Blended finance at Stockholm Water Week 2018: going deeper

At Stockholm Water Week 2018, IRC and Water.org collaborated to advance the conversation on blended finance and look more specifically at how it can be utilized to reach the last mile. This summary reviews and reflects on the most relevant take-aways from both sessions. Presentations can be downloaded from the webpage.

Blended finance: from principles to practice
Monday, 27 August 2018

Session takeaways:

- The water sector lags behind other sectors in terms of harnessing alternative financial sources, including options that blend development and private finance;
- Finance exists for water sector players who can demonstrate that they are effective managers of service delivery and financial stewardship (i.e. recover their costs);
- Good governance is needed as a pre-condition to shape and enforce financial and technical regulations;
- A necessary first step for making the sector more attractive for private investment is a focus on developing the enabling environment. This will lead to increased technical and financial operational efficiency and also improve the availability of financial data in the sector;
- Public finance will always be needed for the poorest segment of the population. Therefore, financial structures that share risk with partners and strategically utilize subsidies is key to enabling investment.

"The High Level Political Forum in July 2018 concluded with a clear message: the world is not on track to meet SDG 6 in contrast to other SDGs. We need to invest and innovate. Even though there are positive examples of increased financial resources in different countries, bridging the finance gap is crucial. Blended finance solutions are an essential part of looking for innovative solutions."

Niels Vlaanderen, Dutch Ministry of Infrastructure and Water Management

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This session, co-organised with the Organization for Economic Cooperation and Development (OECD), the World Water Council and the Government of the Netherlands' Ministry of Infrastructure, opened with Kathleen Dominique and Paul Horrocks from OECD framing the conversation by stating that while the water sector clearly provides investment opportunities for the private sector under a blended model, but the sector is not yet attractive enough.

Crowding private investment into this space requires a sector with a long tradition of ODA and public funding to re-evaluate its 'pitch' and look at risks (macroeconomic, business, regulatory, political, technical, environmental, social) as well as expected returns. The OECD highlighted that it is currently embarking on deeper research regarding the feasibility of blended finance for the water sector, including: Which water sub-sectors are the most relevant to blended financing solutions? What combination of attributes should be present to attract private investment? What are the roles and responsibilities of different stakeholders in developing and realizing blended finance projects?

> *"Over the past four years, USD 81 billion of development funding was mobilised from the private sector. Only 1.9% of this amount was mobilised for water. The water sector is, despite the demands and needs, not doing well."*
> *Paul Horrocks, OECD*

Dick Pajarillo of Water.org gave an example of how blended finance has been successfully utilised in The Philippines. A small municipal water utility borrowed expansion capital from the government at concessional terms. Water.org provided technical assistance to the utility to help them strategically expand in areas of high need and where potential clients were ready to connect – either with their own funds or though taking locally-available loans (also facilitated by Water.org) that are specifically designed to help interested parties pay for the connection fees. Loans were provided with local capital and clients repaid the banks as well as the water utility with their private funds. In this way, the government, the private/domestic market and an NGO all combined efforts to make the project successful.

Catarina Fonseca of IRC observed that the key constraints to blended finance in countries like Ethiopia and some states in India include two crucial aspects:

1. **There is a lack of an enabling environment to attract additional finance, public or private.** Service providers and the organisations that are responsible for regulating the sector lack staff with (financial) skills - there is usually someone with a water or sanitation technical background, but no corresponding knowledge of how to calculate remaining available budget or how to influence budgeting processes.
2. **Service providers generally demonstrate a lack of efficiency and an inability to recover basic costs for operation and maintenance (O&M).** If returns on investment cannot be guaranteed, no one will lend the funds.

In the context of this conversation, the term 'enabling environment' is a catch-all phrase for conditions that enable or encourage blended financial solutions for water. This includes:

- the technical and financial efficiency of service providers (including capacity);
- governance arrangements for holding employees as well as service providers accountable; and
- an alignment of the regulatory environment and political will.

The implication of the above is that if private finance is to be crowded in, a sizeable part of investment has to be directed toward fixing the enabling environment. Until that happens in low income countries, rural areas and informal urban settlements, people will remain reliant upon other financing instruments.

The World Bank's Joel Kolker corroborated the above, observing that when considering blue bonds, green bonds and blended finance solutions, the technical and financial proficiency of people in the system is just as important. The focus should be less on the money and more on the underlying quality of service providers. Quick turnaround will indeed be possible with the right political leadership, as demonstrated in the Philippines".

Christopher Flensbourg, Head of Climate and Sustainable Finance at Swedish bank Skandinaviska Enskilda Banken (SEB), underscored the importance of good governance and the need for technical assistance. Investment models that benefit different players need to be created. When the challenge of merging financial requirements for capital expenditure (CapEx) and operational expenditure (OpEx) is overcome, the money will be available. He observed that investment banks regularly mention the high cost of supporting small projects, or rather that a bank's transactions costs remain consistent regardless of project size, incentivising them to focus on bigger projects. Capacity investments were also highlighted as a basic precondition: service providers need to have data available as a measure of investment risk, but there is a lack of financial data as well as on service providers' overall performance. Only a few countries are monitoring their financial expenditure against services delivered.

> *"There are very high transaction costs for pushing forward projects that are interesting but complicated in set-up. The investment banks face limits in developing blended options for anything smaller than several million Euros."*
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> *Nick Marchese, European Investment Bank*

Blended Finance deep-dive: What are the real blockages to financing SDG 6?
Tuesday, 28 August 2018

Breakout group take-aways:

- Capital for technical assistance is crucial, and where the money is not flowing. Public / development money should be used for technical training and to catalyse private.
- Bottlenecks of financial supply cannot be de-coupled from those of financial demand. Both sides need to be addressed, at all levels – local as well as global.
- Know what to target with blended finance mechanisms – who are the real beneficiaries? Awareness about the needs of service users, and appropriate segmenting the types of solutions offered to them, is critical.
- Without improved professionalisation it will be nearly impossible to attract financing to the base of the pyramid.
- Universal demand for household-level WASH cannot be met solely from the households themselves when you consider the absolute base of the economic pyramid or the most excluded. There will always be a role for public/ODA money.

> *"Simplified definition of blended finance: using public money to de-risk investments and thus make them more attractive to private money."*
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> *Dr. Catarina Fonseca, IRC*

The second session, acknowledging that most success with blended finance to date has occurred in higher-income countries, was designed to explore implementing blended finance mechanisms in lower-income countries. After a few examples of pro-poor blended finance were provided, the group broke into small tables for deeper guided conversations.

> *"The main concern for Banks is the risk, but what we have to realise is that it is not about the poor not being able to pay - usually they pay more than middle-income costumers. Conversations need to shift towards affordability."*
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> *José Tomás Frade, former Deputy Director, European Investment Bank*

Maren Barbee; Blue Harvest Regional Manager at Catholic Relief Services explained how their Azure initiative has worked in El Salvador. Private, NGO and public finance have come together in a model which is based on two key areas: (1) supporting the providers of finance (the supply side) by de-risking the investment with a grant; and (2) providing technical support to the service providers (the demand side). The communities are paying for the water services, demonstrating the model's viability.

This programme combines grant investment, local investment and impact investment. The funds in this model to flow to service providers through local credit companies (originally created for agriculture, not water). At the other end of the financial flow, a trust was created in El Salvador, supported by a holding company in the US.

Vedika Bhandarkar, Managing Director of Water.org-India, presented another example of blended finance geared for the poorest. Water.org works with different types of financial institutions to enable finance to flow for water and sanitation-related lending. These efforts have also included partnering directly with various branches of the government to ensure that appropriate regulations are in place and understood down to the field level.

Water.org stimulates the market for household water and sanitation by encouraging financial institutions (banks, self-help group organizations, microfinance institutions) to develop loan products for water and sanitation. Water.org provides technical assistance, sometimes through a small project preparation grant, to help understand what kind of investment makes sense in a certain context. Financial actors source their capital locally and lend to interested households. These efforts have reached 8 million people in India to date.

One of the biggest challenges is convincing banks that WASH loans are not such a risky sector. Water.org is trying to think how else to change this perception, and what other types of risk mitigation can be provided - grants are meaningless for bigger banks.

> *"My dream is to stay in touch and make sure that this discussion doesn't end in this room. Be in touch with IRC and Water.org. Seeing this many people in one room is great, but it's not enough. We have to continue to inform each other and work together to move faster to address the finance gap."*
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> *Claire Lyons - Senior Strategist, Water.org*