoto, Japan exactly one year ago, the presidents of the World Bank and the other multilateral aid agencies who had convened as a panel on water finance to examine the needs and financial tools available to increase the amount of funds available for the water sector, issued their report. I commend it to you. It is titled "Report of the World Panel on the Financing of Water Infrastructure" and is generally known as the Camdessus Report, after the Chairman of the Panel.¹

You are the success story. You see this here in Bangalore, with the Karnataka and Tamil Nadu water finance facilities and the Tirupur project generating great interest from the World Bank, the International Finance Corporation, US AID, the US TDA and others.

This paper sets forth several observations about municipalities. It suggests that there are several areas in which municipalities can meet the needs of potential investors or buyers of their bonds without any diminution of control they maintain over their projects. I then suggest that the pooling of municipal projects, together with other well known credit enhancement techniques, can vastly expand the amount of money available for water projects.

Municipal Governments Do Not Need to Give Up Any Control to Achieve Private Financing

Governments need not lose nor cede any control over water supply and sanitation projects as a condition to the use of private sector loans to finance such projects.

Governments everywhere in the world are concerned about their control over essential infrastructure services. This is proper. The use of funds borrowed from private sector sources involves no abdication by government of control over the facilities, control over the environmental quality standards, control over ownership of the facility, or other appropriate governmental roles.

Lenders care about the security of their investment and about the predictability and stability of repayment. Private sector investors are not interested in the public policy or political control issues which are of direct interest to the government.

We are not talking about privatization of any kind or about any kind of public private partnerships. We are talking here about borrowing of private funds in the capital markets for public projects. The lenders may be commercial banks. Because of the long term nature of the investments, the lenders are more likely to be investment funds with long term goals such as life insurance companies and pension funds. Such lenders normally access investment opportunities through the capital markets, with the

¹ <http://www.gwpforum.org/gwp/library/FinPanRep.MainRep.pdf>

investment arranged by investment bankers. The traditional capital market instrument is the long term bond. Long term bonds can be very attractive to institutional buyers due to the secondary market that exists throughout the world for such transferable bond instruments.

Many Municipalities Are Not Familiar with Access to Private Capital

Municipal governments do not generally submit themselves to review or scrutiny by private entities. There is an understandable reluctance of municipal officials to do so. Such reluctance is in part social, it is in part political, and it is in part borne of a responsible exercise of government control over governmental activities.

If a municipality has not sought private sector financing for its projects, the municipality is unlikely to be familiar with the procedures or methods for achieving such financing. However, those procedures are not obscure. The procedures do not reduce government's control over its own projects.

Commercial and investment bankers are very interested in doing business with most municipalities. They are available to municipal officials to guide them through the processes by which municipalities can attract financing for projects.

A key component in the ability of a municipality to access private capital markets is the provision of information about the municipality's budget and finances. Private lenders need to make their own determination about the municipal credit. This determination, the municipal credit rating, allows financial institutions to evaluate the risk of timely repayment of municipal obligations. This evaluation permits private decisions to be made regarding the attractiveness of municipal debt instruments. In practice, it allows the municipality and its bankers to determine the interest rate and terms of the debt offering to make the bonds attractive to the potential bond buyers – the private lenders.

How Municipalities Get Private Investment Funds

To achieve access to private investment funds, government needs to recognize the investor's needs. These investor needs to understand the stability, certainty and reliability of repayment in accordance with the terms and conditions of the borrowing. That is, if an investor lends a sum of money to a municipality through the purchase of publicly issued bonds, the investor will need to know what risks, if any, exist with respect to the timely repayment of that bond in accordance with the promises contained in that bond. So, if a municipality offers a 15-year bond with a stated interest rate and a stated payment schedule, the investor will need comfort that it will be repaid in accordance with the terms of the bond.

To achieve access to private investment funds, government needs to accommodate the investor's need for transparency, certainty and security. There are international standards for predictability and credit risk analysis which are well known to the international capital markets.

- Municipal Credit Ratings

The three major international companies that provide independent analysis of bond issues for the international financial markets are Standard & Poor², Moody's Investment Service³ and Fitch Ratings⁴. Here, the Indian national credit rating organization, CRISIL, is active in rating commercial and governmental issues. Each is active in the governmental market rating national governments and sub-sovereign entities, including cities, counties and other levels of government and governmental agencies. Each is also active in the international corporate market, rating corporate debt issues of many kinds.

The international capital markets rely heavily on the independence, analysis and integrity of the ratings issued by these ratings services in making their investment decisions. For many substantial pools of funds, an "investment grade" rating from these agencies is a pre-requisite to buying the bonds being offered.

It is useful to review the information sought about municipalities by the ratings agencies and the issues suggested by this information. These comments follow the published criteria and issues of Fitch Ratings. They are similar to those used at the other services, although the analytical methods vary.

First, they want to know about the administrative and legal structure of the entity seeking a rating. For example, they want information about the issuer's government responsibilities, its organizational chart, its procedures for selecting its key officials, the professional qualifications of key administrative and professional employees. Among the legal issues they will examine are the source of the municipality's governmental powers, its relationships to other governmental entities, including the national government, any relationships to other government bodies, particularly in terms of service provision, governmental-owned utilities, environmental regulations, or foreign currency or debt restrictions, the relevant bankruptcy and insolvency laws and related court rulings and statutory, charter, and constitutional limitations on debt issuance and ability to raise additional taxes. They want to understand in detail the remedies and procedures available in the event of temporary or ultimate default on the repayment obligations. For example, if there is a pledge of the facilities, how can that pledge be realized upon if necessary.

Second, they will accumulate information about the economy of the municipality. This will include information about employment, trends in employment,

² The Web site for Standard & Poor's is <http://www2.standardandpoors.com>, its Russian website is <http://www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp/Page/HomePg&r=5&l=RU>

³ The website for Moody's Investment Service is <http://www.moody.com>

⁴ The website for Fitch Ratings is <http://www.fitchratings.com>

the largest employers, population trends and demographics, income measures, including per capita income. trend of property values, condition of a variety of infrastructure services, information about the real property value and utilization, including new construction and other economic information, such as foreign investment by sector and investor.

Third, they will seek information about the budget and fiscal operations of the municipality. They will look for current, historic and forecast revenues and expenditures, with clear information about existing and new borrowing and debt repayment. They want to know about the anticipated sources of revenue for the water projects, such as user fees, dedicated taxes or government transfer payments. They want information about the accounting standards used in the municipality, and how consistently they are applied. They want substantial information about the municipal budget, the budget history and how operations, income and expenditures conform to the budgeting process. They need information about the municipal revenue, including taxpayer composition for major tax sources and a description of each tax and rate-setting powers, tax and other revenue arrears. They want the details about the predictability of fund transfers from the national government and transfers to it. They want information on capital improvement plans and about internal audit policies.

Fourth, the rating agencies develop information about the existing and anticipated borrowing that the municipality will undertake. They want to know how the debt is managed, the size and maturity, and anticipated cash flow implications of the debt service on the proposed issue. They need details on guarantees, pledges, collateral and potential other sources of funds available to provide credit support for the municipality. They want information on any history of defaults, not only of ultimate payment of obligations but also of untimely payment and of compliance with other covenants of existing debt that may or may not be in default. Where there is off-balance sheet debt, such as may be held by such special purpose municipal entities as electric companies or district heating systems, the details of that debt and the interrelationship between the entity and the municipality's obligations will be investigated.

With this information, the rating agencies will undertake their analysis. The result of that analysis will be a designation of a rating on a scale, such as AAA, or A-, or BB. That rating is claimed by the ratings service to be as objective as it can be, in according with its own internal criteria. The ratings are intended to have no political or social meaning. They are intended solely as an objective rating of the credit of the borrower in connection with the publicly marketed debt instruments, such as bonds of the municipality. They serve the municipality's needs by providing to the market an objective evaluation of the safety and security of the debt. This influences the municipality's access to the capital markets and to commercial banks. it also influences the interest rate and the terms of the bonds. The higher the rating, the better the interest rate and the better the terms.

In their evaluation of the credit, certain practices of the municipality will be given positive recognition. Such practices as multi-year budgeting and revenue forecasting, periodic monitoring of revenues and expenses against budget goals,

contingency planning, recognition of depreciation and the need to provide for maintenance and replacement of capital goods and clearly monitored and disciplined spending according to the budget will have positive influence in the credit rating determination.

Municipalities must recognize that there are certain indicators that the ratings agencies look for which adversely affect ratings decisions. Obvious ones are incidents of defaults on existing obligations or the lack of willingness of the municipality to be forthcoming and public respecting its finances. These include the use of deficit financing, borrowing to pay for current expenditures, the reliance on one-time grants or aid as recurring sources of revenue, overly optimistic revenue assumptions, imprudent management of current cash, political issues influencing the predictability and stability of revenue and expenditures and lack of good fiscal planning.

How Municipalities can increase the credit of water project lending

Municipalities around the world frequently look to legal or financial mechanisms which will permit them to enhance their credit.

Frequently used credit enhancement mechanisms include (1) the dedication of a specific source of revenue to the support of the debt obligation; (2) the pledge of the general revenues of the municipality, including a pledge to raise taxes if necessary; (3) the pledge of funds which they are legally entitled to receive from others (such as from the national government); (4) the creation of municipal reserve funds; (5) the pledge to raise tariffs or revenues to meet any unanticipated costs; and (6) the purchase of third-party credit insurance.

Even using these mechanisms, municipal borrowing from private sector entities involves transaction costs that make it expensive to access the capital market for small projects. The transaction costs can include feasibility, engineering and environmental studies needed to support the financing and banking and legal fees.

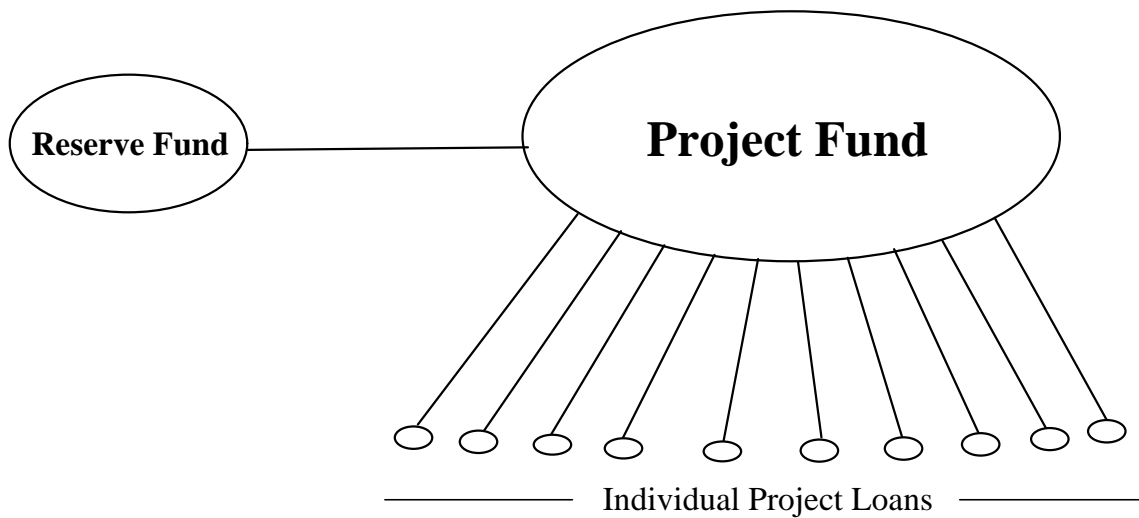
It is well recognized that the aggregate credit of many municipalities, or of many individual projects, can exhibit a stronger credit profile than can individual projects. The rest of this paper addresses a financing model which uses several credit enhancement techniques at the municipal and at the facility level to provide a very strong credit for small and medium size municipal water projects. More than \$15 billion worth of water projects have been privately financed using this model.

Collective efforts - the Sustainable Water Finance Facility Model

Capital market funds are available to finance pools of small and medium size projects, the credit for which can be collectively enhanced using known techniques, the combination of which results in good and recognizable credit. Simply put, the model is the combination of a Project Fund, a pool of loans to small and medium size projects and a Reserve Fund that provides credit support. The structure of this financing model is depicted here.

It is “sustainable” because it dedicated the funds that are repaid by municipalities to be lent again for additional projects. The structure is recognized by the credit rating agencies as being very strong. It justifies good investment grade ratings without federal or state guarantees.

The Sustainable Water Finance Facility Model



There are three basic elements of this model. These elements work as follows:

- The Project Fund – The Project Fund is money raised in local and international capital markets. It is the money which is lent to municipal or private borrowers. The loans are made for individual municipal water projects. The money in the Project Fund is held by trustees, such as banks or other financial institutions, and is administered by its management. It is held in trust for the purposes for which the financing facility is created.
- The Pool of Project Loans – A reasonably large number of small and medium size project loans is aggregated into a pool for collective credit purposes. The pool provides the basic credit support for the financing of the Project Fund. Project loans are issued for discrete projects. The individual projects are likely to involve the upgrading of existing facilities or the development of primary water resources or sanitation facilities. Typical projects might be the drilling of new wells, the rehabilitation of a water distribution or collection system, the construction of a primary wastewater treatment facility or the support of the administration of a municipality’s water planning, engineering and program activities.

- The Reserve Fund – The Reserve Fund is the legally inviolate fund which serves as credit support for the market oriented borrowing undertaken by the facility to provide funds for the Project Fund. The Reserve Fund can be provided by multi-national financial institutions, by national government or otherwise. The Reserve Fund is held as a separate trust fund and earns interest. The principal and interest accumulates in the Reserve Fund and serves as the ultimate credit support for the repayment of investors in the Project Fund.

Layers of Credit Support

Several credit support mechanisms are frequently employed in the sustainable finance model. The particular combination of credit support mechanisms will vary by country. The combination will be a function of the local legal structure and the desire of national and local governments to provide the necessary combination of credit support to make the Facility a reality.

A possible scenario of layers of credit support for a typical Facility organized under the Sustainable Water Finance Facility model would be:

Layer 1. The municipality's promise to repay its project loan out of tariff revenue together with the unconditional obligation of the municipality to pay out of general municipal funds.

Layer 2. The first curing of individual project loan difficulties would be made from the accumulated net interest earned by the Project Fund. It is anticipated that individual project loans will be made at rates of interest slightly higher than the cost of money to the Project Fund. This interest margin can be used as a level of credit support for project loans.

Layer 3. An aid intercept mechanism might be the next cure of individual project loan defaults. Several countries permit the intercept of transfer payments made by the national government to local governments to be used as credit support for municipal borrowing. In the event of default in payment of principal or interest by a municipality, the trustee for the pool is permitted to directly attach such transfer payments to satisfy any default of the underlying loan. Experience in several countries shows that the existence of this aid intercept mechanism substantially increases the repayment performance by municipalities. The very existence of the mechanism reduces the chances of default.

Layer 4. National government support may be necessary or appropriate. The national guarantee might be made (a) in support of the individual municipality's obligations to the Project Fund, (b) in support of the Project Fund's obligation to pay its lenders or (c) to replace funds in the Reserve Fund which might have to be called upon to support repayment to Project Fund lenders. National guarantees are likely to be necessary for only a small portion of the total of the project loans. This leverage

substantially minimizes the use of sovereign guarantees.

Layer 5. Interest earned on the corpus of the Reserve Fund is available to support repayment to Project Fund lenders. When not so needed, the interest could be allowed to accumulate to strengthen the reserve or it could be used to support additional lending. If and when the market deemed additional credit support unnecessary, the interest earned on the Reserve Fund could be used to subsidize the interest rate paid by municipalities on project loans.

Layer 6. The ultimate security for the repayment to the Project Fund's lenders is the principal of the Reserve Fund. The certainty of the existence of the Reserve Fund for the term of the loans supporting the Project Fund is a basic element of this framework model.

Observations about the Sustainable Finance Facility Model

This model permits the active participation of local financial institutions and local investors. The model will work better with such participation. Substantial involvement of local investors is important because it provides a local fiscal discipline for municipal loan repayment. That is, with local lending, the failure of a municipality to timely repay a loan will have local consequences. The local consequences of default have has greater local political meaning than similar defaults solely to international lenders whose recourse is not as immediate or as locally meaningful.

The use of local capital markets has advantages independently or when combined with international lending. Private local capital markets can provide a unique discipline. Local lenders with local knowledge will not lend their private funds unless they are convinced of the timeliness and certainty of repayment. The credit structure of the facility is sufficient to provide a homogenizing of risk and the ability to repair some default. The oversight of local lenders is a check on the reality of credit decisions.

Local lenders are understood by the international lending community to be particularly understanding of local conditions. The international lenders are attracted to the specific sustainable water facility as a direct result of locally imposed discipline on the process.

The model has proven that municipalities or private project sponsors which do not otherwise have investment grade credit ratings can achieve the financing of their projects at favorable interest rates with private capital raised through the sale of bonds in the capital markets. These bonds are issued on the credit strength of both the pool of loans and the oversized Reserve Fund.

The facility raises capital on commercial terms for the Project Fund, normally through an investment banker in the capital markets or a commercial bank syndicate buying the facility's bonds. Internationally, a multi-lateral financial institution might lead the financing through the provision of an A/B loan structure or otherwise.

The credit features of the sustainable model are sufficient to make the pool of individual project loans more creditworthy than the individual loans themselves. The credit support arises through the interrelationship of the independent elements: (a) the pool spreads the credit risk amongst the large number of projects, (b) the aggregate interest on the pool of loans provides a first level of credit support, (c) as each project loan is paid down, money is returned to the pool and a portion of the Reserve Fund is “freed-up” - - the returned money is available as a second credit to cure any project loans which may be in default; (c) the interest earned on the invested Reserve Fund constitutes a next level of credit support for potentially defaulting loans; and, (d) the money in the Reserve Fund itself is an ultimate credit support for the individual loans.

The Reserve Fund must be inalienable. The Reserve Fund must not be diverted from its sole purpose of providing credit support for the water financing facility. If there is any possibility of the diversion of the Reserve Funds, the credibility of the whole model collapses. Accordingly, the Reserve Funds must be established and maintained with utmost independence as a matter of law and as a matter of administration. The Project Fund management must be transparent. The commitment to repay private lenders must be credible. The pool must be sufficiently diversified as to be insulated from the performance of one or a small group of non-performing borrowers. The layers of credit support must work sequentially in a seamless fashion.

Independent management of the facility is necessary for the credibility of the program. That independence is particularly important in credit analysis of municipalities, in the decision to make individual project loans, in the administration of individual loans, and in the enforcement of loan covenants. Discussions with experts around the world have suggested that such loan administration is only possible through the use of a independent management company, working through or with a well-regarded banking institution which has the respect of the local lenders and of local municipal borrowers.

Credit enhancement may be necessary to encourage lending of private capital to municipal water projects. The credit enhancement made possible by this framework can help achieve the goals of this conference.

The model permits the aggregation of a large number of small and medium size projects to be financed. By concentrating on small and medium size projects, needs can be met within a country which otherwise could not be financed. The number and relatively small size of these projects puts them beyond the ability of the international grant agencies and the multi-national financial agencies to directly support them.

Conclusion

Money is available in the private sector to support municipal water projects. This money will be forthcoming through loans or municipal bonds. This is possible as long as the terms provided for the return to the investor are comparable to the returns which are otherwise available to the investor.

There are standardized evaluations of the credit standing of municipal debt offerings. These criteria are easy to understand and relate to the stability and reliability of the investment. They require that a municipality publicly disclose its budget and financial situation. The creditworthiness of the municipality and/or of its debt is a function of the stability, predictability and reliability of the repayment in accordance with the terms of the debt instrument.

Municipalities seeking to access private capital may need to adopt their internal budget practices and will need to disclosure budget information in ways that are difficult for them to do so. There may be operational and political reluctance to do so. However, the requirements for accessing the capital markets do not require municipalities to give up any decision making or control with respect to the water projects themselves. The municipality can maintain full control over the selection of projects, the nature and degree of service to be provided and the environmental standards to be achieved.

There are several credit enhancement mechanisms that can increase the access of municipalities to capital market financing. These include financing through pools of municipal loans, reserve funds provided at the individual loan or pool level, aid intercepts and collateral guarantees. Structured together, these credit enhancement mechanisms can very substantially increase the credit of a collected group of water projects. So enhanced, water projects become very attractive investments for several classes of private investment funds.

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