Sustainable Water Integrated Management (SWIM)

Regional Training Event

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Day 2 – Session 3
Guarantees in PPP for Water Infrastructure, & the Use of Insurance for Securing Interests

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The Role of Guarantees (1)

- Guarantees to underwrite a portion of the commercial risks has also been introduced selectively by the multi lateral banks like the EIB and the WB, while USAID offers the DCA (Development Credit Agency) program.
- Guarantees are mostly used to allow the Project company /sponsor easier and less pricey access to the capital markets.

The Role of Non-Financial Guarantees

Depending on the project Government may reduce the risk to the private sector through guarantees:

✓Typically in a bulk water scheme, it may be a “take-or-pay” type of guarantee, or

✓In a distribution network it could be a minimum demand guarantee.

✓And in extreme cases it could even be debt guarantees to launch specific programs like NRW reduction.

Credit Guarantees

Credit Guarantees cover losses in the event of a debt service default regardless of the cause of default (that is, both political and commercial risks are covered with no differentiation of the source of risks that caused the default).

✓*Partial Credit Guarantees (**PCGs**)* fall into this category and cover “part” of the debt service of a debt instrument (regardless of the cause of default).Typically, a PCG would improve the terms of the commercial debt of the borrower, extending the maturity and/or reducing interest rate costs, through the sharing of the borrower’s credit risk between the lenders and the guarantor.

✓*Export Credit Guarantees or Insurance* cover losses for exporters or lenders financing projects tied to the export of goods and services. Export credit guarantees or insurance cover some percentages of both political risk and commercial risk.

Political Risk Guarantees

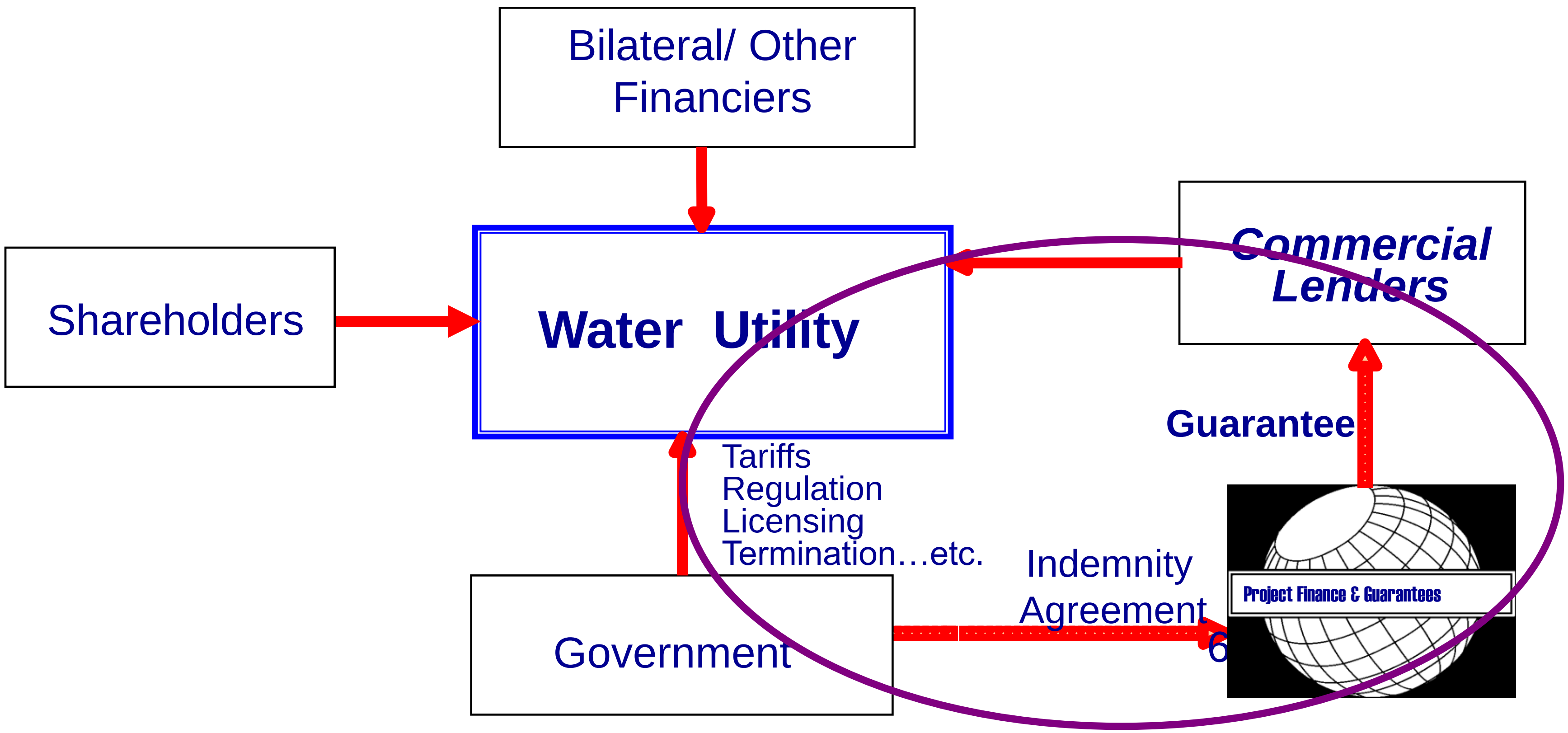
Political Risk Guarantees or Insurance cover losses caused by specified political risk events. They are typically referred to as ***Partial Risk Guarantees (PRGs)***, or ***Political Risk Insurance (PRI)*** depending on the provider.

✓PRGs cover commercial lenders in private projects. They typically cover the full amount of debt. Payment is made only if the debt default is caused by risks specified under the guarantee. Such risks are political in nature and are defined on a case-by-case basis.

✓PRI, or investment insurance, can insure equity investors or lenders. PRI can cover the default by a sovereign or corporate entity but only if the reason for a loss is due to political risks.

Partial Risk Guarantee (PRG)

A PRG will cover lenders in case of a default on a covered contractual obligation to a project company leading to a Debt Service Default



Deployment of the PRG

PRGs should be considered in the following situations:

- Early stages of reform
- Larger size/riskier operations
- Operations highly dependent on support/undertakings of weaker governments/municipalities

Review of IFI Risk Mitigation Instruments

The Role of IFI Risk Mitigation Instruments

"…is to address the need for political risk mitigation products by commercial lenders, debt and/or equity investors contemplating investment in developing countries…"

For lenders and investors these products can:

- Mitigate threshold risks—allowing investment consideration in potentially high risk markets
- Enhance credit-worthiness/lower investment costs--by insuring against specific risks
- Provide access to "honest broker" services of IFIs-- in negotiations with a government

Risk Mitigation Instruments

Current Guarantee Instruments
- **Political**
- **Credit**
- **Contractual**
- **Other**

Participation Instruments
- A Loans
- B Loans
- C Loans

Special Facilities
- Devaluation backstop facilities
- Standby LOCs
- Other

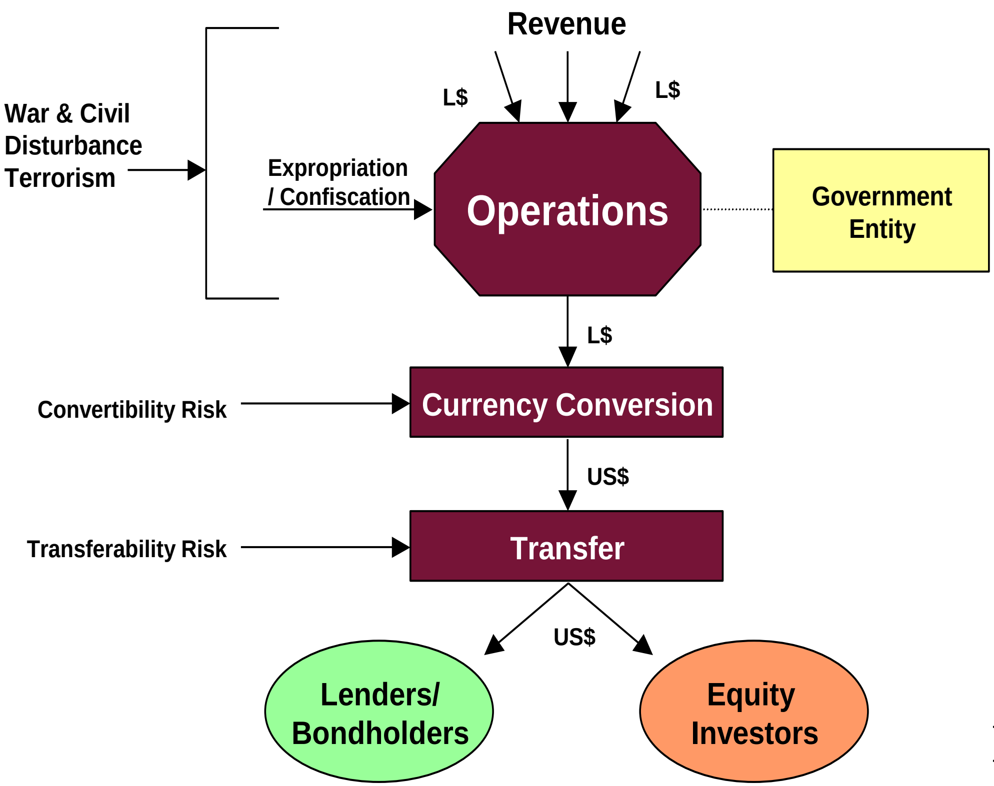
International Financial Institutions
- **IBRD,** The International Bank for Reconstruction and Development (including IDA)
- **IFC,** The International Finance Corporation
- **MIGA,** The Multilateral Investment Guarantee Agency
- **EBRD,** The European Bank for Reconstruction and Development
- **EIB,** The European Investment Bank (non-EU programs only)
- **ADB,** The Asian Development Bank
- **IADB,** The Inter-American Development Bank
- **IsDB,** The Islamic Development Bank
- **AfDB,** The African Development Bank

Categories of Risk Instruments

The risks faced and instruments available to investors, lenders and bondholders in emerging markets projects fall into the following risk categories:

- Political Risks
- Contractual/Regulatory Risks
- Credit Risks
- Foreign Exchange Risks

Political Risk Instrument Coverage

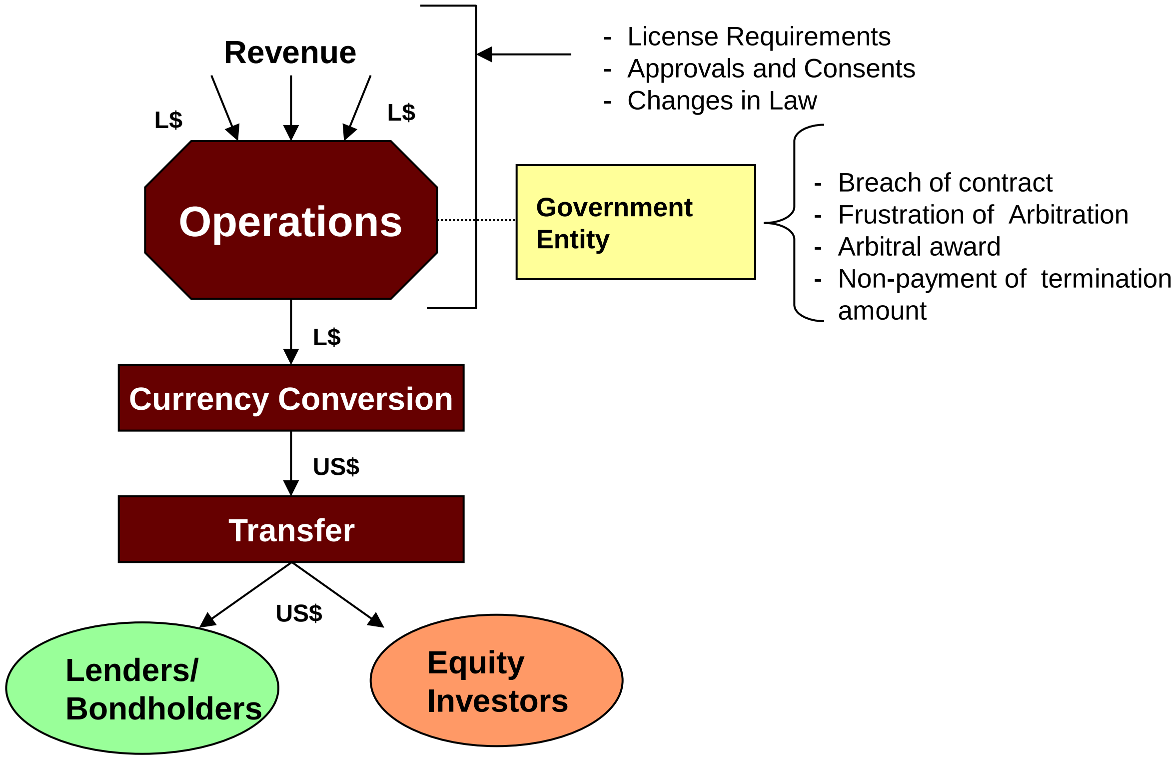


- Five of the nine IFIs offer "traditional" political risk cover either as standalone instruments or as part of larger coverages.
- MIGA, IADB, AsDB and IsDB offer these coverages without requirement of a sovereign guarantee, and only MIGA offers equity cover.

	Coverage	Political Risks				
Institutions	Debt/Equity Coverage	Terrorism	Confiscation	Expropriation / Nationalization	Transferability / convertibility	War and civil disturbance
IBRD PRG	Debt					
AsDB PRG (Public Sector)	Debt					
IsDB Export Credit Insurance Policy	Debt					
IsDB Bank Master Insurance Policy	Debt					
MIGA PRI	Debt/Equity					
IADB PRG (Private)	Debt					
AsDB PRG (Private Sector)	Debt					
IsDB Foreign Investment Insurance Policy	Debt/Equity	TBC				

Regulatory/Contractual Instrument Coverage

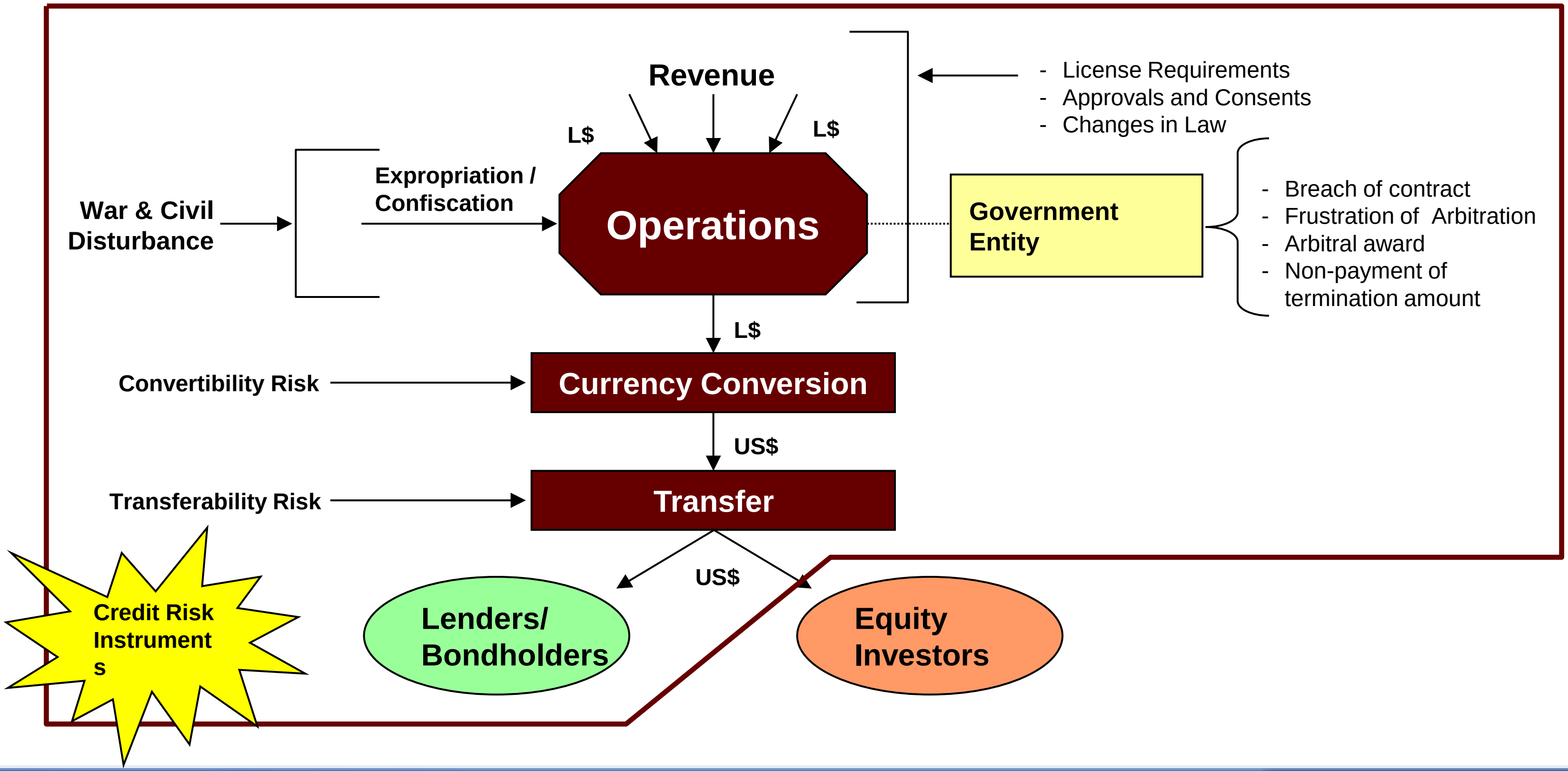
- In response to market demand, a number of IFIs began to offer more complex coverage to address risks which were not in the developers control but had significant impact on the viability of operations and cash flows over the extended period of an infrastructure project.
- Regulatory/Legal Environment and Contractual Risks address the operating environment, agreements and assumptions which form an integral part of the successful financing of these projects. By nature, such coverages are more complex to write, rely on clear legal documentation and require explicit but sometimes time-consuming dispute resolution processes.



Credit Risk Instrument Coverage

Credit risk instruments provide coverage specifically for lenders and/or bond holders. Typically, they cover all or part of the debt payment stream.

Because of the nature of these guarantees, they pay in the event of default for any reason (except, in some cases, devaluation).



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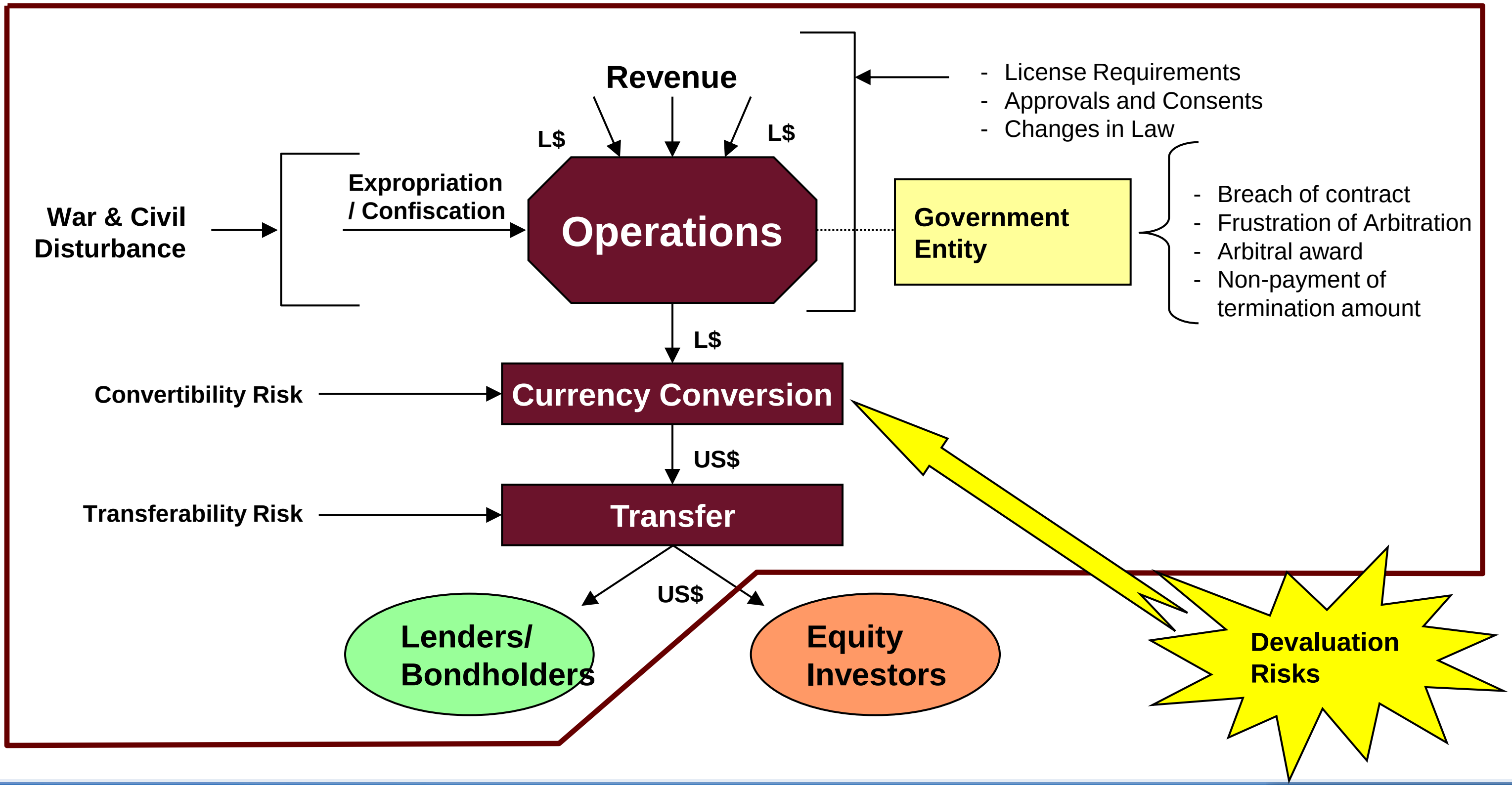
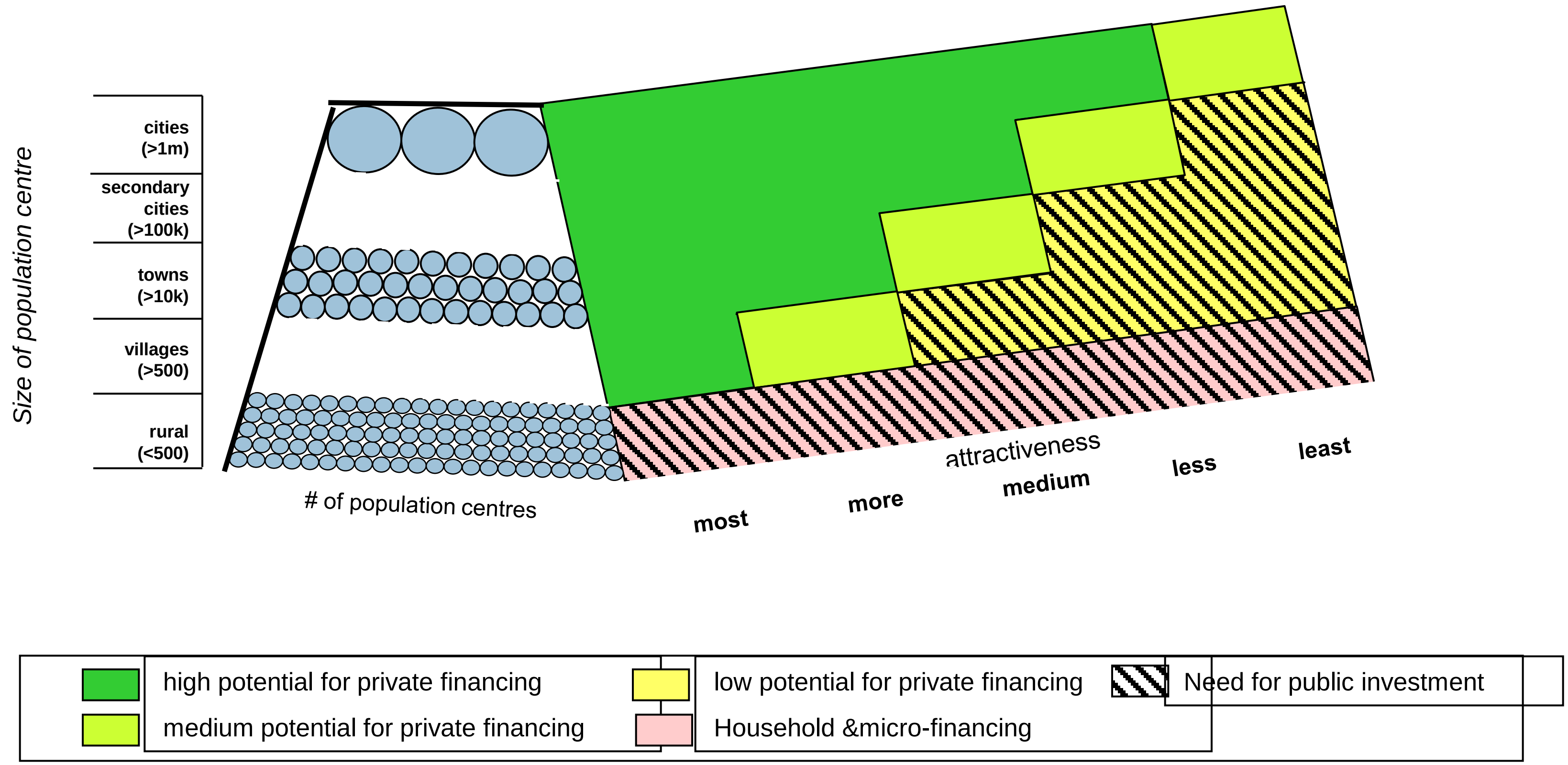
Foreign Currency Risk

- Devaluation risk is a top ranking risk concern to debt and equity investors in emerging markets infrastructure projects.
- Water projects in particular are exposed to devaluation risk with their frequent substantial upfront foreign currency investment costs, long-term repayment streams in local currency and dependence on balanced regulatory, social and political regimes.



Key Issues for WSS use of Risk Instruments

The market poses special challenges



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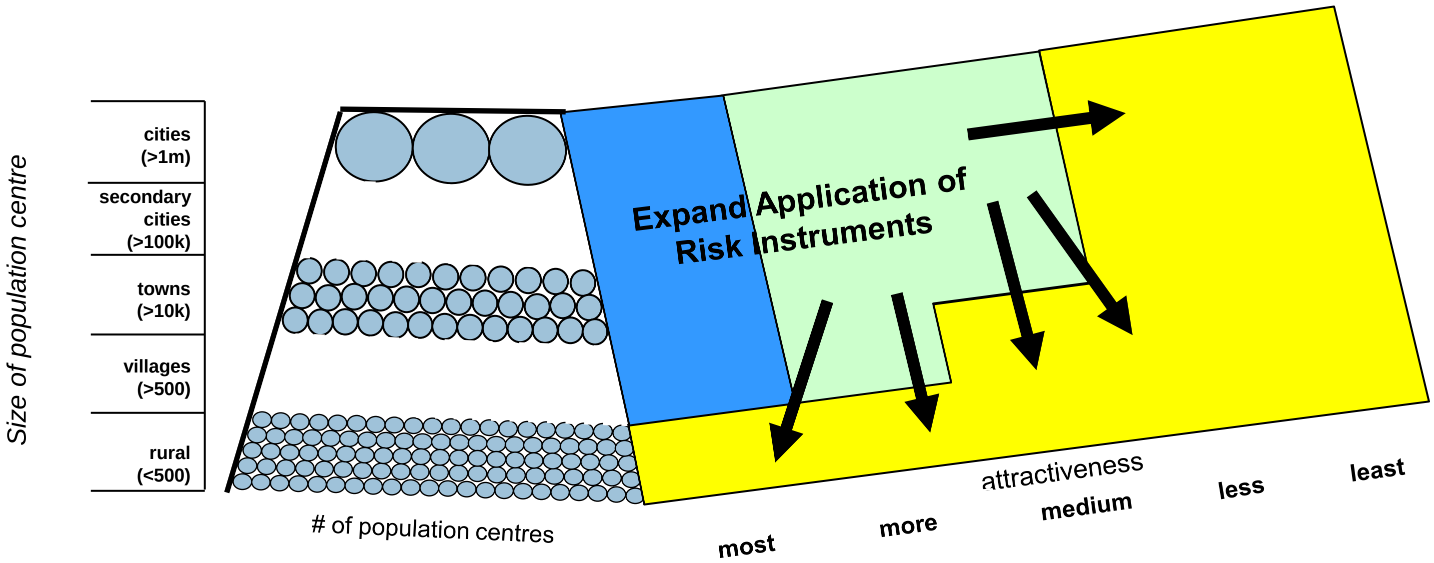
The Risk Mitigation Instruments: Needed, Available ? Used?



Do not require risk mitigation, Adequately credit worthy	Risk mitigation instruments could be effective: Nearly/marginally creditworthy & reforming
Risk mitigation instruments will be ineffective: Non-creditworthy and low performing or instruments too expensive	

Where risk mitigation can make a difference

- Adequately Creditworthy – Do Not Require Risk Mitigation
- Near Creditworthiness
- Marginally Creditworthy, but Reforming
- Non Creditworthy and Low Performing

Risk Mitigation Instruments Could Be Effective

Key Questions

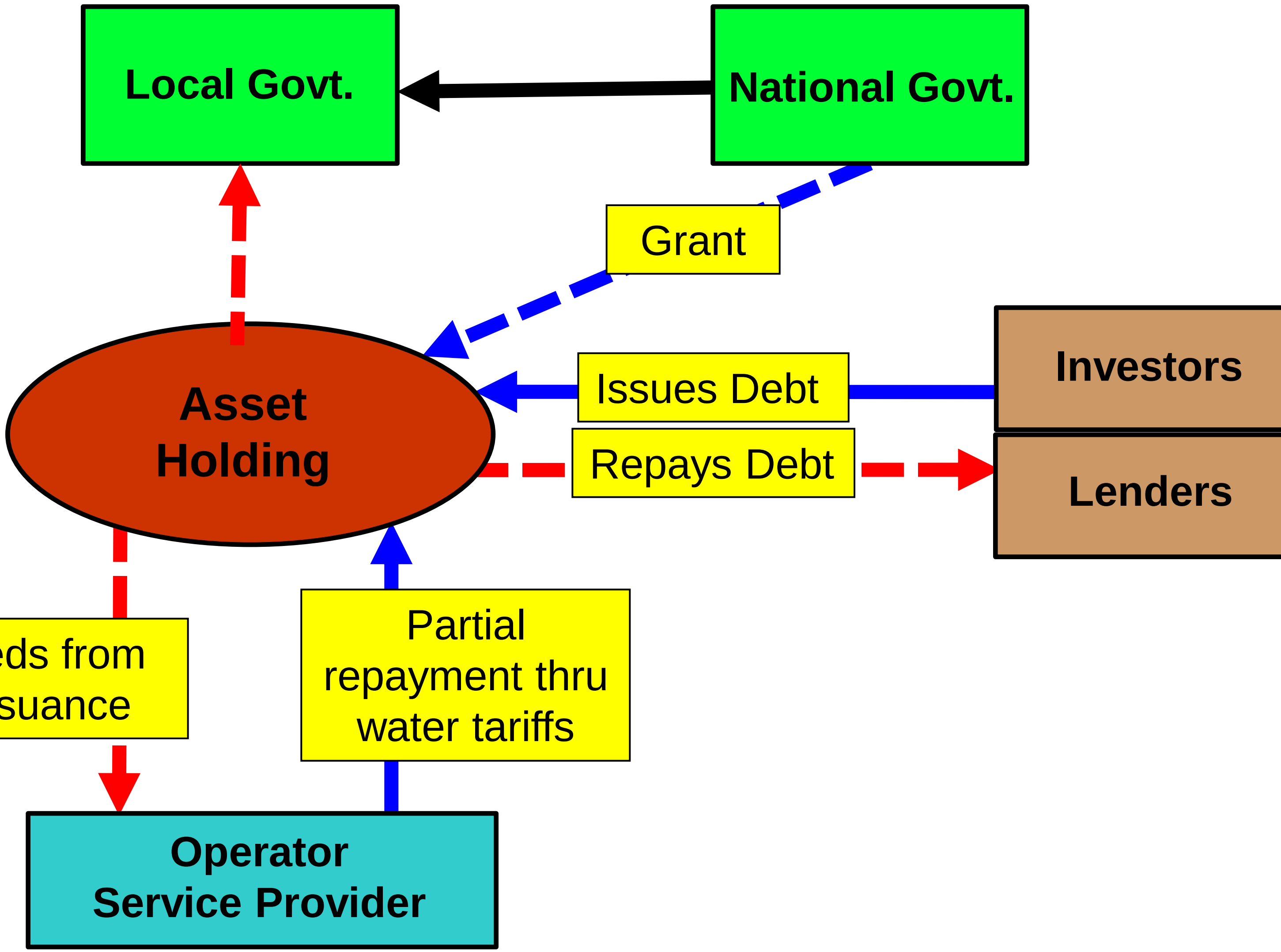
- How to **structure** the PPP to create comfort for private investors to take equity?
- How to **create** conditions to attract private sector (debt)finance?
- How to **design** the PPP transaction linking finance to achieving predetermined performance targets?

(Innovative) Instruments to Attract Financing in the WSS Sector

The Trust Structure Concept

- Reasons for interest
  - ✓ The strongly expressed position of major private international water operators that their interests are fundamentally as operators of such systems, not investors.
  - ✓ The need to mobilize capital for rational investment in specific opportunities.
  - ✓ The need to improve operations and maintenance of existing facilities and to efficiently manage new and expanded facilities.
  - ✓ The inability in many cases of tariffs to cover capital investment, operating costs and return on capital (debt and equity).
  - ✓ The weak contractual, legal and regulatory environment for WSS investments, particularly at the sub-sovereign level.

Financing—Using the Trust / Asset Holding Structure



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(Innovative) Instruments to Attract Financing in the WSS Sector

The Trust Structure Concept

- **Key attributes**
  - ✓ A financing and contractual structure, which is ring-fenced and insured against political manipulation and at least partially guaranteed against default.
  - ✓ A combination of tariff and public sector financing sources including as appropriate, transfers, local taxes, donor institution grants and loans, output based aid and other possible sources.
  - ✓ High participation from the private sector in the provision of services to design, build, operate, maintain, rehabilitate, and arrange financing for the facilities.
- **Pros and Cons**
  - \+ Local capital markets stimulation.
  - \+ Potentially greater local currency financing.
  - \+ Potential to convert the Trust into an equity investment vehicle.
  - − Establishment of Trust structure can involve high transaction cost.
  - ~ *Concept is mostly applicable in middle-income countries.*

Concluding Remarks

Issues in the Water Sector (1)

- It is advisable that the project company undertakes to arrange the insurance even if there are separate operator and contractors as the policies are often intertwined like the delay in start up and all risks.
- The quantum of insurance covering physical damage: not all the components of the works are vulnerable, e.g. pipes underground are very unlikely to be damaged by fire, and even war, and even if they are damaged it is likely to be a small percentage of the overall line.

Issues in the Water Sector (2)

- If the project is vulnerable to bulk supply from a third party the contingent customer extension policy (also sometimes referred to as contingent business interruption) should be worded to cover interrupted supply and potential penalties.
- The political risk insurance is important and every effort should be made to include the formula for price adjustments and regular reviews in the contract with government and to ensure that it is covered by the political risk insurance.

Issues in the Water Sector (3)

- Address affordability and costs with selected caps and collars on premiums
- Quality of data
- What happens if risk becomes “uninsurable” ?
- Lack of understanding of the sector impacting on insurance availibility market

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Market Responsiveness—Some Key Issues

Contractual/Regulatory Instruments

- Can underlying documentation be better standardized?
- What efforts are necessary to better familiarize developers and lenders with these products?
- Can the products be designed into a WSS program from an earlier stage?
- What aspects of the cover are most desirable for investors/lenders?
- What will the market need to see in order to gain greater comfort with these products?

Foreign Exchange Instruments

- Is it possible to design a FOREX risk cover that fairly allocates risk to respective parties (investor, government, IFI)?
- Can this be done without undue burden on the project financing?
- How can Credit Risk Instruments be expanded to cover more local currency financing?

All Instruments

How can the instruments be tailored to support:

- Management contracts?
- Lease agreements?
- Government investment commitments?
- Hybrid PPPs?
- Sub-sovereign borrowings?

Closing Thoughts

- Private sector insurers are unlikely to enter the emerging markets and the WSS sector, until products and coverages, particularly for contractual/regulatory and forex instruments, are better defined and tested.
- IFIs have the ability to help shape and develop projects to the point where guarantees can make a difference in private sector participation.
- IFIs have the leverage to enforce guarantees and serve as honest brokers between government and the private sector.
- But guarantees alone won't solve the WSS financing need
    - They are part of the solution to bringing private capital, management and know-how to the sector
    - Considerable effort is still needed at the water sector level to bring projects to the point of potential private sector interest

Conclusion

- There are many risk mitigation facilities available, some tied to origin and some untied, that cover both commercial risk and political risk to varying degrees
- There is a need to create more awareness of these facilities among private sector investors and potential investors inthe water sector

'You are now insured against fire, flood, theft liability, sickness, accident, death and any attempts on my part to sell you any more insurance.'

Thank you