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Financing more Water projects by mitigating currency risk

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Good morning, ladies and gentlemen,

I have just come from Stavanger in Norway where an International Water Conference found that we were not going fast enough to meet the Millennium Development Goals. It even said that no major advance has been seen in the field. More projects are necessary, which means more finance is needed.

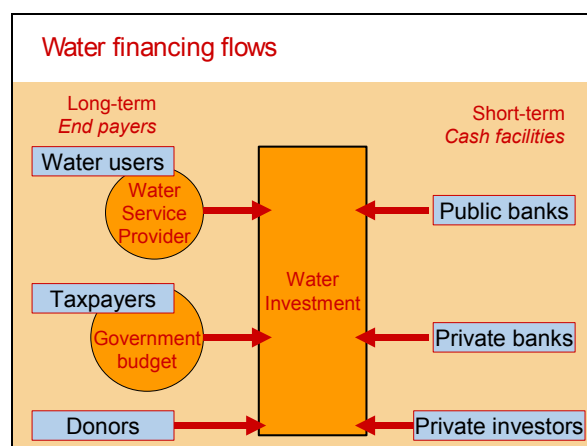


Figure 1. Types of financing flows

In many cases new water investments – if they are important - require additional borrowings. However, banks and investors only bring cash if they think that they will be reimbursed. Their long-term confidence in the success of the project is key. If their level of confidence is not high enough, projects simply do not move.

Temporary cash facilities
are only obtainable if
long-term confidence is created

To address this issue, the Financing Water for All report makes many recommendations about water governance. It also makes recommendations about how to allocate and manage project risks better. Why ? Because, one way to raise more cash to finance more water investments is to manage risk better, in particular currency risk.

Let me explain the impacts of currency risk.

In many countries – to-day – long term loans are not available in local currency so that the local Water Service Provider [WSP] has no other choice than to borrow foreign money. If not, it cannot invest and water services cannot be satisfactory.

The WSP's revenues are in local currency but it has to reimburse foreign currency debts. If the rate of exchange is stable, there is no problem. In case of depreciation, it may become difficult, or when there is a brutal devaluation even unmanageable. The currency risk affects public operators as well as private ones – I remember that SABESP, the publicly controlled operator of San Paulo (Brazil), had huge currency losses in 2002 totaling 33% of its turnover.

Managing the currency risk has recently appeared as fundamental to allow future investments to proceed.

Let us take the example of a typical water project decided by a local government and implemented by its Water Service Provider, either public or private. The new investment is temporarily financed by foreign currencies (loans from public or private banks).

The project will only work properly if the necessary economic balance between revenues and expenses can be maintained for the whole life of the project.

It is easy to maintain this balance when there is a gradual currency depreciation. However, if a brutal devaluation occurs, the project is thrown into complete disarray. Let us consider those two cases then potential solutions.

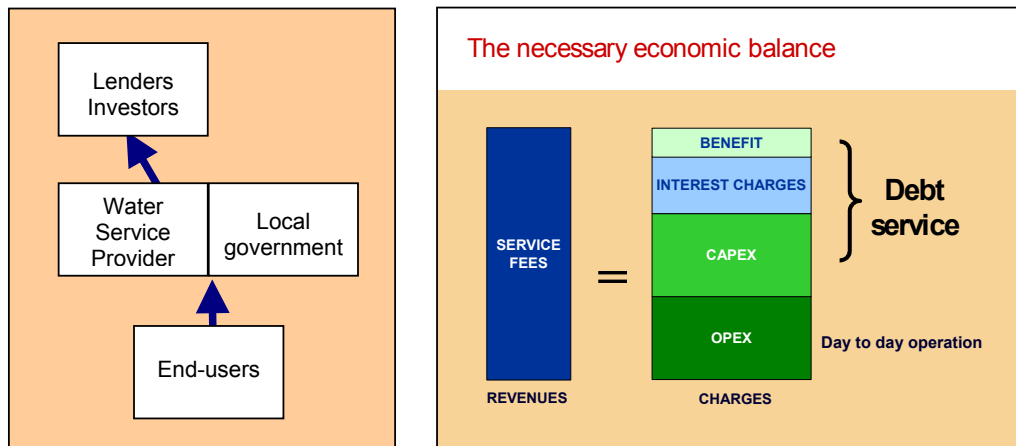


Figure 2. Project economic sustainability

1. Mitigating slow currency depreciation

When the currency depreciation is slow, the debt increase is gradual.

Gradual tariff increases allow the economic sustainability of the project to be maintained and are affordable to the population. The balance sheet and the cash flows of the Water Service Provider are gradually modified. The economic balance can be maintained by adjusting the water tariffs according to local inflation.

The tariff increases may be decided by the local government. The debt service is “affordable” to the WSP. The situation is manageable.

2. Impact of a brutal devaluation

In case of a brutal devaluation, the situation is completely different. The debt service immediately explodes.

For example, if the local currency is depreciated by 50%, the debt service is immediately multiplied by 2. If the local currency loses 2/3 of its previous value- you know that it has happened- the debt service is multiplied by 3 !

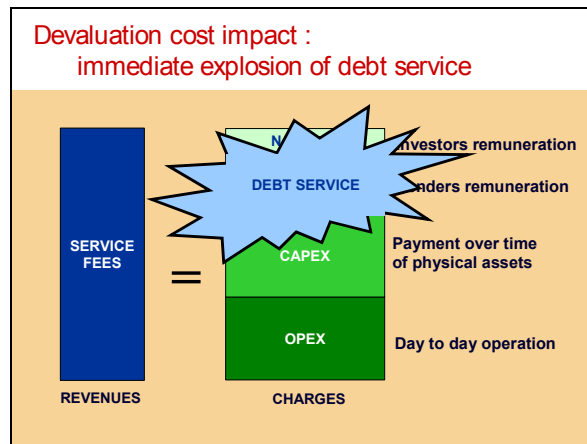


Figure 3. Brutal devaluation

As a result, the WSP's balance sheet is immediately destroyed. Furthermore, the WSP is unable to maintain debt service and default appears. The project survival and the continuity of the water delivery are at risk. Urgent action is needed to salvage the project.

However, experience shows that the government may not solve this issue immediately. The brutal devaluation may have social and political impacts which makes it very difficult to implement any significant tariff increase quickly.

2 actual examples : Manila (The Philippines) and Buenos Aires (Argentina) (see box 1).

<u>Manila</u>	<u>Buenos Aires</u>
The burden of the debt of the former public WSP had been transferred to the new WSP (90% to West Zone) with specific contractual compensation provision when devaluation occurred. Rate increases were only decided several years later.	The huge Capex program (> 1.6 bn\$) has been financed with operational cash-flows and foreign borrowings. Devaluation occurred early 2002. No rate increase has yet been decided although the concession contract provides for compensation and debt is not fully served.

Box 1 : actual cases.

Even with clear contractual provisions for compensation, the government may be unable to comply with its obligations because it cannot immediately increase water tariffs. Such a situation is more visible when there is a private WSP but public WSPs face exactly the same issues. For example, to-day in Argentina many public WSPs are indebted in US dollars and cannot service their debts. They are in default and have been compelled to restrain investments.

So, there is a paradox : on one hand, time is necessary for the government to mitigate political and social constraints, on the other hand, maintaining the debt service and the project economics requires quick action. There is no obviously available solution to this time issue.

Solving this paradox requires innovative tools. This is why the “Camdessus panel” seriously considered potential devaluations and its “Financing Water for All” [FWA] report makes recommendations to mitigate the currency risk.

3. The “Financing Water for All” proposals

The Panel explored various ways. Obviously, the preferred one is to avoid any kind of currency risk by funding the project with local currency. The FWA report makes several recommendations to develop access to local currency financing. However, the Panel understood that local currency will not be available everywhere. In many places, there is no other choice than to borrow foreign currency. The Panel made a specific recommendation to address this situation.

3.1 Develop local currency financing

Water projects involve long-term assets and deliver a product with a low value perception. They require local currency financing with two characteristics :

- *long-term maturities* (typically 15 years). Unfortunately, they are unavailable in many countries.
- *low cost* , which requires adequate guarantees or securities.

What could the mission for Multilateral Development Banks be ? They can help water services in two ways :

- making local currency funds available:
(between brackets the references of related FWA recommendations)
 - issuing local bonds (C51)
 - providing guarantees or securities to local loans (C51)
 - using aid (ODA funds) as catalyst to mobilize local flows (C50,C57)
 - promoting local capital markets (C23,C51,C65)
 - encouraging ratings of sub-sovereign bodies (C24,C59)

- providing them with appropriate qualities:
 - *maturity* via maturity enhancement schemes (C29). This is a very promising way : in a country where 6-years loans are available, enhancing their maturities to 15 years, as proposed by some international institutions, would allow water projects to be financed.
 - *cost* via guarantees to lenders (C61,C29)

3.2 A facility allowing foreign currency borrowings

If there is no other choice than foreign borrowings, the government has to consider a potential depreciation from the very start. It must recognize that in the case of a brutal devaluation it will not be able to make the appropriate decisions in due time.

The “Financing Water for All” report suggests that a third party intervenes to soften the immediate impact of devaluation. The recommendation is detailed in annex 1 to the FWA report. It calls for a Devaluation Liquidity Backstopping Facility.

This Facility would be made available by a third party to assume the additional debt service for the period needed to gradually transfer it to end-users. How would that work ?

An International AAA guarantor- it may be a multilateral development bank – takes on board the additional debt service by servicing the lenders for the part which is not affordable by the WSP. The guarantor issues new long-term loans to the government. Loan maturity allows gradual tariff increases to reimburse the third party through the government.

It is not an insurance framework, it really is a financial tool.

Example. In a theoretical case where water rates use to follow 100% local inflation and a brutal devaluation by 2 (50% depreciation) occurs in year 6, a financial simulation shows that with third party loans of 18 years (3 years grace + 15 years / 7%), the user payments annual increases due to compensation surcharge are limited to 0.8%. See figures 4 & 5.

Such a tool is necessary and legitimate.

It is necessary because water delivery is essential to life and to the local economy. Its disruption can worsen local crisis. It is also necessary because project sponsors and lenders will no longer take devaluation risks if not protected.

It is legitimate because the project (government + WSP) cannot avoid devaluation. The WSP has no means to mitigate devaluation. Only government can make the necessary decisions. A complete solution requires several years but immediate action is needed.

More water projects are necessary. If we are serious about the Millennium Development Goals, we must be serious about mitigating currency risk !

Thank you.

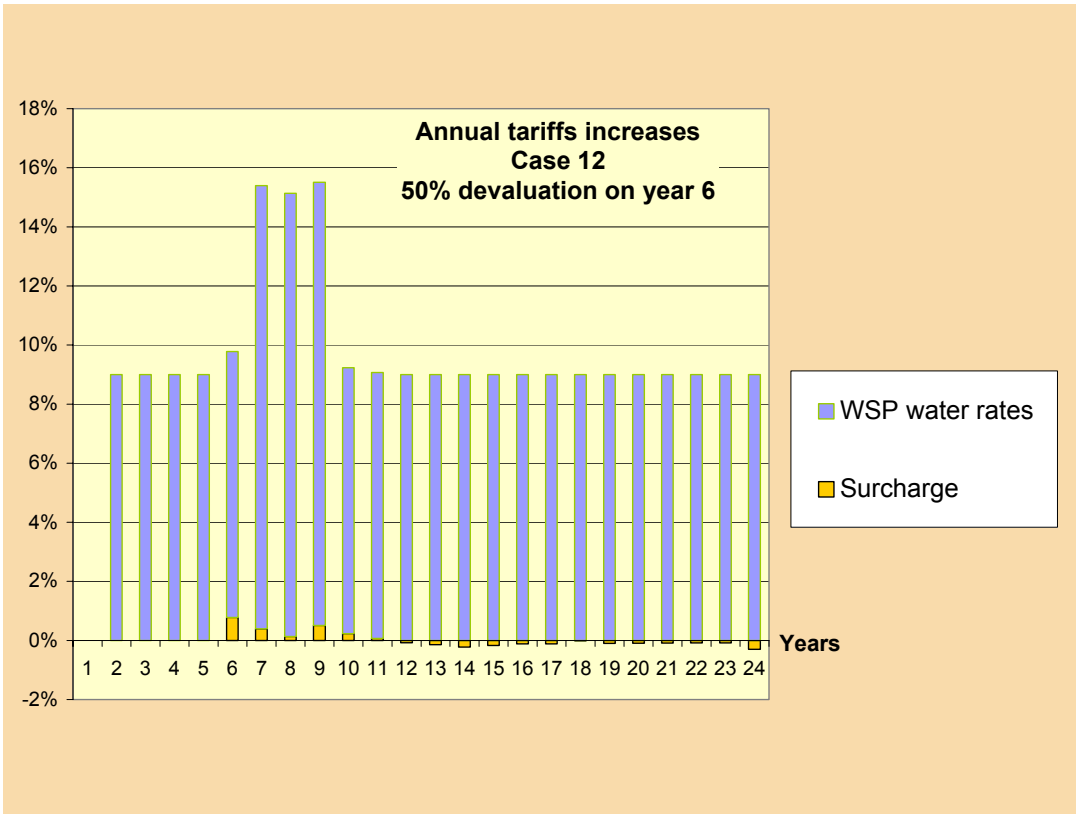


Figure 4

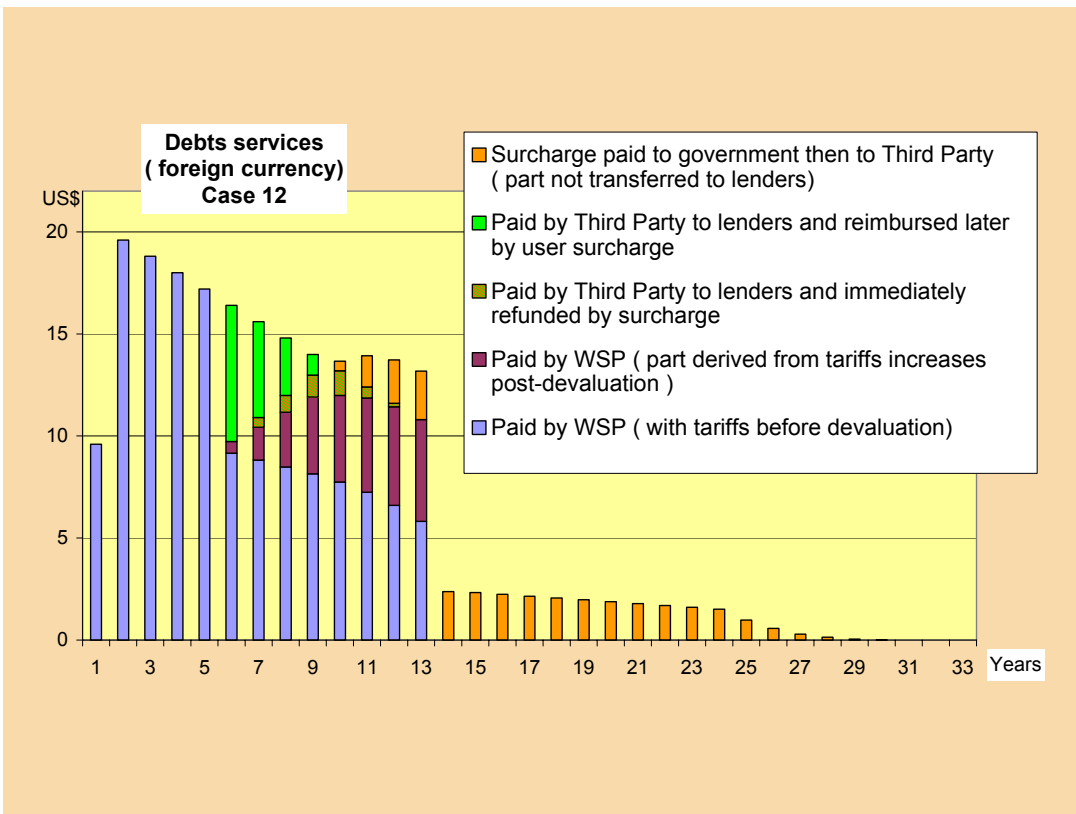


Figure 5