

ADB - DMC Sanitation Dialogue Manila

Knowledge Sharing - Finance

04 March, 2009



Overview

Considerations in Financing of Projects

Rating Methodology for Credit-worthiness

ADB Financial Instruments

Key Messages



Considerations in Financing of Projects

ADB

Economic and Financial Challenges

- Absence of knowledge of the economic costs & benefits to the country
- Service provider unable to sustainably meet the O&M costs
- Absence of utility creditworthiness and bankable projects
 - low interest of financing institutions and private sector
- Consumers unwilling to pay for poor services

Business as Usual

PROJECTS

Project
Identification

FUNDING

CAPEX

Municipal
Funds

National
/ State
Funds

Multi-lateral
agencies

Pension,
Housing
Funds

Govt. guarantees

OPEX

Budgetary Allocation

**MEETING
CAPEX & OPEX**

Not fully
provided

**Unsustainable model
Wasted asset investment
Repeated drain on Public Funds**



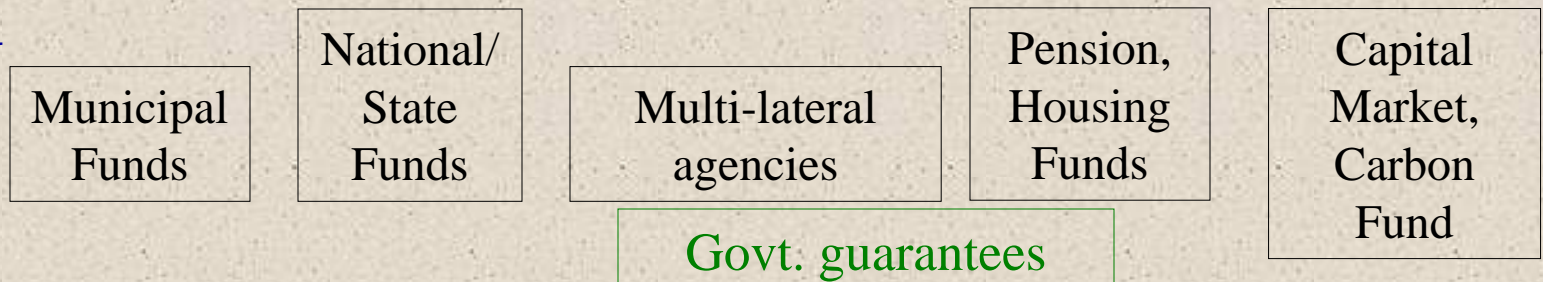
Business Unusual - Financing of Projects

PROJECTS



FUNDING

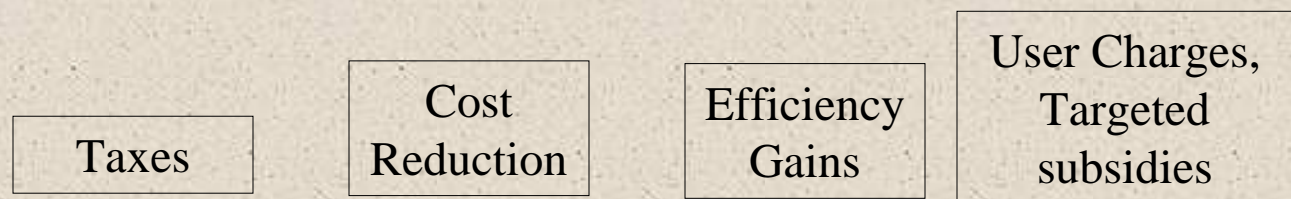
CAPEX



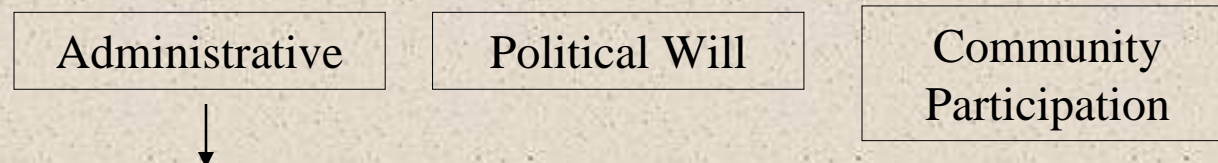
OPEX



MEETING CAPEX & OPEX



REFORMS



Policies, Accounting Practices, Asset Inventory, Capacity Building,



Sanitation Business Plan

Cost Centers

- **Capital Expenses**
(Grants, Loans, Equity, Carbon Funds)
- **Operating Expenses**
(direct O&M, support services, taxes, financing charges, depreciation and write-offs)



Revenue Centers

Income:

- Taxes
- User Charges
- Targeted subsidies
- Carbon credits

Savings from:

- Cost Reduction
- Performance efficiency savings



Business Plan for Sustainable Utility

Regulatory Requirement

- Economic regulation must require that a utility be sustainable and hence entitled to:
 - Recover its operating costs
(minimum O&M if grant for capex, else full cost including capex)
 - Achieve a return on its investment in the infrastructure
 - can be ploughed back
 - Return sufficient funds to be able to replace its infrastructure as it reaches the end of its useful life
 - depreciation of assets
 - Return sufficient funds to be able to pay its taxes

Cash Flow Analysis

- Appropriate periods (short and longer term)
- Clearly stated assumptions
- Improvements incorporated
 - e.g. cost reduction, efficiency gains, wider coverage, higher collection performance, greater productivity etc.
- Risks and sensitivity testing
- Financial indicators: assess ability to service O&M, reserves, interest, principal etc.
- Financial instruments for possible improvements by matching cash flows (income, revenues) with liability



Different Financial Frameworks...1

- Project Development Fund (PDF)
 - Can be recovered with returns in successful projects
- Viability Gap Fund (VGF)
 - Enhancing viability to make it financially attractive
 - Usually upfront grant
- Operational/Transition Support Fund (OSF)
 - Limited initial period cash flow issue
 - Debt to project in O&M

Different Financial Frameworks...2

- Other measures
 - Credit Enhancement
 - Risk Guarantee Mechanisms
- Define ground rules for accessing financial support

**Each serves different
purpose in project life cycle**



Rating Agency Perspective

Moody's Methodology...1

Ratings: for creditworthiness, broadly

- Investment grade: **Aaa, Aa and A**: Strongest, very strong and above-average; **Baa**: average;
- Non-investment grade: **Ba**: below average; **B**: weak; **Caa**: very weak; **Ca**: extremely weak; **C**: weakest

Five Factors

1. Market Position
2. Governance and Management
3. Financial Position and Performance
4. Debt and Capital Plan
5. Covenants and Legal Framework



Moody's Methodology...2

1. Market Position

- Scope of Operations: assets use vis-à-vis user distribution, development stage (ramp up, fully established)
- Competition: from similar providers and alternatives
- Service area characteristics: diverse and vibrant economy
- Demand levels: stability of demand and user base

Moody's Methodology...3

2. Governance and Management

- Governance: Board independence with sector expertise
- Regulation: Autonomous regulatory body
- Management:
 - Good capital and operating budgeting practices
 - Debt and investment management practices
 - Dealing with industry volatility
 - Ability to achieve favorable financial results
 - Responses to opportunities and challenges

Moody's Methodology...4

3. Financial Position and Performance

- Operating performance: revenue consistency and volatility vis-à-vis debt service safety margin (>10% for "A" rating)
- Debt Service Coverage Ratio (DSCR): ability to repay principal and interest from net operating revenues (at least >1.5 for "A" rating)
- Revenue Diversity: service area economy composition
- Budget flexibility: frequency of monitoring actual vs. budget performance, flexibility in changing user charge
- Financial reserves: leverage, net debt to net assets ratio, cash flows, DSCR, for "A" rating: (Days cash > 6 months, Low to moderate debt ratio 30-80%)



Moody's Methodology...5

4. Debt and Capital Plan

- Capital needs: current leverage and its impact on future debt repayment structure
- Capital planning and funding: management's track record for on time, within budget implementation

5. Covenants and Legal Framework

- Security pledge and flow of funds: revenue flow for funding O&M only (better rating) as against O&M + funding various reserves (lower rating)
- Rate covenant: covenant for rate increase if DSCR falls below 1.5, regardless of rating- at least 12 months debt service reserve, 6 months operating reserve



ADB Financial Instruments



ADB Financial Products

- Multi-tranche Financing Facility (MFF)
 - Series of loans and guarantees to finance large projects with discrete and sequential components over the medium to long-term in a specific sector
- Local Currency Loans
 - Loans in local currency where income stream of project in local currency
 - Aims to reduce mismatch between income and debt repayments
 - Offered to public and private sector entities
- Non-sovereign Public Sector Facility
 - Covers loans and guarantees
 - No central government guarantee required
 - Public sector clients (i.e. Government Ministries, agencies and departments, Government corporations, etc.)

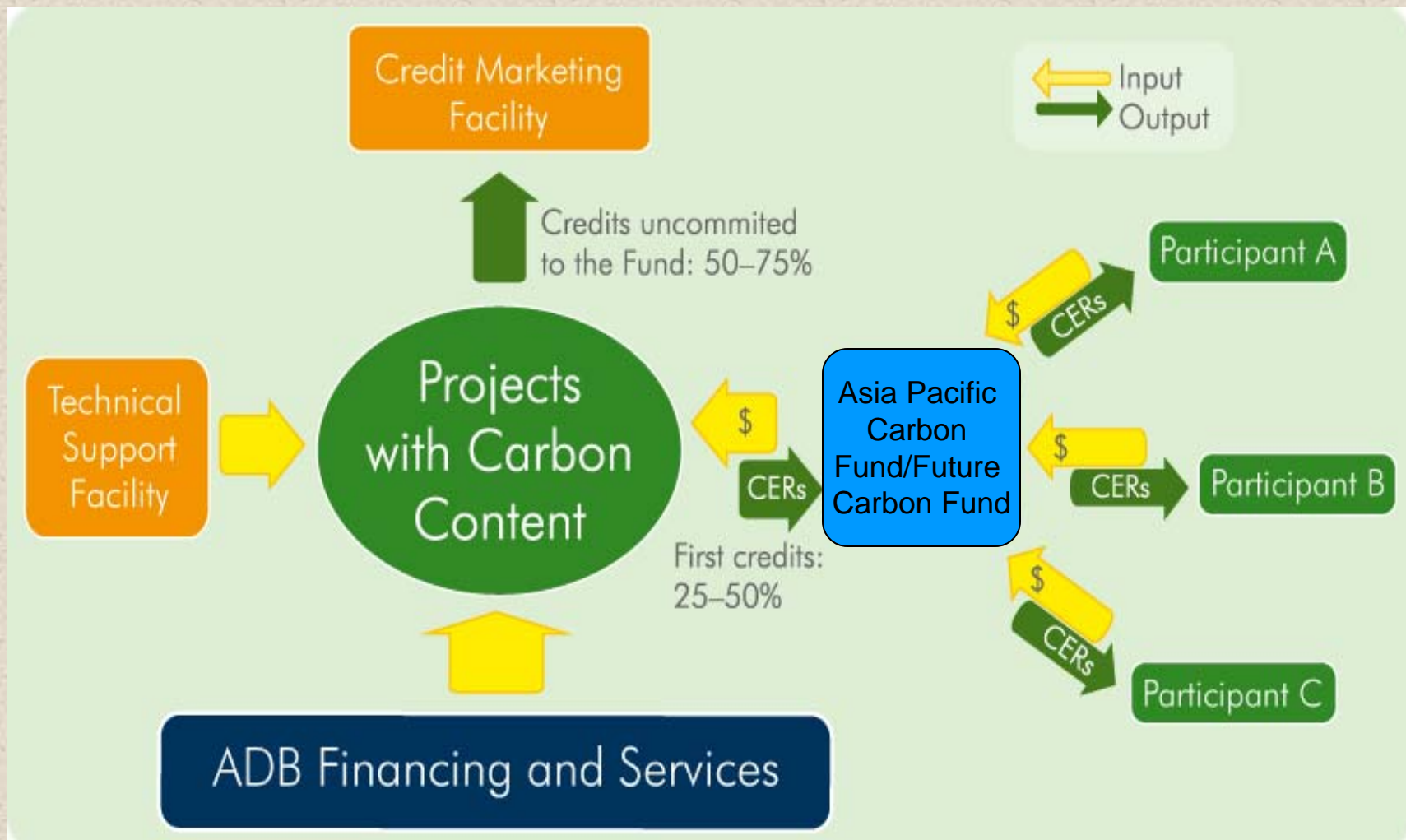


ADB Private Sector Financing

- Private Sector Operations Department
 - private sector projects with clear development impacts that has limited access to capital
 - focused primarily on capital markets and financial sector as well as infrastructure sector
 - Covers equity investments, loans, guarantees, and B loan (complementary financing scheme)
- ADB, through PSOD acts as:
 - An investment catalyst for the private sector
 - Helping to mitigate risks, facilitate regulatory regimes
 - Dialogue with Governments and provide technical expertise

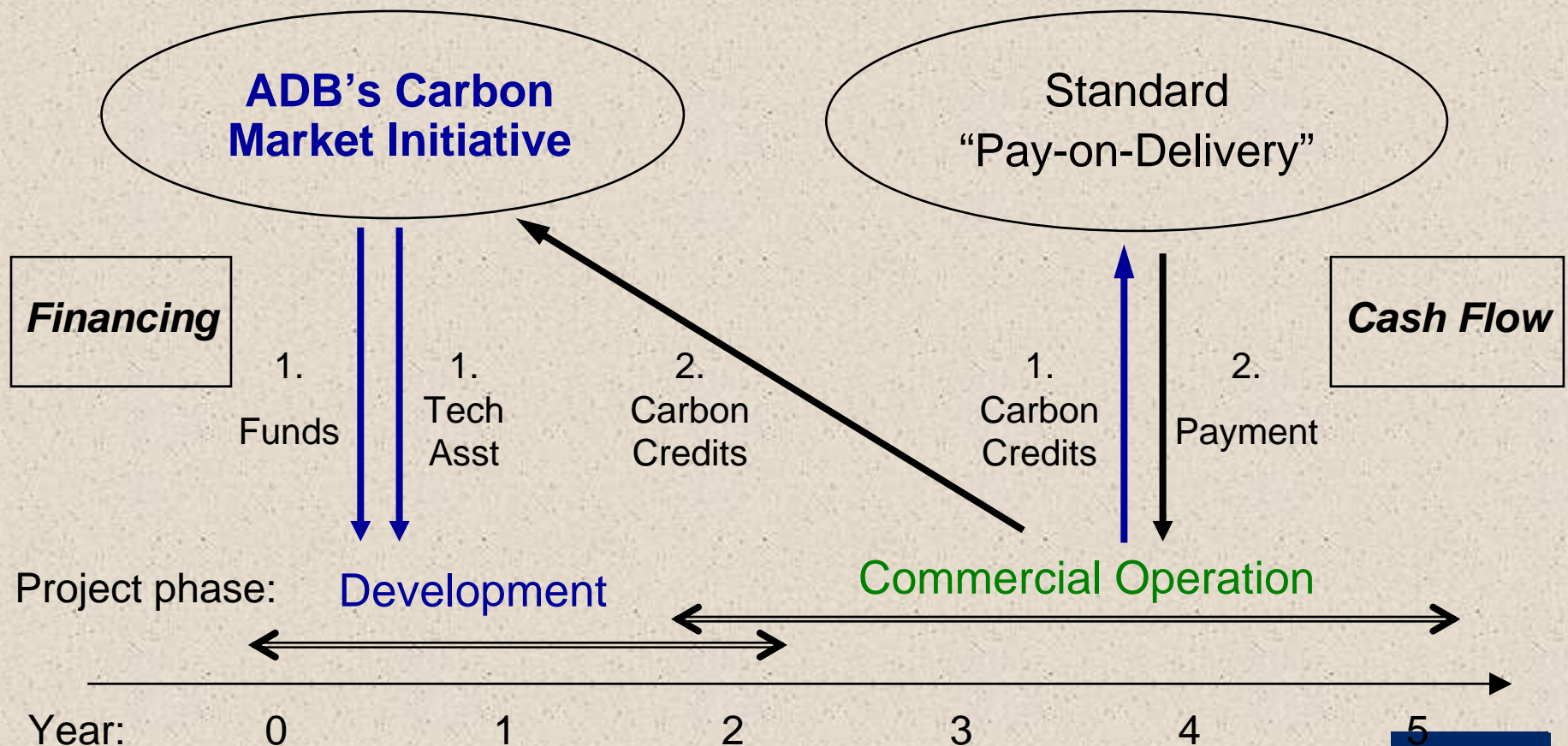


Maximizing Market Mechanisms (Carbon Market Initiative)



Carbon Market Initiative

Turning Cash Flow into Financing



Case Studies

Australia



Sewerage Utilities can be Viable

- Case of **City West Water** based in Melbourne Australia

| | |
|--------------------------|-------------------------------|
| ➤ Customers | 337,000 |
| ➤ Industrial | 10% |
| ➤ Asset (regulated) base | \$480 ml (replace 2.5 bil) |
| ➤ Operating costs | \$56 ml (incl TP full costs) |
| ➤ Depreciation (2%) | \$10 ml |
| ➤ Profit (before taxes) | \$30 ml - allowed 6.2% |
| ➤ Revenue permitted | \$96 ml |
| ➤ Process system – | Lagoon system |
| ➤ Average tariff | \$285 per property |
| ➤ Affordability | ave is 0.72% of family income |

- Public Utility pays income tax equivalent to State Government

Sewerage Utilities can be viable

- Case of **South West Water** based in Melbourne Australia
 - Customers 615,000
 - Industrial 8%
 - Asset (regulated) base \$1253 ml (replace 3.1 bil)
 - Operating costs \$102 ml (incl TP full costs)
 - Depreciation (2%) \$25 mil
 - Profit (before taxes) \$75 mil - allowed 6.2%
 - Revenue permitted \$227 mil
 - Process system – Activated Sludge Plant
 - Average tariff \$369 per property
 - Affordability ave is 1% of family income
- No cross subsidies between water and sanitation, nor within the sanitation customer classes. Public Utility obliged to pay income tax equivalent to State Government.



Lessons

- Economic regulation requires that a utility be sustainable
- Operating costs can be readily assessed
- Likely revenues more difficult to judge
- Revenue Risks high if
 - Inconsistent regulation, User affordability, Effectiveness in collection performance
- Much depends upon assumptions about income stream from user charges and/or government support

Operations Funding the real issue to create bankable projects



Key Messages

Key Messages

- Financing is not a constraint - there are a variety of sources
- Operations funding is the real issue – it has to be provided
 - can operating costs be covered? Else think of Operations Support Fund, or govt. should provide balance grant funding.
- Utilities (public or private) providing sanitation services can be financially viable
- Private Sector is prepared to get involved if risks are manageable



Thank You

For further information contact:

Anand Chiplunkar at achiplunkar@adb.org

